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How a divorcing couple can avoid the requirements of a QDRO by using IRC §408 IRA to accomplish the division of an employer sponsored plan?

Many qualified plans allow for “in-service distributions,” while others allow for distributions after age 55 or 59 ½, even if the participant is still actively employed. Plans that allow voluntary after tax contributions usually make those contributions available for in-service withdrawals. In most cases, if a participant withdraws assets from their retirement plan prior to age 59 1/2, they would be liable for income tax consequences and premature distribution penalties. However, if the participant *transfers* awarded benefits to an IRA, the party can use the marital settlement agreement to divide the IRA. This process eliminates the need for a QDRO, paperwork, fees, delays, etc.

It should be noted there is a distinction between “rolling” over an IRA opposed to “transferring” an IRA. Under the terms of a rollover, the qualified plan would make the distribution directly to the participant. Under federal law the plan administrator must withhold 20% for federal income tax purposes. However, if the account were transferred, no 20% withholding applies. Under a rollover option you get physical receipt and use of the funds for up to 60 days before the proceeds must be returned to avoid taxation and penalties. Under a transfer, you never receive physical receipt of the proceeds; they are transferred directly to the new IRA custodian.

Consider a couple of different arrangements for your clients to facilitate the transfer. The plan participant can directly transfer the exact amount needed to satisfy the obligation required in the MSA to an IRA, and subsequently re-register the IRA to the former spouse. Or, the participant could transfer a larger amount to an IRA and subsequently split the IRA into two separate accounts. A disadvantage to this approach is that once the proceeds are transferred to an IRA, they are subject to the distribution rules governing IRA’s. Unlike a premature distribution made directly from a qualified plan via QDRO, premature distributions from an IRA are subject to the 10% federal premature distribution rules and in Wisconsin, they are also subject our 3.3% premature distribution penalty. This strategy works best when either the participant or alternate payee have intentions to use the proceeds prior to age 59 ½.

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