Darby v. Commissioner, 97 T. C. 51 (1991)

The participant in a qualified pension plan, not the former spouse, is taxed on the full amount of a lump sum distribution, even when part of it is paid to the former spouse under a divorce decree.

Summary

Lewis Darby was fully vested in his employer's profit-sharing plan when he divorced in 1976. The divorce decree required him to pay $75,000 to his former wife, Yolanda, representing her share of his plan interest. Upon retirement in 1983, Darby received a lump sum distribution from the plan and paid the remaining $52,970 owed to Yolanda. The Tax Court held that Darby, as the plan participant, was the distributee of the entire distribution and must include it in his income under Section 402(a)(1). No part of the payment to Yolanda was excludable from Darby's income under Section 72, as it did not constitute an investment in the contract.

Facts

In 1976, Lewis Darby divorced Yolanda Darby. At the time, Lewis was a fully vested participant in Sears' tax-qualified profit-sharing plan. The divorce decree mandated Lewis to pay Yolanda $75,000, approximately half the value of his interest in the plan, at $60 per week until fully paid or until his death or retirement, when the balance would be due as a lump sum. Lewis assigned to Yolanda the portion of his interest in the plan necessary to satisfy this obligation. Lewis retired in 1983, received a lump sum distribution of $182,481. 39 from the plan, and paid the remaining $52,970 to Yolanda.

Procedural History

Lewis Darby filed a tax return for 1983, excluding the $75,000 paid to Yolanda from his income. The IRS determined a deficiency, leading Darby to petition the U. S. Tax Court. The Tax Court ruled in favor of the Commissioner, holding that Darby was the distributee of the entire lump sum distribution and must include it in his income.

Issue(s)

1. Whether Lewis Darby properly excluded from income the portion of the lump sum distribution he paid to Yolanda under the divorce decree, on the basis that she was the distributee for purposes of Section 402(a)(1).
2. Whether all or any portion of the amount paid to Yolanda is excludable from Darby's gross income under Section 72.

Holding

1. No, because Lewis Darby, as the plan participant, was the distributee of the entire lump sum distribution under Section 402(a)(1), and not Yolanda.

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2. No, because the payment to Yolanda did not constitute an investment in the contract under Section 72, and thus no part of it was excludable from Darby's income.

Court's Reasoning

The Tax Court reasoned that under Section 402(a)(1), the distributee of a qualified plan distribution is the participant or beneficiary entitled to receive it under the plan, not necessarily the recipient. The court examined the legislative history of the Retirement Equity Act of 1984 (REA '84) and the Tax Reform Act of 1986 (TRA '86), which clarified that a former spouse receiving a distribution under a qualified domestic relations order (QDRO) would be treated as the distributee. However, these amendments did not apply retroactively to Darby's case. The court also noted that the distribution consisted entirely of employer contributions, which were not includable in Darby's income if paid directly to him, thus not constituting an investment in the contract under Section 72. The court rejected Darby's argument that the payment to Yolanda constituted a basis adjustment under Section 72(g), as it was not a transfer of the plan interest itself but a payment for her interest in the marital estate.

Practical Implications

This decision clarifies that in divorce settlements involving pension plan distributions, the plan participant remains the distributee for tax purposes, unless a QDRO is in place. Attorneys drafting divorce agreements should consider including QDROs to shift tax liability to the former spouse receiving the distribution. The ruling also underscores the importance of understanding the tax implications of property settlements, as payments made from a pension plan distribution are not treated as an investment in the contract, and thus are not excludable from the participant's income. This case has been cited in subsequent cases involving the taxation of pension distributions in divorce, reinforcing the principle that without a QDRO, the participant bears the full tax burden of the distribution.

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