powered by iContact

EMPYRION™ WEALTH MANAGEMENT

Who Gets Custody of the IRA?

January 29, 2019

Important Things to Remember about Divorce and Retirement Plans

The latest multibillion-dollar divorce, that of Amazon founder Jeff Bezos and his wife, MacKenzie, has been getting a lot of attention in the headlines lately. Speculation has run rampant on various topics, including what effect, if any, the split will have on Amazon.com, arguably the most dominant retailer in the world; the size of the settlement MacKenzie is likely to receive, especially since their marriage predates the founding of Amazon; and even the length of time needed for the divorce to be finalized, with some media sources suggesting it could all be over "as quickly as an Amazon delivery."

Most of us will never rise to the dizzying wealth levels of the mega-rich, but even for people with more modest means, divorce can pose some thorny financial problems in addition to the emotional wear and tear. Because the principal source of wealth for many of us is in our retirement plans — 401(k)s, IRAs, 403(b)s, and pension plans — knowing how these assets will be treated in a divorce is very important for both parties. It's also important for those of us advising clients who might be going through a divorce to ask the right questions and to listen carefully to the answers.

First, it is important to know whether or not you live in a community property state. There are nine of them: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. If you live in one of these states, your divorce will proceed under the principle of community property, which dictates that any property earned or acquired during the marriage is owned equally by both spouses. Assets excluded from community property include those owned by one or the other partner before the marriage, gifts or inheritances obtained by either party during the marriage, and debts incurred prior to the marriage. In other words, divorce in a community property state involves dividing the assets evenly between the two parties, and that includes assets held in either party's retirement plans.

partition the assets. One might be tempted to think that in a typical case where the majority of retirement plan assets are held by the husband, that he could simply take a distribution from his IRA or 401(k) and hand it over to the wife — or vice versa, if the wife was the primary earner during the marriage. But that would be a big mistake. In the 2018 court case, Kirkpatrick v. Commissioner of Internal Revenue, the court held that when John Kirkpatrick transferred assets from his IRA to an IRA in his wife's name, the transfer was a nonqualified distribution that required payment of early distribution penalties and tax on the amount transferred. In other words, by taking a distribution and putting it in an IRA owned by his ex-wife, the plaintiff and his ex-spouse incurred thousands of dollars in unnecessary taxes and penalties. If, on the other hand, he had included in the divorce decree a stipulation for a direct transfer of IRA assets, he could have executed such a transfer, directly ceding ownership of a portion of the account to his wife. This would have avoided the penalty and taxation problem.

A similar situation can arise when assets in a 401(k) or other employer plan need to be divided. In these cases, clients can take advantage of a qualified domestic relations order (QDRO) to partition the ownership without incurring early distribution penalties or taxes on the assets transferred. The QDRO must be submitted to the plan administrator for the 401(k) for qualification. Once it is duly qualified, plan assets may be retitled in the spouse's name and made available, which most plans allow.

The federal law governing retirement plans, the Employment Retirement Security Income Act of 1974 (ERISA), can sometimes take precedence over state laws when retirement plan assets are apportioned. One example occurred in the Louisiana case of Boggs v. Boggs, in 1997, when Mr. Boggs remarried following the death of his first wife. Upon his death, he left 100% of his retirement account assets to his second wife, naming her as beneficiary. Boggs's children sued, stating that because Louisiana was a community property state, they were entitled to half of the retirement account assets that had rightfully belonged to their deceased mother on the basis of community property. However, the U.S. Supreme Court ruled that ERISA supersedes state law, and they awarded the assets to the second wife. Though this case did not involve a divorce, it is important because of what it demonstrates about the importance of federal law as opposed to state law when an estate is being divided. It also points to the importance of making sure your beneficiary designations are up to date.

A second case, Bunney v. Commissioner of Internal Revenue (2000), does involve a divorce and also underlines the importance of using the correct method of dividing assets. Michael Bunney and his wife, residents of the community property state of California, divorced. In dividing up the retirement account assets, Bunney took a distribution of half of the assets and gave them to his wife. As with the Kirkpatrick because they lived in a community property state, the assets were already property of his ex-wife and not subject to taxation. However, the tax court ruled, once again, that even though spouses are equal owners of an IRA account, taxes are still due on the distribution, due to the provisions of ERISA.

If you are contemplating, or even in the midst of a divorce, it is vital for you to know the right questions to ask. You need to know all the avenues that are available to you in the law, and you especially need to understand how tax and retirement plan rules can affect the assets you may receive. I specialize in advising women in transition, thriving retirees, and others on the most advantageous strategies for their financial futures. If I can be of assistance to you or someone you know, please get in touch.

Stay Diversified, Stay *Your* Course!

Kimberly Foss, CFP®, CPWA®
President, Empyrion Wealth Management

For more information on Empyrion Wealth Management, visit www.empyrionwealth.com.
To learn more about Kimberly Foss, visit www.kimberlyfoss.com.