Options for Withdrawing Money from a Defined Contribution Plan under a Qualified Domestic Relations Order (QDRO)

Distributions from a Defined Contribution Plan before a participant reaches the age of 59 1/2 years of age normally are considered “early distributions” by the Internal Revenue Service. In addition to ordinary income taxes, early distributions are subject to a 10% penalty on the amount withdrawn.

I.R.S. tax regulation (72)(t)(2)C provides that when money is withdrawn in accordance with a QDRO, the recipient can take the distribution without penalty. However, there are various factors to consider if making this choice. Consider the following scenario.

Sarah, age 55, receives one half of her former husband’s 401(k) in the settlement of her divorce pursuant to a QDRO in the amount of $320,000. As a result, she decides to pay her attorney’s fees and make a down payment on a condo for a total cost of $80,000.

Sarah has several options at this juncture:

- Directly transfer the entire distribution into a separate Individual Retirement Account (IRA) in her name (Trustee to Trustee Transfer). *She would not incur a 10% penalty, nor would she have to pay income taxes.* However once the money is transferred into her IRA, which is not a qualified plan, if she withdraws any amount prior to age 59 ½ she will have to pay the 10% penalty *and* the income tax due on the distribution.

- Receive 100% of the funds directly, then roll all or a portion of the funds over into an IRA within the allowed time period (60 days). Although *Sarah would not incur a 10% penalty, she would still be subject to the mandatory 20% income tax withholding.* Should she wish to roll 100% of the total distribution into an IRA and defer tax on the entire taxable portion she would have to add funds from another source equal to the 20% that was automatically withheld.

- Keep all of the funds. *Sarah would be subject to a 20% mandatory income tax withholding, and at tax time, she would reconcile this withholding with her actual income tax liability on the whole distribution. She still would not be subjected to the 10% early distribution penalty.*

- Elect to receive enough of the funds to cover bills, expenditures and the resulting income taxes. *Because the IRS will require a 20% withholding by the Payor on the distribution to Sarah, she would likely have to request a withdrawal of $100,000 and directly transfer the remaining $220,000 into an IRA. In this case, Sarah would avoid the 10% penalty and pay income taxes only on the amount received (i.e. $100,000).*

We believe it is important for individuals who are divorcing to understand the differences between and the effects of direct (trustee to trustee) transfers and eligible rollovers, as well as the penalty provisions for early distributions under the Internal Revenue Code when a QDRO is contemplated. The examples above demonstrate the grossly different consequences of a chosen planning technique and the need to obtain appropriate financial advice in divorce proceedings involving the division of a qualified retirement plan.