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If Divorcing, Divide Investments with Care

Options Include a Qualified Domestic Relations Order, or QDRO, to Split a 401(k)

By
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When it comes to negotiating a divorce, many couples give relatively little attention to retirement and investment accounts—seeing them as pots of money that can be simply split in two.

That's often a mistake.

Accounts and their contents require careful examination before a "fair" division can be determined. Various types of retirement accounts have their own rules on tax treatment and access to the money. Two investments, meanwhile, can appear to have identical value but turn out to have wildly different tax liabilities.

Here are three important points to consider when divvying up accounts.

First, Know What You Own

Couples should begin by making an inventory of their investment holdings, including all joint or individually owned checking, savings, retirement, and brokerage accounts. They shouldn't forget stocks and bonds in a safe-deposit box or an account that is still titled in a maiden name; these types of holdings sometimes get overlooked.

Insurance policies and employment benefits, like deferred compensation, vested stock options or pensions, also can have a cash value and be an important source of future income. In sorting through and earmarking various assets and accounts, each spouse's living expenses, immediate bills and long-term savings goals should be considered.

"It may be worth hiring a forensic accountant to help locate each and every asset," says Mary Ryan, a financial planner at Vanguard Group.

When dealing with taxable brokerage accounts, couples should look at each individual holding—and its cost basis. A $40,000 stake in a stock purchased for $10,000 has a value of far less than $40,000, once the tax bill on the unrealized capital gain is considered. In contrast, a $40,000 investment purchased for an initial $50,000 is effectively worth more than $40,000 because the capital loss could be used to reduce the holder's tax bill, says Jay LaMalfa, a financial planner and partner at Macro Consulting Group in Parsippany, N.J.

Dollars in individual retirement accounts or 401(k) plans funded with pretax dollars will be subject to tax at ordinary income rates. Assets in those accounts generally can't be tapped without a penalty until age 59½. Assets in Roth IRAs may be particularly valuable because contributions (not earnings) can be withdrawn without penalty anytime. Earnings can be withdrawn tax- and penalty-free in retirement, as long as it has been at least five years since the first contribution.

Weigh Dividing Retirement Accounts

Both spouses can simply walk away with the money in their own IRAs and 401(k) plans. But it is also possible as part of a divorce to transfer some of those assets from one spouse to the other without any immediate taxation or penalty.

In the case of IRAs, a court-approved divorce decree or legal separation agreement must indicate how the accounts should be divided between spouses. Some financial institutions also require the decree to reference the retirement account number and the custodian or trustee. So it is important for the owner of the IRA to check with an institution beforehand to see what is required.

Once the divorce is final, funds from an IRA can be transferred tax-free into another IRA account owned by the ex-spouse. But timing is important. If assets are transferred before the divorce decree or legal separation agreement is approved by the judge, it could be seen as a taxable distribution, subject to the 10% penalty, says Thomas Rowley, a director of retirement business strategy at Invesco Ltd.'s Invesco Consulting.

Retirement plans run by an employer, such as 401(k)s and pension plans, are governed by the Employee Retirement Income Security Act, or Erisa. To divide these assets and future benefits, a court order called a Qualified Domestic Relations Order is necessary.
With a QDRO, funds from a 401(k) account can be transferred to an ex-spouse without a 10% early-withdrawal penalty. There would be no immediate income tax if the money was moved to another retirement account, such as an IRA.

A QDRO can be part of a divorce decree, but if it isn't incorporated it should be drawn up at the same time or immediately after the divorce settlement, says Louise Nixon, president of QDRO Counsel Inc. in San Marino, Calif.

QDROs can also be used to collect overdue child or spousal support from a 401(k), says Gary Shulman, co-owner of QDRO Consultants Co., in Medina, Ohio.

Be Diligent About Follow-Through and Housekeeping

After the divorce settlement is approved, couples should make sure every detail is executed properly; otherwise, huge sums of money could end up with the wrong party.

QDROs, for example, need to be approved by the plan administrator before funds can be transferred between accounts.

Also, review the beneficiaries named on holdings including retirement accounts and insurance policies. Often the ex-spouse is mistakenly left on.

Each spouse should also review the asset allocation within his or her accounts and rebalance or make adjustments as needed. Savings goals may change significantly, so both spouses should make sure their new portfolios reflect their own personal goals for the next chapters in their lives.

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Links referred to in article:

US Dept of Labor: "QDROs: The Division of Retirement Benefits Through Qualified Domestic Relations Orders"
http://www.dol.gov/ebsa/publications/qdros.html