Retirement Assets: What's Mine and What's Uncle Sam's?

Scott M. Weinbaum, Esq.
Maddox & Gerock, PC
sweinbaum@maddoxandgerock.com

We all know the importance of planning for retirement. We scrimp. We save. We cut back. Then, when it is time to retire, when we are finally ready to reap the rewards of all of the planning and contributions that we have made throughout the course of our working lives, that money is all ours, right? Not so fast; Uncle Sam has other plans.

As you might imagine, retirement money is taxable. Retirement money may be taxed up front (*i.e.*, a Roth contribution) or upon distribution, but regardless, retirement assets will be taxed. You might not be aware that so-called "premature" distributions are subject to a hefty penalty. Whether from a retirement annuity[1], a qualified plan[2], a modified endowment contract[3] or even an Individual Retirement Account (IRA)[4], withdrawals from retirement assets prior to age 59 ½ are taxable at an additional 10% penalty.

Under the Internal Revenue Code, "the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income"[5]. To avoid getting wrapped up in the Internal Revenue Service's overly technical language, here's a (relatively) simple demonstrative example:

> John is single and 50 years old. John earned $100,000 in wages in 2018. John has no other investment income, capital gains, *etc*. However, John took a $50,000 withdrawal from his 401(k). For simplicity's sake, all $50,000 is includable in his gross income. Therefore, John's gross income is $150,000 for 2018. This level of income should place John in the 24% tax bracket (as he will be filing separately) for 2018. Under normal circumstances, John would owe $36,000 in taxes (24% of $150,000). However, due to John's "premature" withdrawal from his qualified retirement plan, John's taxes attributable to the $50,000 will be increased by 10% in 2018. This complicates his tax filing and decreases the net funds John will have in his pocket.

It is at this point that the author feels compelled to inform his readers that he is not a tax attorney, nor a tax professional. This article is intended to provide an educated layperson's overview of the 10% penalty as well as ways in which those seeking to withdraw retirement funds can get around this rule, including when transferring retirement funds upon divorce. Thankfully, although this 10% penalty is the rule, there are a number of exceptions which allow us to retain just a bit more of our hard-earned retirement money. Although the penalties on premature withdrawals from retirement annuities and modified endowment contracts are also subject to a number of exceptions, the remainder of this piece will focus on withdrawals from "qualified" plans as well as IRAs. As a side note, qualified plans under the Employee Retirement Income Security Act (ERISA) are those described in 26 U.S.C. §401(a) and are retirement assets received as the exclusive benefit of employment. They may include 401(k)s, stock bonus plans, profit-sharing plans, pensions, *etc*.

There are a number of itemized exceptions listed in Section 72(t) of the Internal Revenue Code where this 10% penalty does not apply. For example, there is no 10% penalty if the withdrawal is made after the asset holder attains the age of 59 ½ as this would not be considered to be a premature withdrawal.[6] The penalty also does not apply if the withdrawal is made after the death of the asset holder.[7] Further, the 10% penalty does not apply if the distribution is incident to the asset holder becoming disabled (as defined under

26 U.S.C. §72(m)(7))[8] or to withdrawals which are periodic payments (made at least annually) made for the life or life expectancy of the holder and/or the joint lives of the holder and his/her beneficiary[9]. In addition, the 10% penalty does not apply to withdrawals under certain specific plans, annuities, contracts and trusts under the Code[10] nor in other specific instances described in U.S.C. §72, part of the Internal Revenue Code.

Similarly, exempted withdrawals from such plans may be made in furtherance of the purchase of a first home (in an amount up to $10,000)[11], to pay medical expenses (in an amount not to exceed 10% of one's adjusted gross income)[12], to pay for certain "qualified" post-secondary education expenses[13], to those individuals called to active duty (though those withdrawals must be repaid)[14], and to those separating from their service (employment) after attaining the age of 55[15].

In the context of family law, however, the most relevant of these remaining exceptions, for qualified plans, are "[p]ayments to alternate payees pursuant to qualified domestic relations orders. Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of [26 U.S.C. §414(p)(1)])"[16]. In other words, transfers from a 401(k) or other qualified plan (as described above), pursuant to divorce, are exempt from the 10% penalty rule. Further, thankfully, these transfers are not even considered to be taxable events and no taxes must be paid when such a transfer is made[17].

Curiously, it appears from the Internal Revenue Code that there is a specific limitation on the above exception: it does not apply to transfers from IRAs[18]. Does this mean then that IRA transfers pursuant to divorce are subject to this harsh penalty? Are we to lose a substantial amount of money in each post-separation IRA transaction? Thankfully, the answer is no.

According to the Internal Revenue Code:

> The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2) is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest at the time of the transfer is to be treated as an individual retirement account of such spouse, and not of such individual. Thereafter such account or annuity for purposes of this subtitle is to be treated as maintained for the benefit of such spouse.[19]

Broken down again for those of us who are not fluent in the Internal Revenue Code's complex language, this provision states that, pursuant to divorce, a transfer of funds from an IRA to another retirement savings vehicle is not taxed. Once the transfer is completed, the funds are treated as an IRA for the recipient spouse, for the benefit of the recipient spouse. Why then, is there a limitation on the exception cited above? The reason is that transfers from an IRA, unlike transfers from a 401(k) or other "qualified" plan under ERISA, are not subject to the requirement that such transfer be pursuant to a Qualified Domestic Relations Order, Qualified Court Order (used for the division of military retirement), Retirement Benefits Court Order (used for the division of government Thrift Savings Plans), or other similar court order.

In fact, in the case of IRAs, most companies will accept a signed letter from both parties confirming the transfer (along with copies of the Final Order of Divorce, Marital Settlement Agreement and any other related documents or orders). Some companies, such as Fidelity and John Hancock, even have forms they allow parties to fill out in order to effectuate the transfer without the need for any further formalities.

Be careful though; just because the transfer from one spouse to the other is tax and penalty free does *not* mean that you can withdraw those funds free and clear. Here, it is important to note that there is a difference between a transfer and a withdrawal. A transfer is the transition of retirement funds from one retirement vehicle to another. A withdrawal is the cashing out of those funds. Unlike with transfers, withdrawing the funds, even upon divorce, *would* be subject to taxes and the 10% penalty. That is, of course, unless the withdrawal is subject to one of the exceptions discussed above (or those others listed in the Internal

Revenue Code).

What it boils down to is this: just because you have a certain balance in your retirement account does *not* mean all that money is yours. Not only are you on the hook for taxes (unless you paid those up front), but unless you fall within a specifically itemized exception, you will pay a significant penalty if you decide to withdraw any of those funds prior to turning 59 ½. Although all funds will be maintained and will not be taxed upon a transfer to a spouse or former spouse pursuant to divorce, that does not mean that either party can withdraw the funds penalty-free. If you do need (or want) to withdraw from your retirement assets, be sure to discuss the potential impact with a tax professional and financial planner. We would not want you to give Uncle Sam any more money than you have to. ❖

Endnotes

1. 26 U.S.C. §72(q)
2. 26 U.S.C. §72(t)
3. 26 U.S.C. §72(v)
4. T.C. Memo 2017- 125 (https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11306). This Tax Court ruling confirms that the 10% penalty also applies to IRAs although not necessarily specifically articulated under the Internal Revenue Code. This Memo holds that the penalty imposed upon qualified plans also applies to non-qualified plans.
5. 26 U.S.C. §72(q)(1)
6. 26 U.S.C. §72(q)(2)(A)(i)
7. 26 U.S.C. §72(q)(2)(A)(ii)
8. 26 U.S.C. §72(q)(2)(A)(iii)
9. 26 U.S.C. §72(q)(2)(A)(iv)
10. 26 U.S.C. §72(q)(2)(A)(viii)
11. 26 U.S.C. §72(t)(2)(F)
12. 26 U.S.C. §72(t)(2)(B)
13. 26 U.S.C. §72(t)(2)(E)
14. 26 U.S.C. §72(t)(2)(G)
15. 26 U.S.C. §72(t)(2)(A)(v). Please note, however, that this exception specifically *does not* apply to withdrawals from Individual Retirement Accounts. See 26 U.S.C. §72(t)(3)(A).
16. 26 U.S.C. §72(t)(2)(C)
17. 26 U.S.C. §1041(a)(2)
18. 26 U.S.C. §72(t)(3)(A)
19. 26 U.S.C. §408(d)(6)