

In the October 2007 issue of Family Law News we published an article which reviewed the circumstances under which an Individual Retirement Account might be divided. We now provide you with the following article, which expands upon this important topic.

## **Tax Free Transfer of IRA to Divide Marital Property Revisited: Separation Agreement Must Be Incident To Decree of Divorce**

by Marcia C. Fidis

Individual Retirement Accounts, some of which are of quite substantial value, are marital property to the extent acquired during the marriage. Accordingly, they are subject to equitable distribution at divorce. Generally, it will be in the best interests of the account owner that he or she incur no tax liability as a result of a transfer to carry out a property division and that the transferee spouse receive the future tax liability for the portion of the account that will go to him or her. When the spouse receives the transfer into his or her own IRA, the assets will continue to grow tax-deferred until the spouse is ready to retire. This is generally the result parties intend. The Internal Revenue Code dictates the tax consequences of a transfer of some or all of an IRA from the account owner to the spouse to carry out a division of marital property as part of a divorce.<sup>1</sup> This article addresses how to carry out such a transfer to obtain the correct tax consequences.

### **Basic Rule for IRA Transfer as Part of Marital Property Settlement**

IRC § 408 (Individual Retirement Accounts) governs the transfer of an interest in an IRA between spouses to carry out a marital property division or to provide support for a spouse.

In order for the transfer of an IRA from one spouse to the other to be nontaxable, Section 408(d)(6) requires that the transfer be under “a decree of

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<sup>1</sup> IRC § 408(d)(6). An IRA transfer could also be used to meet a support obligation - not just a division of marital property - so long as the transfer meets the requirements of this section, including that the instrument requiring the transfer for support be a divorce decree or a written instrument “incident to a decree of divorce”. All section references in this article refer to the Internal Revenue Code of 1986 as amended.

divorce or separate maintenance or a written instrument incident to such a decree.”<sup>2</sup> Specifically, Section 408(d)(6) provides:

The transfer of an individual’s interest in an individual retirement account . . . 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 . . . and such interest at the time of the transfer is to be treated as an individual retirement account of such spouse . . . .

IRC § 408(d)(6) (emphasis added).

### **What Is a Divorce or Separation Instrument?**

Section 71(b)(2) defines the term “divorce or separation instrument” as “a decree of divorce or separate maintenance or a written instrument incident to such a decree,” IRC § 71(b)(2)(A), **or** “a written separation agreement” IRC § 71(b)(2)(B), **or** “a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse”, IRC § 71(b)(2)(C). Significantly, the Section 408, authorizing the nontaxable transfer of an IRA, specifically refers *only* to subparagraph (A) of paragraph 71(b)(2) (“written instrument incident to such a decree”). The statute does *not* refer to subparagraph (B) (“a written separation agreement”) or subparagraph (C) (“a decree other than the one described in (A) requiring a spouse to make payments for support or maintenance of the other spouse”) which are the other two subparagraphs of Section 71(b)(2). Thus, the plain meaning of Section 408(d)(6) appears to preclude a nontaxable IRA transfer based merely on a separation agreement that is not incident to a decree.

### **What Is an Agreement “Incident to Decree of Divorce?”**

#### Agreement Incorporated in Judgment of Divorce

A marital settlement agreement that has been incorporated in a judgment of divorce is a “written instrument incident to such a decree” under IRC § 71(b)(2)(A). Therefore, upon entry of the judgment, the IRA owner can

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<sup>2</sup> See IRC § 408(d)(6) referring to IRC § 71(b)(2)(A).

direct the financial institution to carry out the IRA transfer to the spouse's IRA. Under IRC § 408(d)(6), the transfer will be nontaxable.

### Status of Agreement Before Entry of Judgment of Divorce

Can an IRA be transferred tax free prior to divorce? The answer turns on whether a separation agreement can be considered incident to divorce (or incident to a decree) before the divorce actually occurs.<sup>3</sup> It seems clear from the plain language of the statute and the regulations that a separation agreement that is not “incident” to a decree of divorce is *not* sufficient to make the IRA transfer nontaxable.<sup>4</sup> Section 408, and the regulations under Section 408, offer no specific guidance on the question of the timing of the transfer.

IRC § 1041 governs the nontaxable transfer of other types of assets (but not IRA accounts).<sup>5</sup> A transfer under this section is incident to divorce if the transfer is “related to the cessation of the marriage.”<sup>6</sup> However, it is difficult to rely on Section 1041 for guidance to the application of Section 408 to IRA transfers for two reasons. First, regulations under IRC § 1041 define the required instrument to include both a decree of divorce or separate maintenance or a written instrument incident to such a decree, IRC § 71(b)(2)(A), *and* a written separation agreement, IRC § Section 71(b)(2)(B). Section 408, on the other hand, specifically refers *only* to Subparagraph (A) (decree of divorce or separate maintenance or written instrument incident to such a decree).

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<sup>3</sup> For purposes of this article, “incident to divorce” and “incident to a decree” are used interchangeably. See, Treas.Reg. § 1.408-4(g)(1) (The transfer of an individual's interest in an IRA to former spouse “under a valid divorce decree or a written instrument incident to such divorce” is nontaxable).

<sup>4</sup> The IRS has so concluded in PLR 9344027 (August 9, 1993). Also, see Technical Advice Memorandum 199935055 (July 6, 1999). Written determinations (including private letter rulings and technical advice memoranda) cannot be cited as precedent (IRC § 6110(k)) but indicate the IRS positions on tax issues.

<sup>5</sup> IRC § 1041 does not apply to transfer of IRAs. PLR 9422060 (March 14, 1994).

<sup>6</sup> IRC § 1041(c); Treas. Reg. § 1.1041-1T Q&A 6.

Second, *all* outright transfers of Section 1041 property before divorce are nontaxable for income tax purposes. By contrast, Section 408 refers to a more limited group of transfers by referencing *only* subparagraph (A) of section 71(b)(2) and *not* subparagraph (B). Therefore Section 1041 doesn't provide any clear guidance that can be applied to transfers of IRAs before the end of the marriage.<sup>7</sup>

### **Uncertainties and Risks in Pre-Divorce IRA Transfer**

Until the IRS provides more specific guidance, the determination of whether a marital settlement agreement is “incident to the decree” for purposes of a pre-divorce transfer of an IRA under Section 408(d)(6) is likely to be one of facts and circumstances.<sup>8</sup> Any time a determination of tax liability is based on facts and circumstances, there is a risk the determination could go against the taxpayer. If the transfer of an IRA to a former spouse occurs after a written separation agreement that provides for the transfer and before a divorce decree, and the parties do subsequently divorce within a year or two, then the IRS should deem the separation agreement to be incident to a decree so that the transfer is nontaxable. However, there is less certainty in the following scenarios.

- (1) What if the parties execute a separation agreement but never intend to divorce? It seems hard to argue that the transfer of an IRA pursuant to an agreement where there will be no divorce meets the requirement of being incident to a decree. In fact, the IRS has held that where the facts and circumstances show that a divorce is not contemplated,

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<sup>7</sup> IRC § 2516 in the estate and gift tax subtitle of the Internal Revenue Code provides that an agreement executed within a three year window beginning two years before divorce and concluding one year after divorce will cause a property transfer between spouses or former spouses to be deemed for full and adequate consideration and not a taxable gift. The purpose of this gift tax section is to make certain that an agreement to transfer property between spouses or former spouses is actually related to divorce and thus presumably obtained through arms-length bargaining and not a gift. By analogy, it could be argued that a separation agreement executed no more than two years before divorce should be “incident to divorce” *if the divorce actually occurs*. Even here the parallel is not without question since Section 2516 is an estate and gift tax section, not an income tax section as is Section 408 which governs transfers of IRAs. At least one court has held that the income and gift tax rules of the Internal Revenue Code are *not* to be construed in pari materia. The court held that gift tax limitations should not be imported into the income tax rules without an act of Congress. *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812(2d Cir. 1947).

<sup>8</sup> See n.5 above.

the transfer of an IRA is taxable even though the parties had executed a separation agreement.<sup>9</sup>

- (2) What if the parties execute a separation agreement intending to divorce, transfer the IRA from one spouse to the other and then one party dies or the parties reconcile before divorce? Can the separation agreement meet the requirement that it be “incident to a decree” if the parties intended to divorce but did not?
- (3) What if the parties execute a separation agreement intending to divorce, but years pass and there is no divorce?

There have been no IRS rulings or court decisions that answer the questions in (2) and (3). As a result, a party who transfers an IRA after signing a separation agreement but before a divorce decree takes a risk that a reconciliation or death before divorce, or that an unintended delay in obtaining a divorce, will deny the parties the favorable tax treatment afforded transfer of an IRA incident to a decree.

### **Tax Consequences of Nontaxable Transfer.**

What are the tax consequences to the parties if nontaxable treatment is not available for the IRA transfer? The IRA transfer will be treated as a distribution to the IRA owner who will have to report the amount transferred as taxable income and pay taxes.<sup>10</sup> Moreover, if the IRA owner is under age 59 and a half, there may be penalties on the amount withdrawn.<sup>11</sup> Further, the transferee spouse will receive the entire proceeds free of tax but will *not* be entitled to transfer the proceeds to an IRA in his/her own name, thus losing the benefit of tax deferred growth. If the transferee spouse does receive the transfer directly into his/her own IRA, and fails to withdraw the taxable amount prior to the due date of the tax return for the year of the transfer, the transferee spouse’s IRA account will be subject to penalties for

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<sup>9</sup> See n. 5 above.

<sup>10</sup> IRC § 408(d)(1)

<sup>11</sup> IRC § 72(t) imposes a 10% penalty on amounts distributed before age 59½ unless the distribution falls within listed certain exceptions.

“excess contributions” to an IRA for each taxable year that the excess contribution remains in the account.<sup>12</sup>

### **Can Parties to a Marital Settlement Agreement Carry Out an IRA Transfer Before Entry of a Judgment of Divorce.**

A number of readers requested clarification of the premise of an article in a prior issue of this newsletter entitled “Can You Get Your Client A Piece of That IRA before Final Divorce?” The thrust of the article is that under the applicable statute, IRC § 408(d)(6), a spouse may make a nontaxable transfer of an IRA to the other spouse after a separation agreement is signed and before the divorce occurs. That may be correct in some circumstances, but the limitations and risks discussed above should be considered.

Because of the significant adverse tax consequences if the transfer is taxable, the parties may wish to avoid the risk, however small, by postponing the transfer until after divorce. If the transferee spouse intends to keep the IRA tax deferred anyway, there is less reason for an immediate transfer. If the spouse who is to receive the IRA really needs to withdraw and use the funds prior to divorce, there is an alternative. The separation agreement could provide that the IRA owner will withdraw the funds, pay the taxes, plus any premature withdrawal penalty, and make a nontaxable transfer of the net proceeds to the transferee spouse. The tax consequences of this transaction are known and avoid the uncertainty of a pre-divorce transfer of an IRA.

Unless and until the IRS clarifies the uncertainties discussed above, attorneys should advise clients of the risks inherent in transferring an IRA before divorce.

### **How To Avoid Adverse Tax Consequences in Transfer of An IRA**

- Include specific language in the separation agreement or divorce decree: *W will transfer fifty percent of her (name of institution) IRA Account # \_\_\_\_\_ to H in a trustee to trustee IRA transfer which the parties intend to be a nontaxable transfer under IRC § 408. For purposes of this transfer, the account shall be valued as of \_\_\_\_\_ and H’s share of the account*

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<sup>12</sup> IRC § 4973; IRC § 408(d)(4)

*shall include earnings and losses on such amount from the valuation date until the transfer to an IRA in H's name.*

- The divorce decree should contain language requiring the transfer or the decree should incorporate the separation agreement requiring the transfer.
- The transferee spouse, should open a new IRA account, or identify an existing IRA, to receive the transferred IRA and provide this information to the other spouse.
- After divorce, the IRA account owner should provide a copy of the written instrument and/or the divorce decree to the financial institution maintaining the IRA and request the transfer, providing the name of the institution and account number that will receive the IRA transfer as well as the transferee spouse's name and social security number.

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*The author wishes to thank her partners, Linda J. Ravdin and Anne Walker (Jan) White for their contributions to this article from a family law attorney's perspective.*