

STRATEGIES FOR SURVIVING SPOUSES DESIGNATED AS BENEFICIARIES OF DECEDENT'S IRAS

Beneficiaries of IRAs (or qualified plans) are well advised to get expert tax advice before taking action on their inheritance. As the Tax Court's recent *Gee* decision illustrates, that is particularly true for spousal beneficiaries, who have more tax saving choices (and potential pitfalls) than other beneficiaries. In *Gee*, a spouse-beneficiary who rolled over her deceased husband's IRA into her own IRA and then took a distribution wound up paying a penalty tax of \$97,800 which she easily could have avoided without diminishing any of her other tax saving options. This *Hot Topic* explains the tax-saving avenues open to individuals who inherit IRAs from their deceased spouses.

■ **Unique choices**

If a taxpayer dies before exhausting the balance in his IRA and his spouse is the sole designated beneficiary of the account, the spouse-beneficiary can simply leave the account as-is, may choose to roll over the decedent's IRA into her own IRA or elect to treat the IRA as her own for all purposes, including the rules for pre-age-59 ½ withdrawals. The rollover or election is not available to non-spouse beneficiaries.

Whether the rollover or election should be made by the surviving spouse (and when) depends on the surviving spouse's age.

■ **Surviving spouse age 59 ½ or older**

The surviving spouse-beneficiary of an IRA who is age 59 ½ or older has much to gain and little to lose by making this choice:

- By making the rollover or election, the surviving spouse can name her own beneficiaries for the IRA and thus give the IRA a longer life-span. If the surviving spouse dies before the IRA is depleted, the balance will be paid over her beneficiary's life expectancy. By contrast, if the rollover or election isn't made, the balance remaining in the IRA when the surviving spouse dies will be paid over what remains of the surviving spouse's life expectancy.
- After the rollover or election, the receiving IRA is treated as if the surviving spouse had funded it. That means the surviving spouse can compute RMDs (required minimum distributions) using the Uniform Lifetime Table. For IRA owners, the Uniform Lifetime Table carries longer life expectancies and, therefore, results in smaller annual RMDs and a longer payout period than the Single Life Table used to compute RMDs paid to a surviving spouse as beneficiary of (rather than as the owner of) the decedent's IRA.

- With the rollover or election, the required beginning date (RBD) for distributions is April 1st of the year following the year in which the surviving spouse attains age 70 ½. By contrast, if the IRA remains in the decedent's name, he died before his RBD and the IRA permits lifetime distributions to the beneficiary, minimum distributions must begin by the later of:
 1. December 31st of the year following the year in which the decedent died, or
 2. December 31st of the year in which the decedent would have attained age 70 ½ had he or she lived.

Thus, a surviving spouse who is younger than the decedent can arrange for longer deferral by making the rollover or electing to treat the decedent's IRA as her own.

Observation

The Uniform Lifetime Table produces smaller annual payouts and a longer-lived tax shelter for a designated spouse beneficiary even if he or she is exactly the same age as the decedent.

Illustration

When an IRA owner dies at age 69 in 2005, the designated beneficiary of the account is his surviving spouse, also age 69. The IRA's balance as of December 31, 2004, was \$500,000. The surviving spouse attains age 70 ½ and also turns age 71 in 2006, which is the first distribution calendar year for RMDs.

- < If the surviving spouse elects to treat the decedent's IRA as her own, the RMD for 2006 is \$18,868 ($\$500,000 \div 26.5$, which is the Uniform Lifetime Table life expectancy for a 71 year-old).
- < If the surviving spouse does not elect to treat the decedent's IRA as her own, the RMD for 2006 is \$30,675 ($\$500,000 \div 16.3$, which is the Single Life Table life expectancy for a 71 year-old).

■ Surviving spouse much younger than 59 ½

If the surviving-spouse beneficiary is much younger than age 59 ½, the spousal rollover or election to treat the decedent's IRA as the surviving spouse's IRA could have a significant disadvantage: Once the rollover or election is made, pre-age-59 ½ withdrawals from that IRA generally will be subject to the 10% penalty tax on top of regular income taxes. By contrast, if the spousal rollover or election is not made, pre-age-59 ½ withdrawals from the decedent's IRAs are not subject to the penalty tax. Distributions made to a beneficiary (or estate) on or after the death of the IRA owner are excepted from the 10% penalty tax. Thus, if the surviving spouse knows he or she will have to tap the decedent's retirement funds before attaining age 59 ½, the rollover or election will result in unnecessary tax erosion.

Observation

Pre-age-59 ½ withdrawals are free of the penalty tax if they don't exceed qualified higher education expenses during the withdrawal year. To the extent the surviving spouse plans to use pre-age-59 ½ payouts from the decedent's IRA to pay for college expenses, there would be no disadvantage to rolling over the decedent's IRA into his or her own IRA.

Recommendation

A young surviving spouse who may need to tap the funds before he or she attains age 59 ½ should keep the entire IRA balance in the decedent's name until the spouse attains that age. This way, any withdrawals from the IRA before that age will be penalty-free. When the spouse attains age 59 ½, he or she can roll over the IRA into an IRA in the spouse's own name.

A surviving spouse beneficiary's election to treat the decedent's IRA as her own may be made any time after the account owner's death.

Observation

Thus, if the IRA owner died before RMDs began (and as a result there was no minimum payout for the year of death), the surviving spouse can make the election in the year of death or at any time after that year, even if the survivor previously withdrew funds from it.

■ **Older surviving spouse beneficiary**

If the surviving spouse-beneficiary is substantially older than the deceased IRA owner, it will be difficult to choose between making and skipping the election.

- Making the election will accelerate the required beginning date for distributions. For example, assume Anne designated her husband, Al, as the beneficiary of her IRA. Al is exactly ten years older than his wife. Anne dies this year at age 61. If he makes the election, Al will have to begin taking RMDs immediately. If Al leaves the IRA in Anne's name, payouts from it can be deferred for another ten years.
- If the election is not made, the surviving spouse won't be able to name his or her own beneficiaries for the IRA, and thereby defer payouts after the surviving spouse's death over the beneficiary's Single Life Table life expectancy.

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