

Divorce and Taxes: Retirement Benefits and Overall Costs

Retirement assets are frequently among the most significant—and most complex—items to address in a divorce settlement. This section covers the tax rules for IRAs in divorce, the requirements and mechanics of Qualified Domestic Relations Orders (QDROs), and how Social Security benefits factor in when a marriage ends. You'll also get an overview of which divorce-related costs may be deductible. Whether you're helping a client divide a pension or structure an IRA transfer, this section equips you with the knowledge to handle retirement and cost issues accurately and confidently.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course 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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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 (2026) 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, up to \$72,000 in 2026.

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 \$17,000 per year in 2026 into a SIMPLE IRA (excluding catch-up contributions and/or higher limits applying to small businesses of 25 or fewer employees).

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.

C. QDRO NOT REQUIRED

In most cases, a qualified retirement plan such as a pension cannot be redistributed away from the owner absent a Qualified Domestic Relations Order (QDRO). The mechanics associated with a QDRO are discussed in detail below. For purposes of transferring an IRA, however, federal law does not require the issuance of a QDRO. This is true even in cases where the IRA in question is a rollover from a qualified retirement account.

Even though division of an IRA incident to divorce does not require a QDRO, it may be advisable to have one in certain cases. This is because the IRA custodian or trustee, whether a bank, trust company, brokerage firm or insurance company, will usually request a copy of the court order. In addition, it should be noted that there is some authority for the position that division of a SEP IRA does require a QDRO. In such cases, it may be advisable to seek a QDRO to eliminate any risk of taxation or penalties.

III. QUALIFIED DOMESTIC RELATIONS ORDERS

More than 60 million private wage and salary workers are currently covered by employer-sponsored retirement plans in the United States. For many of these Americans, retirement savings represent one of their most significant assets. For this reason, whether and how to divide a participant's interest in a retirement plan are often important considerations in separation, divorce, and other domestic relations proceedings. While the division of marital property generally is governed by state domestic relations law, any assignments of pension interests must also comply with federal law, namely the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code. Under ERISA and the Internal Revenue Code, pension interests may be assigned only if the judgment, decree, or order creating or recognizing a spouse's, former spouse's, child's, or other dependent's interest in an individual's retirement benefits constitutes a "qualified domestic relations order" or "QDRO."

In general, ERISA and the Internal Revenue Code do not permit a participant to assign or alienate the participant's interest in a retirement plan to another person. These "anti-assignment and alienation" rules are intended to ensure that a participant's retirement benefits are actually available to provide financial support during the participant's retirement years. A limited exception to the

anti-assignment and alienation rules is provided for assignments of retirement benefits through qualified domestic relations orders (QDROs).

Under the QDRO exception, a domestic relations order may assign some or all of a participant's retirement benefits to a spouse, former spouse, child, or other dependent to satisfy family support or marital property obligations if and only if the order is a "qualified domestic relations order." ERISA requires that each retirement plan pay benefits in accordance with the applicable requirements of any "qualified domestic relations order" that has been submitted to the plan administrator. The plan administrator's determinations on whether a domestic relations order is a QDRO, therefore, have significant implications for both the parties to a domestic relations proceeding and the plan.

A. TAX CONSEQUENCES

Having a QDRO protects the funds transferred pursuant to a divorce from taxation. The alternate payee (the recipient spouse or former spouse) is taxed on the funds only when they are withdrawn from the retirement plan account, but the 10 percent early distribution penalty tax does not apply pursuant to Internal Revenue Code § 72(f)(2)(C). Alternatively, the distribution can be rolled over into an Individual Retirement Account (IRA) owned by the alternate payee without incurring income tax, if the alternate payee is the spouse or former spouse rather than child or other dependent of the participant. However, the rollover must be done within 60 days of the alternate payee's receipt of the QDRO distribution from the qualified plan. To avoid the 20 percent federal income tax withholding that will be taken out of a QDRO distribution, the transfer should be made directly to the trustee of the IRA from the trustee of the qualified plan.

Ordinarily, any funds distributed from a qualifying retirement plan are taxable to the plan participant or beneficiary who, under the plan, is entitled to receive the distribution. Yet under section 402(a)(9) of the Internal Revenue Code, the "spouse or former spouse" of the plan participant who receives "any distribution or payment made ... under a qualified domestic relations order (as defined in section 414(p))" shall be considered an "alternate payee" and taxed on such distribution or payments as the distributee.

A domestic relations order qualifies as a QDRO only if it: (1) creates, recognizes or assigns to an alternate payee the right to receive all or a portion of the benefits payable under a plan; (2) clearly specifies certain information about the plan; and (3) does not alter in a prohibited manner the amount or form of the benefits payable under the plan. These requirements are discussed in greater detail below.

The QDRO has an additional function besides tax allocation. The legislative history demonstrates that the primary purpose of the QDRO exception was to enable plan participants to assign or alienate their plan interests in connection with a domestic relations order. Prior to 1974, a participant's interest in a tax-exempt retirement plan was freely assignable under the Code.

However, the enactment of the Employee Retirement Income Security Act of 1974 (“ERISA”) changed existing law by providing that benefits obtained “under [a qualifying retirement] plan may not be assigned or alienated.”

B. QUALIFIED DOMESTIC RELATIONS ORDER DEFINED

A “qualified domestic relation order” (QDRO) is a domestic relations order that creates or recognizes the existence of an “alternate payee’s” right to receive, or assigns to an alternate payee the right to receive, all or a portion of the benefits payable with respect to a participant under a retirement plan, and that includes certain information and meets certain other requirements.

To be recognized as a QDRO, an order must be a “domestic relations order.” A domestic relations order is:

- A judgment, decree or order (including the approval of a property settlement);
- That is made pursuant to a state domestic relations law (including community property law);
- That relates to the provision of child support, alimony payments, or marital property rights for the benefit of a spouse, former spouse, child, or other dependent of a participant.

A state authority, generally a court, must actually issue a judgment, order, or decree or otherwise formally approve a property settlement agreement before it can be a “domestic relations order” under ERISA. The mere fact that a property settlement is agreed to and signed by the parties will not, in and of itself, cause the agreement to be a domestic relations order.

There is no requirement that both parties to a marital proceeding sign or otherwise endorse or approve an order. It is also not necessary that the retirement plan be brought into state court or made a party to a domestic relations proceeding for an order issued in that proceeding to be a “domestic relations order” or a “qualified domestic relations order.” Indeed, because state law is generally preempted to the extent that it relates to retirement plans, the department takes the position that retirement plans cannot be joined as a party in a domestic relations proceeding pursuant to state law. Moreover, retirement plans are neither permitted nor required to follow the terms of domestic relations orders purporting to assign retirement benefits unless they are QDROs.

1. Issuing Body

A domestic relations order may be issued by any state agency or instrumentality with the authority to issue judgments, decrees, or orders, or to approve property settlement agreements, pursuant to state domestic relations law (including community property law).

2. Persons Who Can Be an “Alternate Payee”

A domestic relations order can be a QDRO only if it creates or recognizes the existence of an alternate payee's right to receive, or assigns to an alternate payee the right to receive, all or a part of a participant's benefits. For purposes of the QDRO provisions, an alternate payee cannot be anyone other than a spouse, former spouse, child, or other dependent of a participant.

3. Required Information

To be valid, a QDRO must contain the following information:

- The name and last known mailing address of the participant and each alternate payee;
- The name of each plan to which the order applies;
- The dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee; and
- The number of payments or time period to which the order applies.

In addition, there are certain provisions that a QDRO must not contain. The order must not require a plan to provide an alternate payee or participant with any type or form of benefit, or any option, not otherwise provided under the plan. The order must not require a plan to provide for increased benefits (determined on the basis of actuarial value). In addition, the order must not require a plan to pay benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO. Finally, the order must not require a plan to pay benefits to an alternate payee in the form of a qualified joint and survivor annuity for the lives of the alternate payee and his or her subsequent spouse.

4. QDRO May Be Part of the Divorce Decree or Property Settlement

There is nothing in ERISA or the Code that requires that a QDRO (that is, the provisions that create or recognize an alternate payee's interest in a participant's retirement benefits) be issued as a separate judgment, decree, or order. Accordingly, a QDRO may be included as part of a divorce decree or court-approved property settlement, or issued as a separate order, without affecting its "qualified" status. The order must satisfy the requirements described above to be a QDRO.

5. Domestic Relations Order

A domestic relations order that provides for child support or recognizes marital property rights may be a QDRO, without regard to the existence of a divorce proceeding. Such an order, however, must be issued pursuant to state domestic relations law and create or recognize the rights of an individual who is an "alternate payee" (spouse, former spouse, child, or other dependent of a participant).

An order issued in a probate proceeding begun after the death of the participant that purports to recognize an interest with respect to retirement benefits arising solely under state community property law, but that does not relate to the dissolution of a marriage or recognition of support