Divorce and Taxes: Retirement Benefits and Costs of Divorce

Course #30054B

Taxes

2 Credit Hours

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DIVORCE AND TAXES: RETIREMENT BENEFITS AND COSTS OF DIVORCE

This course covers the tax rules for dividing retirement plans in divorce, including distribution requirements and potential tax consequences. It also identifies which divorce-related fees may qualify as deductible expenses, helping individuals and professionals navigate the financial aspects of divorce with greater clarity.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Divorce and Retirement Benefits
Costs of Getting a Divorce

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recall the distribution and tax rules that govern the division of retirement plans associated with divorce.
- Identify what fees related to divorce are deductible.

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: DIVORCE AND RETIREMENT BENEFITS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the distribution and tax rules that govern the division of retirement plans associated with divorce.

I. INTRODUCTION

A retirement plan or account such as an IRA is typically just one piece of property that is subject to division when a couple divorces. The simplest thing to do in the event of a divorce is for each spouse to keep his or her own retirement plan or account. In an ideal world, each spouse would have his or her own plan and the two plans would be worth the same amount. In reality, of course, this rarely occurs. So how is something like a retirement account or a pension plan to be divided? What are the tax consequences, if any?

There are many different types of retirement and pension plans, including military and government pensions. A complete discussion of all of these is well beyond the scope of this course. Military retirements, for example, have complex rules of their own. For purposes of this course, this chapter will look at individual retirement arrangements, Qualified Domestic Relations Orders – which govern division of retirement plans – and social security benefits available for a former spouse.

II. INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)

A. TYPES OF IRAs

An individual retirement account is a desirable way to save for things like retirement because it allows the account holder to place pre-tax dollars into the account. There are five different types of IRAs.

1. Traditional IRA

With a traditional IRA, an eligible individual can contribute a certain amount of money pre-tax into his or her account each year. The amount of contribution that is deductible on his or her income tax return depends on the individual's adjusted gross income (AGI) and whether he or she is covered under an employer sponsored qualified retirement plan.

2. Education IRA (Coverdell Savings Account)

With an education IRA, an individual can put away up to $2,000 per year into an education IRA, the money grows tax-free, and has preferential tax treatment upon distribution to the beneficiary who uses it for authorized education expenses.

3. SEP IRA

A Simplified Employee Pension is an employer-established and funded IRA. The employer can place up to 25 percent of an employee's compensation into a SEP IRA.

4. SIMPLE IRA

This type of IRA is also an employer-sponsored plan. This type of account allows employers to make contributions as well as employees. Employees are permitted to contribute up to $16,500 per year in 2025 into a SIMPLE IRA (excluding catch-up contributions).

5. Roth IRA

In the case of a Roth IRA, contributions are not deductible when the funds are contributed. However, the earnings accumulate tax-free and remain tax-free upon distribution. To be eligible to contribute, an individual or married person must meet maximum income requirements. Persons are not allowed to withdraw money from a Roth IRA within the first five years after establishment of the account without a penalty.

B. GENERAL TAX RULES

Distributions from an IRA generally are taxable to the owner of the account. Thus, if the IRA owner transfers funds from his or her IRA to a spouse or former spouse incident to a divorce decree, the IRA owner could face taxation of the transferred amount as an IRA distribution, whether or not the IRA is community property and whether or not the transfer is ordered by the court.

To avoid this tax result, there is a special taxation provision found in section 408(d)(6) of the Code. This section allows the division of an IRA without tax consequences to either the IRA owner or the spouse if certain requirements are met.

Internal Revenue Code § 408 (d)(6) Tax treatment of distributions. –

Transfer of account incident to divorce. – *The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2) is not to be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest at the time of the transfer is to be treated as an individual retirement account of such spouse, and not of such individual. Thereafter such account or annuity for purposes of this subtitle is to be treated as maintained for the benefit of such spouse.*

For § 408(d)(6) to apply and avoid a tax penalty, the following requirements must be met: (1) there must be a decree of divorce, a decree of separate maintenance, or a written instrument incident to such a decree; and (2) there must be a transfer of an interest in an IRA to the spouse or former spouse.

1. Decree of Divorce

The Internal Revenue Code provides that an IRA can be divided upon a divorce or separation agreement. In Private Letter Ruling 9344027, the IRS addressed what arrangement met this requirement. In that case, the husband had received substantial qualified plan benefits upon retirement and had rolled them over to several IRAs. He and his wife separated and she moved out of the country. They entered into a "separation agreement" in which they agreed to divide the IRAs equally. They sought a ruling from the IRS that the transfer of one-half of each of husband's IRAs to an IRA in wife's name would not be taxable pursuant to Code § 408(d)(6).

The IRS ruled that the transfers to wife's IRA from husband's IRAs would be taxable to husband. The IRS concluded that the taxpayers' written separation agreement was not "a written instrument incident to a decree of divorce or separate maintenance" as required by section 408(d)(6).

Although not authoritative, private letter ruling are instructive. In this private letter ruling, the IRS identified additional factual representations that the taxpayers might have made in their ruling request that could have changed the IRS's conclusion. The taxpayers had not asserted that they were "legally separated." Second, the taxpayers had not asserted that they intended to present their agreement to the court so the court could enter a decree with respect to it. According to the ruling, permanently living apart, with no intention of divorcing, does not constitute being legally separated.

2. Transfer of an Interest in an IRA to the Spouse or Former Spouse

The IRS rule provides that the account holder's interest in the IRA is transferred to an IRA in the name of the spouse or former spouse. Such transfer does not, however, constitute a distribution. Rather, the recipient spouse or former spouse's account must also be an IRA. Once this transfer is made, the recipient spouse is the owner of the IRA. If he or she then elects to withdraw some or all of the amount transferred, he or she will be subject to the 10 percent penalty if the transferee spouse is younger than age 59.

3. The Mechanics of the Transfer

Once a court has entered an order requiring an IRA to be transferred in whole or in part, the account can be divided. This can be done through transfer of either a specific dollar amount (i.e., $10,000) or a percentage of the account (i.e., 50%) to the transferee spouse's account. Another option is for the IRA account holder to establish a separate IRA containing the amount to be transferred and then assign that entire separate IRA to the spouse by changing the name on the account. Either way, the transferee spouse becomes the owner of the IRA.

Securities can be liquidated or transferred in kind, and expenses can be shared or borne by one of the parties. The court order should specify these terms to avoid delays and the need for post judgment negotiation. This is particularly true when the account has been invested in securities such as individual stocks or mutual funds that may need to be liquidated to effectuate the transfer.