IRS: FRIEND OR FOE

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CHAPTER 14
EDUCATION

M.A., University of Texas at Austin
B.A., University of North Texas

PROFESSIONAL ASSOCIATIONS & AFFILIATIONS

CPA, Texas State Board of Public Accountancy
Texas Society of Certified Public Accountants
Certified Divorce Financial Analyst, Institute for Divorce Financial Analysts
The International Academy of Collaborative Professionals
Collaborative Law Institute of Texas
Founding Member Collaborative Divorce Professionals Alliance
Senior Fellow Texas College of Collaborative Law

COLLABORATIVE LAW EXPERIENCE & TRAINING

University of Texas School of Law Collaborative Law Course 2010
Center for Public Policy Dispute Resolution Basic Mediation UT School of Law 2009
American Institute of CPA’s Guide to Marriage, Divorce and Family Taxation
University of Texas School of Law Collaborative Spring Retreat 2008
University of Texas School of Law Collaborative Spring Retreat 2007
IACP Summertime Harvest of Collaborative Skills
Collaborative Law Institute Interdisciplinary Collaborative Law Training 2006
University of Texas School of Law Collaborative Law Spring Retreat 2006
Collaborative Law Institute of Texas Basic Training in Collaborative Practice/
Institute for Divorce Financial Analysts Advanced Topics Workshop
Collaborative Law Institute of Texas Collaborative Law Spring Retreat 2005
State Bar of Texas Marriage Dissolution Institute
Institute for Divorce Financial Analysts Financial Issues of Divorce
Institute for Divorce Financial Analysts Tax Issues of Divorce
Institute for Divorce Financial Analysts Fundamentals of Divorce
Institute for Divorce Financial Analysts National Annual Conference
Institute for Divorce Financial Analysts Specialized Knowledge & Application

SEMINARS & ARTICLES

Author/Speaker: Collaborative Divorce Professionals Alliance Master Classes 2008-2009
Panelist Collaborative Law Institute of Texas Spring Conference
Article: Collaborative Review Winter 2006: Co-Author with John Anderson: Business Valuation Standards in the Collaborative Model
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Professional Experience:
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Collaborative Law Qualifications:
Basic Collaborative Law Training April, 2006
Interdisciplinary Training, June, 2006
Panelist, Collaborative Spring Conference, 2007
Panelist, State Bar of Texas Advanced Family Law Seminar, August, 2007

Expert Witness Qualifications:
Have given testimony in District and Federal Court on topics including:
   Business valuation
   Tracing of separate/community property
   Income tax matters
   Professional practice valuation
   Forensic accounting issues
   Damages

Professional Organizations:
American Institute of Certified Public Accountants
Texas Society of Certified Public Accountants
Collaborative Law Institute of Texas
International Academy of Collaborative Professionals
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IRS: FRIEND OR FOE

The question is, IRS: Friend or Foe? The answer is yes. Every issue related to tax law and divorce is fraught with potential for problems and also opportunities that can be used to your client’s advantage if structured properly. It is incumbent upon lawyers to be as informed as they can be regarding tax-related topics, and perhaps more importantly, to have at their disposal professionals who can answer questions and assist when the need arises. Recognizing when there is an issue that bears further investigation is paramount. The topics that invite lengthy examination are far too numerous to be covered in this paper. The authors have limited the scope of this discussion to two topics which come up regularly in discussions with attorneys: how best to deal with retirement assets and alimony. Our discussion does not answer every question that may arise regarding these two topics. However, it is hoped that we can shed some light on the subjects, and at the very least, prompt you to ask the right questions when dealing with divorce and taxes.

RETIRED PLANS

There are two types of retirement plans: qualified and non-qualified. Qualified plans are governed by ERISA (Employee Retirement Income Security Act). In this paper we will address issues related to qualified plans.

There are two types of qualified plans: defined contribution plans and defined benefit plans. Be certain that you understand the difference and clearly identify which type of plan or plans you are dealing with in each case.

A defined contribution plan’s benefits are based on money the participant (and sometimes the employer) has contributed to the account, plus earnings on those contributions. Statements show the dollar amount available to be divided. There is no problem identifying the value of the account. Defined contribution plans have a cash value today.

Defined benefit plans are based on an obligation of the employer to pay to the employee (or alternate payee) a specified monthly amount after retirement. The plan does not have a cash value today. Even if the statement received by the participant shows a lump-sum value of the account, that does not represent the true value, but rather tells how much could be taken out of the account if he/she left employment before retirement. The value is derived from the promise to make future payments, so it will change, based on factors such as age of the employee. Arriving at a value for marital estate division purposes requires an actuarial calculation. If a divorcing spouse has a defined benefit plan, it is essential to hire a competent actuary to value the plan.

Request a copy of the plan documents from the employee spouse’s Human Resources Department or the plan administrator early in the divorce process. Every plan is different. The written plan is the controlling document in each case. Often the plan administrator can help you understand the particulars of a specific retirement plan.

QDRO’S

In an effort to address concerns regarding qualified retirement plans in the divorce context, the federal government created Qualified Domestic Relations Orders, under which qualified plan benefits can go to someone else, known as the “alternate payee” which could be the soon-to-be former spouse or the children of the marriage.

All plans subject to ERISA may have assets segregated for the benefit of an alternate payee. This is accomplished with a court order known as a QDRO, or Qualified Domestic Relations Order. Many non-ERISA plans will also segregate assets in a plan pursuant to a QDRO.

A QDRO recognizes the right of an alternate payee to receive a portion of the benefits payable to the participant under a qualified plan and orders the plan administrator to take the actions necessary to divide the account. It identifies both the participant and the alternate payee and states either a fixed dollar amount or a percentage of the benefits which are to be paid to the alternate payee. The form of the QDRO must be approved by the plan administrator.

A plan administrator cannot split a defined benefit plan or defined contribution plan based on a divorce decree alone. A QDRO is required. This can be confusing because IRA’s are usually divided based on a certified copy of the divorce decree. A surprising number of attorneys submit a divorce decree in lieu of a QDRO, resulting in an unnecessarily long delay in processing the division of plan assets.

Discuss the QDRO with the plan administrator to be sure that you are drafting a QDRO which will be approved. Many plan administrators or HR representatives have model QDRO forms available for attorneys’ use. Some financial institutions also now have their own QDRO forms online, and they may charge much higher fees for processing QDRO’s that are not created online. Many, but not all, plan administrators will pre-approve the form of QDRO so that when the order is presented to the judge, you can be certain that the order will be accepted.

One reason some QDRO’s are not approved is the failure of the QDRO author to use the correct name of the plan. Refer to the plan document for the exact name or contact the employers’ benefits...
department for the full, correct plan name. Often statements from the investment firms holding the assets do not include the correct name of the plan. This is a common error according to third-party administrators.

There is some inconsistency among authors of QDRO’s as to exactly what language should be included in a QDRO. In addition, each third-party administrator may have his own ideas as to what must be contained in a QDRO for it to be approved. If the divorce decree states that a QDRO is anticipated, then as soon as the administrator is made aware of this, a hold can be placed on the account for up to 18 months in order to insure that the assets in the plan are not distributed prior to implementation of the QDRO.

QDRO’s are not required to be signed by the judge at the same time the divorce decree is signed, although it might be the best practice to tie up all loose ends in a case at the same time, while the issues are front and center for the clients and lawyers. If this does not happen, however, the QDRO may be signed at a later date, after it has been approved by the plan administrator.

There is a 30-day appeal period, during which the plan participant has the opportunity to disagree with the terms of the QDRO. This 30-day appeal period can be waived by the agreement of both parties.

The time frame for implementing a QDRO is often a sixty-day process, so be sure your client is aware that there will be some delay in receiving the distribution. The law allows a plan administrator to place a hold on an account for up to 18 months, no longer. Delays can result from the necessity for changes to the QDRO. It is important for the author of the QDRO to specify that the alternate payee is to receive all gains and losses on his/her part of the account from the date the order is signed until the funds are transferred. Some plan administrators will reject a QDRO that does not specify treatment of gains and losses. Others assume that if the QDRO is silent on this, then it does not apply. This could represent a substantial amount of money for the alternate payee if compliance takes 18 months.

**Be sure to specify treatment of gains and losses in the QDRO.**

**TAX TREATMENT OF DISTRIBUTIONS**

The transfer of one spouse’s interest in a retirement plan as part of the division of the marital estate is not a taxable event. However, the distribution from the plan (where all or part of an account is cashed out rather than being rolled over to another tax-deferred plan) IS taxable.

Participants in qualified plans must be provided with a direct rollover option so that assets can be transferred without triggering income tax. Any distribution which is not a direct rollover is subject to a mandatory 20% withholding for income tax at the time of the distribution. The 20% withholding is an estimate of tax that will be due and probably will not accurately reflect the total amount of tax due. The actual tax liability will depend on the payee’s total income and available deductions and credits. In the context of a distribution pursuant to the division of a marital estate, take into consideration that this 20% withholding will reduce the amount of funds available to the recipient of the distribution. The 20% withholding will be applied against income taxes payable by the party taking the distribution for the year in which the distribution was taken.

Refer your client to a qualified CPA for discussions about tax ramifications related to dividing or withdrawing funds from qualified plans.

**DISTRIBUTIONS PURSUANT TO 72(T)(2)(C)**

A very useful and little known section of the Internal Revenue Code (IRC Section 72(t)(2)(c)) allows the alternate payee to receive a distribution from a qualified plan, pursuant to a QDRO, without the 10% penalty which would otherwise be imposed if a distribution were taken before the alternate payee reaches the age of 59 ½. Income tax will still be owed by the alternate payee, at his/her regular tax rate, on the distribution, but the penalty can be avoided. This IRC section applies only to plans divided by a QDRO. It does not apply to IRA’s or other forms of retirement accounts. From a logistical standpoint, what actually happens is that an administrator-approved QDRO, signed by a judge, is sent to the plan administrator, who then sends to the alternate payee a distribution form. By completing the form, the newly named alternate payee instructs the administrator to roll the funds into another tax-deferred account in his/her name, or to distribute some or all of the funds. The QDRO simply allocates ownership of the funds in the plan. It is the distribution form that dictates what the administrator is to do with the funds. The administrator follows the instructions of the alternate payee.

Once funds are removed from the pension plan and transferred into an IRA, the alternate payee loses the opportunity to make a distribution which would qualify under Section 72(t)(2)(c). An IRA is not a qualified plan, therefore IRC Section 72(t) does not apply.

Plan administrators differ on the subject of when a requested distribution will be made. Some want the distribution to be immediate and to be made from the original owner spouse’s 401(k); others want segregate the amount due to the alternate payee into a separate 401(k) account, then make the distribution from the new account.

Ask the plan administrator what rules apply to a given plan. The plan is the controlling document.
Some attorneys do not include language in the QDRO stating that a distribution pursuant to the QDRO is anticipated. However, it seems advisable to reference the fact that the alternate payee may elect to receive a distribution, and also has the right to roll over all or part of the plan assets. Referencing the possible decision to take a distribution would serve to underscore the intention of the alternate payee to receive a distribution pursuant to 72(t)(2)(c). While tax consequences are not governed by the QDRO, and a QDRO is not binding on IRS, it still seems a good idea to make reference to this possibility.

When you know that your client intends to take a distribution, drafting the QDRO to include the instruction to do an immediate distribution can protect your client from an IRS challenge later.

INCOME TAX EXCEPTION TO PENALTY

Once the alternate payee has taken a distribution, he/she will receive a Form 1099R at the end of the year in which the distribution was made. The 1099R will reflect the distribution as taxable income to the alternate payee and will state the amount of income tax withheld. Most importantly, the 1099R will include a code which tells IRS whether the distribution may be subject to an early distribution penalty. Some plans will use a code on the 1099R which clearly indicates that there is not penalty. However, others may use a code that does not make this clear. Unless this issue is addressed in the alternate payee’s tax return, it may result in the imposition of the 10% penalty. It is critical that your client be made aware of this so that when he/she files a tax return, the tax return preparer knows to include a Form 5329, if necessary, in which the taxpayer tells the IRS why the distribution is not subject to the 10% penalty. Instructions for the 5329 specify a specific exception, “Qualified retirement plan distributions made to an alternate payee under a qualified domestic relations order” as being an exception to the penalty. IRS has no way of knowing that the distribution is not subject to the penalty unless it is indicated on this form or unless the plan administrator issued a 1099R with the correct code. This is a common problem with distributions to alternate payees. A client who is not made aware of this may very well face an unintended result at tax time.

Refer your client to a competent tax advisor.

IRA’S

As stated earlier, IRA’s are not qualified plans, and QDRO’s do not apply to them. There are no tax consequences of transferring an IRA from one owner to another as part of the division of the marital estate. An IRA can be transferred simply with a letter of instruction.

SEPP’S

If either party wishes to take a withdrawal from an IRA, the 10% penalty will apply unless the individual is 59 ½ or older. Again, there is an Internal Revenue Code Section which allows for withdrawals without imposition of the 10% penalty, if the withdrawals are made in substantially equal periodic payments. Distributions under this section are becoming more popular, as more taxpayers learn about the possibility. It carries with it the risk that, if an error is made in implementing the distribution, there is no way to undo it, and the taxpayer will face a 10% penalty on withdrawals made prior to age 59 1/2. If your client wishes to pursue this, he/she should be referred to a knowledgeable CPA or investment manager who can facilitate the implementation. SEPP’s must be for five years or until the individual reaches age 59 ½, whichever is longer. This is essentially annuitizing the IRA, based on life expectancy. Even though the early withdrawal penalty may be avoided with a SEPP, there could be investment-related penalties due to an early withdrawal.

The SEPP should be structured by an investment advisor or tax attorney who is conversant with the SEPP rules.

ALIMONY

There may be times in the collaborative process where contractual alimony may be of benefit to both parties. I want to emphasize that the parties’ tax preparer should be consulted prior to finalizing the Alimony provisions of the divorce decree. IRS Code Sections 62(a)(10), 71, and 215 deal with Alimony and, generally, the amount paid is deductible by the payor and taxable to the payee. The following are requirements for Alimony payments:

1. The payments must be pursuant to a written divorce or separation instrument, or a court order granting temporary alimony.
2. The payment must be in cash
3. The divorcing couple must not opt out of alimony treatment for federal income tax purposes. For example, absent a designation that cash payments are not deductible by the payor and includible by the payee, they will still be deductible by the payor and includible by the payee even if the state court calculated the alimony award assuming that the payments would be non-taxable.
4. The divorcing spouses cannot be members of the same household
5. Payments must stop on the death of the payee spouse
6. The payor and the payee cannot file joint returns
7. No portion of the Alimony payment can be considered child support
8. Alimony payments cannot be excessively front-end loaded. This requirement eliminates the possibility of disguising Alimony payments as a property settlement. There is not enough time to explain this provision and an income tax expert should be consulted prior to finalizing the details of contractual alimony in the divorce decree.

Notwithstanding some of the seemingly harsh requirements, Alimony can be financially beneficial to the divorcing spouses, particularly if one of them is in a higher income tax bracket.

RELEVANT TOPICS TOO NUMEROUS TO ADDRESS

There are numerous topics in which IRS may be either a friend or a foe. In fact, nearly every tax-related topic could fall under either category, depending on how it is addressed in the context of divorce. Here is a laundry list of important issues that should be taken into consideration whenever they exist in a given situation:

- Retroactive partition of income
- Carryover of tax attributes
- Suspended losses
- Allocation of basis
- Deductibility of legal fees
- Innocent spouse relief
- Change of address
- Interest-bearing notes
- Gain on sale of marital residence
- Dependency exemptions
- Joint & several liability
- Filing status
- Stock options

In the interest of avoiding tax surprises, always include a tax-savvy professional on your collaborative team.