Beware Tax Trap When Transferring IRA to Spouse Pursuant to Divorce Decree

By Myron Kove and James M. Kosakow

In a recent case, the Tax Court held that a withdrawal from an IRA (individual retirement account) was a taxable event even though the IRA owner claimed that it was a nontaxable transfer pursuant to a divorce decree. In *Jones*, TC Memo 2000-219, in connection with a pending divorce, Mr. Jones closed his IRA account in May 1994 and endorsed the check over to his wife on June 12, 1994. The wife never deposited the check into an IRA account. On June 14, 1994, the parties executed a stipulation for judgment and Marital Settlement Agreement, which awarded the IRA to the wife.

Transfer of IRA Incident to a Divorce Not Taxable

Generally, amounts distributed from an IRA incident to a divorce are not taxable, provided two conditions are satisfied: (1) there is a transfer of the interest from the IRA owner, and (2) the transfer is pursuant to an actual divorce or separation instrument.[1] The issue raised by the IRS and decided against the IRA owner was that the withdrawal and endorsement of the check was not a transfer of the IRA.

Withdrawal and Endorsement Are Not a Transfer

The court held that the withdrawal and endorsement was not a transfer of Mr. Jones' interest in the IRA because his interest was extinguished at the time he withdrew the funds. The court stated that § 408(d)(6) does not allow an IRA participant to allocate to a nonparticipant spouse the tax burden of an actual distribution. Therefore, the terminated IRA was subject to income tax and the 10% early withdrawal penalty since Mr. Jones was under age 59½ at the time of the withdrawal.

Practice Pointer

The parties should have effected the transfer in a trustee-to-trustee transfer. If Mrs. Jones thereafter withdraws the funds, she is taxed, not Mr. Jones.

Endnote

1. Code § 408(d)(6).

Myron Kove and James M. Kosakow are members of the firm of KOVE & KOSAKOW, LLC, with offices in New York City and Westport, Connecticut. The firm's Web site is www.kovkos.com.