

Spending Money from a Defined Contribution Plan without the 10% penalty

Normally, distributions made before the participant attains age 59½ are called “early distributions,” and are subject to a 10% penalty tax. The tax does not apply to early distributions upon death, disability, annuity payments for the life expectancy of the individual, or distributions made to an ex-spouse by a qualified domestic relations order (QDRO).

IRC (72)(t)(2)(C) states that when you take money out of a qualified plan in accordance with a written divorce instrument (a QDRO), the recipient can spend any or all of it without paying the 10% penalty. This exception to the penalty does not apply to other retirement savings accounts, such as IRAs or SEPs.

Let’s take a look at what happens when the ex-spouse receives the 401(k) asset. There are some specific rules to be aware of. Here’s an example:

Sarah was married to an airline pilot who was nearing retirement. They were both age 55. There was \$640,000 in his 401(k) and the retirement plan was prepared to transfer \$320,000 to her IRA. She could roll the money over to an IRA and pay no taxes on this amount until she withdraws funds from the account. However, Sarah’s attorney’s fees were \$60,000 and she needed another \$20,000 to fix her roof. She said, “I need \$80,000.” Because the 401(k) withholds 20% to apply toward taxes on a withdrawal, Sarah asked for \$100,000. After the 20% withholding, she had \$80,000 in cash and \$220,000 which was rolled directly into her IRA. She was able to spend the \$80,000 without incurring a 10% penalty on the \$100,000, which saved her \$10,000 in penalties.

After the money from a pension plan goes into an IRA, which is not considered a qualified plan, Sarah is held to the early withdrawal rule. If she says, “Oh I forgot, I need another \$5,000 to buy a car,” it is too late. She will have to pay the 10% penalty and the taxes on that money.

It is important to understand the impact of *how* a rollover is executed from a qualified plan. The Unemployment Compensation Amendment Act (UCA), which took effect in January 1993, stated that any monies taken out of a qualified plan or tax-sheltered annuity would be subject to 20% withholding. This 20% withholding requirement does not apply to withdrawals from IRAs or SEPs, although the withdrawal is still fully taxable.

In other words, if the check is sent directly from the qualified plan to the IRA, the person would not be subject to the 20% withholding; however, if the funds are paid to

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the person first who then remits the money to an IRA, the withholding would apply. A payment to the person, whether or not the amount is then invested in an IRA, is subject to the 20% withholding. Only a direct transfer of funds avoids the withholding tax.

This is a great planning tool when clients have a need for cash and there is no other way to get it.

It has been said that divorce lawyers have the highest number of malpractice claims. One reason may be that while advising their clients on settlement issues, the lawyer may be giving improper financial advice. This is commonly due to the constant changes in tax law and perhaps the fact that the divorce lawyer's expertise is in the law, not in taxes.