PENALTY-FREE DISTRIBUTIONS FROM RETIREMENT PLANS BEFORE AGE 59½: A WINDOW OF OPPORTUNITY

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It's an all-too familiar scene. The parties are nearing the end of their dissolution proceeding. The case is settled and the assets are ready to be divided, but there is little cash. The cost of setting up two households in place of one and the payment of spousal support have created a chronic cash shortage. Unpaid bills have accumulated. One spouse needs a new home, another must buy a new car to replace the 1970 gas-guzzler that finally gave up the ghost. Attorneys' fees and costs must be paid. The sale of the family residence produces some cash, but not enough. There are retirement plan accounts, but the parties are under 59½ and the tax cost of withdrawing the money, particularly after the 10 percent penalty tax is added, are prohibitive.

Is there a way a spouse can tap these retirement plan assets without penalty before age 59½? It appears there may be.

Family law practitioners are familiar with the Retirement Equity Act of 1984 ("REA"), which allows the non-employee spouse to receive part of the employee spouse's retirement plan interest pursuant to a Qualified Domestic Relations Order ("QDRO"). These benefits can be paid directly to the non-employee spouse or rolled over into an individual retirement account ("IRA") in the spouse's name. Benefits received directly by the spouse are taxable as ordinary income. Benefits rolled over into an IRA by the spouse maintain their tax-deferred status until withdrawn.

It is also well known that withdrawals from a qualified retirement plan prior to age 59½ are subject to a 10 percent penalty tax. Internal Revenue Code §72(t). There are two exceptions, however, to the general rule imposing the penalty tax on pre-age 59½ distributions. These exceptions can provide valuable planning opportunities in situations where there are significant retirement plan benefits and the non-employee spouse is under age 59½.

Retirement Plan Interests as Community Property

Retirement plan interests are community property to the extent that the benefits are earned or accrued during the marriage. There are two judicially-approved ways to divide the community interest in a retirement plan. The first method is to reserve jurisdiction over the plan interest and divide each payment between the spouses based on the respective community and separate interests, as and when each payment is received. The second is to value the plan interest actuarially, award assets of equivalent value to the non-employee spouse, and award the entire plan interest to the employee spouse. *In re Marriage of Brown*, 15 Cal.3d 838 (1976).

As noted above, REA allows the non-employee spouse to withdraw a portion of the employee spouse's retirement plan account pursuant to a QDRO.

Taxation of Retirement Plan Withdrawals

The rules governing the taxation of retirement plan withdrawals may be summarized as follows:

1. All such withdrawals are ordinary income for federal and state income tax purposes.

2. An "additional" or penalty tax of 10 percent applies to distributions from qualified retirement plans to recipients under age 59½. Internal Revenue Code §72(t).

3. The combined state and federal income tax, taking into account the deductibility of state income tax on the federal return, is approximately 34.8 percent in California. When the 10 percent penalty tax is added, the effective combined rate approaches 45 percent. In cases where the marginal federal tax rate is 33 percent rather than 28 percent, the combined tax rate, including the penalty tax, can approach 50 percent. The penalty tax, which is not deductible on either the federal or state tax return, can make withdrawals before age 59½ prohibitively expensive.

Fortunately, Code §72(t) contains two little-known exceptions to the application of the penalty tax which may provide relief to the party who finds it necessary to make a premature distribution from a retirement plan in connection with a marital dissolution proceeding.

Code §72(5)(1) actually provides five exceptions to the general rule that if any taxpayer receives any amount from a qualified retirement plan, the penalty tax shall be imposed:

1. Distributions made after the distributee attains age 59½ Code §72(5)(2)(A)(i).

2. A series of substantially equal periodic payments made at least annually for the life or life expectancy of the distributee. Code §72(t)(2)(A)(iv).

3. Distributions which do not exceed the allowable deduction for the distributee's medical expenses

under Internal Revenue Code §213. Code §72(t)(2)(B).

4. Certain distributions from ESOP's. Code §72(t)(2)(C).

5. Any distribution to an alternate payee pursuant to a QDRO. This exception, however, does not apply to distributions from an IRA. Subsection (3)(B) of Code §72(t) provides that periodic payments from qualified plans must begin after separation.

Planning Opportunities

The two common opportunities for planning afforded by Code §72(t) are those relating to distribution pursuant to a QDRO and periodic distributions from an IRA. Any amount may be distributed in a lump sum directly from a qualified retirement plan (other than an IRA) to the non-employee spouse before age 59½, without imposition of the penalty tax. Where an IRA is involved, the benefits may still be withdrawn as periodic payments under Code §72(t)(2)(A)(iv).

Where the retirement plan in question is something other than an IRA, therefore, the non-employee spouse may receive part or all of his or her share in a lump sum, if that option is available under the plan, at ordinary income tax rates, without the imposition of the 10 percent penalty tax, even if the recipient spouse is under age 59½. This can be a source of cash for the purchase of a residence or other assets.

Where the retirement plan in question is an IRA or the plan proceeds have already been rolled into an IRA, the spouse still has the opportunity to receive periodic payments free of the additional tax. These payments will vary depending on the age of the spouse and may require an actuary to calculate them, but there is some flexibility in setting periodic distributions so that greater or lesser amounts may be taken if desired. Once periodic payments are begun, they may apparently be later changed or stopped. Because only periodic payments may be made from IRA's and lump-sum withdrawals may be made from other retirement plans, any decision as to a lump-sum distribution should be made before rolling the non-participant spouse's interest into an IRA.

The opportunity to withdraw retirement plan benefits without penalty appears particularly attractive with today's relatively flat tax rates, which may make it possible to withdraw large amounts from a plan during a particular year at ordinary income tax rates without increasing the tax rates.

The availability of retirement plan funds without penalty increases the options available to the parties and also, of course, creates new arguments for the parties. The spouse who is still working and not receiving benefits from the plan, for example, may argue that the ability to reach retirement plan benefits without penalty should be considered as a basis for reduced support to the non-participant spouse.

The exceptions discussed above will not apply to every case, and in many cases where they do apply, the parties may decide not to take early distributions. Distributions, once taken, are still taxable, and there is a strong inducement to allow assets, whenever possible, to remain in the plan to grow and compound at tax-deferred rates.

Whatever the facts of a particular case, however, if there are retirement plan interests and either spouse is under age 59½, counsel may wish to consider taking advantage of the window of opportunity afforded by the exceptions to the penalty tax on premature distributions found in Code §72(t).