

# Transfers of deferred compensation accounts in divorce

Internal Revenue Code Section 409A (IRC Section 409A) generally does not allow acceleration of benefits under a plan or changes to the time or form of benefit under a nonqualified deferred compensation plan, except in limited circumstances.<sup>1</sup> One such occasion is when a plan participant's benefit becomes subject to a domestic relations order (DRO) pursuant to a divorce.<sup>2</sup>

A DRO is a court order<sup>3</sup> that assigns payment of amounts deferred under the plan to someone other than the plan participant ("alternate payee"), generally to the former spouse<sup>4</sup>. The DRO may accelerate the timing of the payment or provide a different form of payment for the alternate payee than the original terms for the participant, without following the subsequent deferral (i.e., "re-deferral") rules in IRC Section 409A.<sup>5</sup>

To execute a DRO consider:

- Does the plan allow for acceleration of payments due to a DRO?<sup>6</sup>
- Does the administrative committee of the plan have procedures to review DRO?
- Is the DRO signed by a judge with appropriate jurisdiction?

A DRO should include:

- Name of the deferred compensation plan
- Name of the participant, including demographic information (address, date of birth, email, phone, Social Security number, etc.)
- Name of the alternate payee, including demographic information (address, date of birth, email, phone, Social Security number, etc.)
- Date the participant's account is to be split and alternate payee's account is to be established
- Amount of the participant's account to be assigned to the alternate payee's account
- Distribution terms of the alternate payee's account (when the account is to be paid and in what manner)
- Investment elections for the alternate payee's account from the date of the account split

## Unique tax treatment of assets transferred under a DRO

The income-tax treatment of deferred compensation plan benefits transferred in divorce proceedings is unlike that of other assets. Many assets (even qualified plan assets) can be transferred incident to a divorce with no current income-tax implications (IRC Section 1041).

Deferred compensation plan accounts are not subject to these provisions; however, Internal Revenue Service (IRS) guidance<sup>7</sup> makes it clear that any taxable income resulting from a transfer of a deferred compensation account to a spouse incident to a divorce is the responsibility of the former spouse, not

the participant in the plan. Regarding when the income should be recognized, the IRS references Section 1041 of the Tax Code, which:

- Provides that no gain or loss is recognized on a transfer of property to or for the benefit of a former spouse, if the transfer is incident to divorce; and
- Provides that the former spouse's basis in the property is the adjusted basis of the transferor.

This means that the transferee spouse recognizes income on the transferred account at the same time and in the same manner the employee participant would have recognized income, normally upon distribution of the deferred compensation account.

Upon a distribution to a former spouse, the employer reports taxable income as well as the payment and reporting of FICA and FUTA taxes.

## Income-tax reporting

Normally, distributions from a deferred compensation plan are reported as income in Box 1, wages on the employee participant's Form W-2. Since the participant's former spouse is not an employee, income cannot be reported on a Form W-2. IRS Notice 2002-31 specifies that the gross amount of the distribution to the non-employee spouse should be reported in Box 3, Other Income, on Form 1099-MISC. Revenue Ruling 2004-60 specifies that income tax should be withheld from payments to the non-employee spouse at the supplemental withholding rate. Income tax withheld from the payment should be reported in Box 4, Federal Income Tax Withheld on Form 1099-MISC.

## FICA tax reporting

FICA taxes are due on deferred compensation plan distributions only to the extent that non-vested amounts become vested upon distribution. Any FICA taxes due at distribution should be withheld from the payment to the non-employee spouse and reported on the employee participant's Form W-2. The wages should not be reported in Box 1 since they are not taxable to the employee participant. Any FICA wages should be reported as Social Security wages (under the wage limit) and Medicare wages as appropriate on the Form W-2, and the company will owe the match.

## FUTA tax reporting

FUTA taxes (paid by the company) are due on the distribution only to the extent that non-vested amounts become vested, and the employee's total compensation does not exceed the FUTA wage limits.

<sup>1</sup> See IRC Sec. 409A(a)(2), (3).

<sup>2</sup> Treas. Reg. §1.409A-3(j)(4)(ii).

<sup>3</sup> The term “domestic relations order” includes a judgment, decree, or order, including approval of a property settlement agreement, that relates to the provision of child support, alimony payments or marital property rights to a spouse, former spouse, child or other dependent, and that is made pursuant to a state domestic relations law or community property law. IRC Sec. 414(p)(1)(B).

<sup>4</sup> See Treas. Reg. §1.409A-3(j)(4)(ii); IRC Sec. 414(p)(1)(B).

<sup>5</sup> For grandfathered money not subject to IRC Section 409A, regulations allow for modification of the plans to honor DRO without being a material modification to the plan, which maintains grandfathered status. Treas. Reg. §1.409A-6(a)(4)(i)(C).

<sup>6</sup> Principal model IRC Section 409A document permits acceleration of payments due to a DRO. Clients on custom documents should review their plan document for DRO provisions.

<sup>7</sup> Revenue Ruling 2002-22, 2002-19 IRB 849 (regarding the income tax implications); Notice 2002-31, 2002-19 IRB 908 (regarding the FICA/FUTA implications).



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