Top 5 Checklist for Splitting IRAs Under a Divorce Settlement

Aug 20, 2018 / By Denise Appleby, APA, CISP, CRC, CRPS, CRSP

When IRAs are part of a divorce settlement, take care that awarded amounts are transferred properly to the recipient spouse. Mistakes could have negative tax and penalty consequences for the former spouses. These five points will help keep you on track.

> *"With about 40% of marriages ending in divorce, it is highly likely that you will be asked for advice on retirement accounts that are part of divorce settlements. Knowing the applicable rules will help you to provide much needed operational and technical guidance to your clients."*
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> —Center for Retirement Research at Boston College

Generally, divorcing couples come to an agreement about which spouse gets which property as part of their divorce settlement agreement. According to the Investment Company Institute in their report, *The U.S. Retirement Market, First Quarter 2018*: "Retirement assets accounted for 34% of all household financial assets...." That means a significant portion of the 40% of married couples who divorce are likely to own retirement accounts and include these accounts in their settlement agreements.

For those who include IRAs as part of their divorce settlement, care must be taken to ensure that the awarded amounts are transferred properly to the recipient spouse. This process is referred to as a *'transfer incident to divorce.' And, if the process is not handled properly, it could have negative tax and penalty consequences for the affected spouses/former spouses*.

The top 5 items for your checklist

To ensure that you cover the applicable points with clients, consider creating a checklist for handling retirement accounts under a divorce settlement. The following are some of the items that you should add to your checklist.

1. A divorce decree is required

Generally, when one spouse gives another IRA assets as part of a divorce settlement, the amount is transferred to the receiving spouse's IRA *tax-free*, where it remains until the receiving spouse takes distributions from the amount. In order for this tax-free transfer to occur, the amount must be awarded to the receiving spouse under a divorce decree or legal separation agreement (divorce decree).

Once the amount is credited to the receiving spouse's IRA, then the IRA "owner's" rules apply to the receiving spouse, who would be responsible for including any distribution from the amount in his income, and paying any income tax due.

2. Private separation agreements do not qualify

If the intent is to have the receiving spouse receive the assets in an IRA, the arrangement must not be made under a private separation agreement.

Amounts given to the receiving spouse under a private separate agreement would *not* be considered *incident to a decree of divorce*, thus making the transaction ineligible to be treated as a tax-free transfer between the spouses' IRAs. Instead, the results will include the following, all of which would not apply if the amount were awarded under a divorce decree:

- The spouse giving up the assets would be required to treat the amount as a distribution to her, for the year in which the amount was taken from her IRA.
- The spouse giving up the assets would be responsible for paying any income tax due on the distribution, including the 10% early distribution penalty if applicable. And,
- The receiving spouse would not be permitted to deposit the amount in an IRA as a nonreportable transfer.

Timing is important.These results would be the same if the amount is transferred to the former spouse, before the execution of the divorce decree. (For more explanation see this article reviewing a recent case.)

3. Explicit language in the divorce decree is helpful

The divorce decree should identify the IRA by account number and IRA custodian, which is especially important if the individual owns more than one IRA, and different types of IRAs (Roth and traditional). It should also:

- Clearly explain how the assets should be moved/given to the receiving spouse. For instance, it should include language to the effect of: **"The assets should be *transferred* to _____, who will be responsible for including any distribution of that amount in income."**
- State the dollar amount or percentage of the account that should be transferred to the receiving spouse. And,
- In cases where a dollar amount is awarded, state whether such amount should be adjusted for earnings/losses.

These are not regulatory requirements. However, ensuring that these provisions are included can lessen the chances of the IRA custodian refusing to honor the request due to the language being unclear.

4. Instructions to IRA custodian should be clear

The IRA custodians should be provided with a copy of the divorce decree. It is acceptable to redact any sections that are irrelevant to the IRA transfer, if the spouses so choose.

In addition, the custodian's documentation requirements should be met. For instance, they might require that both spouses sign transfer instructions, clearly specifying how much should be transferred between the IRAs. If the amount awarded is less than 100% of the IRA, a custodian might require a list of the assets that should be transferred, including the number of shares. This is often done to avoid the possibility of one spouse crying foul over receiving one share less than he/she should have received.

Caution: If this transaction is not processed correctly, the spouse giving up the assets will find that she is on the receiving end of a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (Form 1099-R), requiring her to treat the amount as a distribution. To prevent this from happening, ensure that any paperwork provided to the custodian provides a request for a "transfer" and not a distribution.

Transfer method: *According to IRS Publication 590A, there are two commonly used methods of transferring the IRA to the receiving spouse. One is changing the name on the IRA from that of the original owner to the receiving spouse. However, I am not aware of any custodian that uses this method. Instead, custodians typically use the second method, which is to transfer the assets from one spouse's IRA to the other spouse's IRA.*

5. Basis should be tracked

The balance of an IRA will include basis, if the IRA owner made any nondeductible IRA contributions or rolled over any after-tax amounts from an employer sponsored retirement plan to the IRA. For this purpose, all of an individual's traditional, SEP and SIMPLE IRAs are aggregated and treated as one.

A distribution of basis amounts is nontaxable; and, in order to ensure nontaxability, IRS Form 8606: Nondeductible IRAs, must be filed to report nondeductible contributions to the IRA. Form 8606 must also be filed for any distribution/Roth conversion from the IRA, as long as the IRA balance includes any basis amount.

When an IRA is split under a divorce decree and the split results in a change of basis, both spouses must file Form 8606 to show their new basis amounts. So as to ensure that the IRS understands the reason for the change, a letter of explanation should be attached to the Form 8606, explaining the source of the basis amount and the reason for the change. This should also be done for Roth IRAs.

Employer-sponsored plans

Additional rules apply to employer-sponsored retirement plans.

The rules discussed above apply to IRAs. While some of the rules discussed also apply to employer-sponsored retirement plans—such as 401(k)s, pension and 403(b) plans, these accounts are subject to additional rules that lay beyond the scope of this article. Clients should check with their plan administrators to determine the requirements that apply to their employer plan accounts.

Be sure of the intent

As explained above, these rules apply when the intent is to transfer IRA assets between the spouses. There are cases wherein an IRA owner might need to make a payment to her spouse, with funds that have already been taxed and held outside of an IRA. Such a spouse could take those funds from any account, including an IRA if it makes good financial/tax sense to do so. In that case, the IRA owner would take a regular distribution from the IRA, and deliver the amount to the receiving spouse as non-IRA funds.

> **Example**
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> Under the terms of John and Mary's Divorce decree, Mary is required to give John $100,000 of non-IRA/non-Retirement account assets.
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> With the help of her CPA, Mary determined that it would make better tax sense to take a distribution from her traditional IRA than to liquidate the securities in her regular brokerage account.
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> She deposited the $100,000 from her IRA distribution to her regular checking account, and subsequently drew a check on that account to John.

> The 1099-R will be issued to Mary, who must include the amount on her tax return as ordinary income for the year in which the distribution occurred.

Under such a scenario, the transfer incident to divorce and applicable rules would not apply.

All hands on deck

A client's attorney is responsible for ironing out the settlement details and getting the divorce decree in order. Advisors can assist with ensuring that any transfer incident to divorce is executed in compliance with applicable requirements; to this end, the IRA custodian should be consulted to ensure that their operational and compliance requirements are met.

Getting interested parties involved with the execution of transfers-due-to-divorce can prevent complications, to what might already be a difficult period in your client's lives.

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