

STRATEGIES FOR A SURVIVING SPOUSE DESIGNATED AS BENEFICIARY OF A DECEDENT'S IRAS

Surviving spouses who are sole designated beneficiaries of a decedent's IRAs have two favorable options with respect to those IRAs other beneficiaries do not. This Hot Topic:

- 1) spells out the two options;
- 2) explains the advantages of those options;
- 3) explains a way to avoid a disadvantage of those options which applies to young surviving spouses who believe they may need to withdraw money from the decedent's IRAs before they attain age 59 ½; and
- 4) explains how to make the election involved in one of the two options.

Observation: For the sake of simplicity, I have assumed the decedent is a male and the surviving spouse is a female.

The special options available to surviving spouses. Like any other beneficiary of a decedent's IRA, a surviving spouse can receive a distribution as a beneficiary from the decedent's IRAs. But, a surviving spouse who is the sole designated beneficiary of the decedent's IRA has two special options which are not available to other beneficiaries: Such a spouse may:

- (1) elect to treat the decedent's IRA as the surviving spouse's own IRA ("election"); or
- (2) roll over the decedent's IRA into an IRA established in the spouse's own name ("spousal rollover"). With either of these special options, the surviving spouse is treated as if she had funded the IRA.

Observation: While the above election is clearly spelled out in the regulations, the spousal rollover needs a bit of an explanation. The Internal Revenue Code (Code) provides that distributions from an "inherited IRA" do not qualify for rollover treatment. But it also states that an IRA inherited by a surviving spouse isn't an inherited IRA. Thus, by negative implication, a spouse may roll over distributions to her from her decedent spouse's IRA as if that IRA were her own IRA.

Advantages of these special options. There are three major advantages to making the spousal rollover or election:

- (1) *The required beginning date (RBD) may be deferred.* With the rollover or election, the RBD for distributions is April 1 of the year following the year in which the surviving spouse attains age 70 ½.

By comparison, if the IRA remains in the decedent's name,

- and he died before lifetime distributions commenced, then lifetime distributions to the spouse generally must begin by the later of: (1) December 31 of the year following the year in which the decedent died, or (2) December 31 of the year in which the decedent would have attained age 70 ½ had he lived.
- and he died *after* required distributions began, and the rollover or election isn't made, payouts to the spouse-beneficiary must begin in the year following the IRA owner's death.

Thus, a surviving spouse who is younger than the decedent can defer the start of the payout period by making the rollover or electing to treat the decedent's IRA as her own.

- (2) *More favorable RMD rules during the life of the surviving spouse.* If, after the death of an IRA owner, the IRA beneficiary either doesn't qualify for the special options or doesn't use either of the special options, her required minimum distributions (RMDs) are based on her single life expectancy.

If there is a spousal rollover or an election, the receiving IRA is treated as if the surviving spouse had funded it. In that case, the spouse can take RMDs using the favorable "Uniform Lifetime Table," which is based on the joint life expectancy of the spouse and a hypothetical 10-years-younger beneficiary.

Note: A separate lifetime distribution table applies if the spouse was more than ten years younger than the IRA owner.

- (3) *Surviving spouse's ability to name her own beneficiaries and thus keep IRA going longer after her death.* By making the rollover or election, the surviving spouse can name her own beneficiaries for the IRA and give the IRA a longer lifespan if the spouse names children, grandchildren or other younger family members or friends as beneficiaries. Thus, if a rollover or election is made and:
- *The surviving spouse dies on or after her RBD* (usually April 1 of the calendar year following the calendar year in which she reaches age 70 ½) and designated a nonspouse beneficiary for the account, the IRA balance is paid out over the longer of:
 - (a) the remaining life expectancy of the designated beneficiary, using the beneficiary's attained age in the year immediately following the year of the IRA owner's death; or
 - (b) the remaining life expectancy of the surviving spouse, using her attained age in the year of his death.
 - *The surviving spouse dies before her RBD*, and she designated a nonspouse beneficiary for the account, one of the following two payout methods apply depending on the terms of the IRA:

- (a) Under the five-year method in the Code, the surviving spouse's entire account must be distributed no later than December 31 of the calendar year containing the fifth anniversary of his death;
- (b) Under the life expectancy method in the Code, annual RMDs are made over the beneficiary's life or over a period not extending beyond his or her life expectancy, and must begin no later than December 31 of the calendar year immediately following the calendar year in which the surviving spouse died.

By contrast, if the rollover or election isn't made, the surviving spouse doesn't have the opportunity to name other beneficiaries for the account. As a result, when the surviving spouse dies, the balance remaining in the decedent's IRA will be distributed over what remains of the payout period that applied when the surviving spouse began receiving required minimum distributions (RMDs) from the decedent's account. Often, this payout period will be the surviving spouse's life expectancy. Thus, if the rollover or election isn't made, the tax-deferred IRA will generally have a shorter lifespan than if the rollover or election is made.

Potential problem for certain young surviving spouses. If the surviving spouse is younger than age 59 ½, the rollover or election could have a significant disadvantage: once the spouse elects to roll over the decedent's IRA into her own IRA, pre-age-59 ½ withdrawals from that IRA generally will be subject to the 10% penalty tax on top of regular income taxes unless an exception applies (e.g., withdrawals in the form of substantially equal periodic payments). For an illustration of this potential tax trap, see Sears, TC Memo 2010-146TC Memo 2010-146, where a surviving spouse got hit with a \$6,000-plus penalty for making premature withdrawals from an IRA containing funds rolled over from her deceased husband's IRA.

However, under the Code, distributions made to a beneficiary (or estate) on or after the death of the IRA owner are excepted from the 10% penalty tax.

IRA payout strategy to avoid this problem. The surviving spouse should keep the entire IRA balance in the decedent's name until the spouse attains age 59 ½. This way, any withdrawals before that age will be penalty-tax-free. When the spouse attains age 59 ½, she can roll over the IRA into an IRA in her own name or make the election. The regulations make it clear a surviving spouse beneficiary's election can be made "any time after the individual's date of death."

Observation: The importance of the last sentence above is that the fact that the surviving spouse takes distributions from the decedent's IRA before the survivor attains age 59 ½ won't affect her ability to make a rollover or election after age 59 ½.

How to make the election to treat the decedent's IRA as the surviving spouse's IRA. The regulations provide several ways to make the election. The surviving spouse can make the election in an affirmative manner by redesignating the account as an account in her name as an IRA owner as opposed to as a beneficiary.

Or, the election can be made automatically by the surviving spouse taking actions which are inconsistent with beneficiary status. This can happen in one of two ways: the surviving spouse can make a contribution to the account (other than a rollover contribution of other benefits

inherited from the decedent), or the surviving spouse can fail to make an RMD that would be required to be made to her as a beneficiary.

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