IRA Strategies for Surviving Spouses

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Inherited IRA Strategies for Surviving Spouses

When a spouse inherits an IRA (Traditional or Roth) from their deceased husband or wife, there are several planning strategies that the surviving spouse can follow in order to meet their specific needs. Spouses who are designated as the sole beneficiary of the IRA have special options available to them compared to the options available for non-spousal beneficiaries. Choosing the correct option for the surviving spouse's circumstances can be a powerful tool for minimizing IRD, preventing IRS penalties, ensuring the preservation of assets and possibly maximizing the special tax attributes of the account. Each strategy has advantages and disadvantages, and with careful tax and financial planning, the surviving spouse can choose the strategy that best meets their specific needs.

Traditional IRA

Option 1 - Receive a Distribution for the Amount of the IRA

This option is available to all beneficiaries of IRA's, whether the beneficiary is the spouse of the decedent or not. Distributions made to a beneficiary from the decedent's IRA after the decedent's death are exempt from the Code Sec. 72(t) 10% early withdrawal penalty.

Pros: Receive lump sum of money immediately; avoid 10% early withdrawal penalty. If prior nondeductible contributions were made to the IRA, the beneficiary receives that carryover basis in determining his or her taxable distributions.

Cons: The distribution is taxable, and depending on the size of the distribution, could raise the beneficiary into a higher tax bracket in the year of the distribution.

Option 2 - Elect to treat the IRA as the surviving spouse's own IRA

According to Reg. Sec. 1.408-8, Q&A 5(a), surviving spouses can make an election to treat the decedent's IRA as if it were their own. This election can be made by the spouse retitling the inherited account into his or her own name as the IRA owner, or it will be made automatically if the spouse begins to contribute money into the account, or take other actions that are consistent with being the owner of the IRA. With this option, the existing monies in the inherited IRA are treated as if the surviving spouse contributed it all themselves.

Pros: The beginning date for required minimum distributions will be deferred until the spouse turns 70 ½ (if the spouse is younger than the decedent, this may be beneficial); the spouse can use the Uniform Lifetime Table to determine the required minimum distributions rather than the less favorable single life expectancy table; the spouse can name his or her own beneficiaries and increase the overall lifespan of the IRA. If prior nondeductible contributions were made to the IRA, the beneficiary receives that carryover basis.

Cons: Unless a 72(t) exception is met, the spouse will be subject to tax and the 10% penalty on all distributions taken before he or she turns 59 ½. Additionally, if the surviving spouse was older than the decedent, the beginning date for required minimum distributions would have been accelerated.

Option 3 - Roll-over funds to an IRA in surviving spouse's name

A surviving spouse can decide to roll-over the funds from the decedent's IRA into his or her own IRA. Similar to the election in Option 2, the funds in the roll-over IRA will be treated as the surviving spouse's own.

Pros: Same as Option 2 – Potentially more favorable rules for Required Minimum Distribution, including beginning date; ability to name own beneficiaries.

Cons: Same as Option 2 – Generally, tax and penalty will be due on any distributions taken before the spouse turns 59 ½.

Option 4 - Leave IRA in decedent's name until surviving spouse reaches 59 ½ years old

As previously stated, a significant 10% penalty is charged by the IRS for any distributions made before the owner of the IRA is 59 ½ years old. So for certain younger spouses, it may be best to not make the election or roll-over the funds until the spouse is old enough to avoid this penalty. According to Reg. Sec. 1.408-8, Q&A 5 (a), the election or roll-over can be made any time after the death of the decedent. As such, distributions from the decedent's IRA to a beneficiary are exempt from the 10% penalty under Code Sec. 72(t)(2)(A)(ii). So in this option, the spouse would be free to take any amount of distributions while the IRA is still in the decedent's name and only have to pay the income tax. The surviving spouse can then make an election or roll-over the funds to their own IRA once he or she is old enough to avoid this 10% penalty.

Pros: Avoid 10% penalty on pre- 59 ½ withdrawals; receive benefits of election/roll-over after age 59 ½.

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Cons: any lump-sum distributed while the IRA is in the decedent's name is subject to tax in the year of the distribution.

Other Traditional IRA Considerations

It is important to understand that if the surviving spouse chooses to treat the inherited IRA as their own or if they choose to rollover the funds into their own account, the fair market value and any carryover basis from the inherited IRA will be included with any other traditional IRA they own directly. This is important for future distributions and could have a significant impact on the tax effect of making any future Roth IRA conversions. In particular, the backdoor Roth Contribution strategy could be jeopardized for the surviving spouse.

The backdoor Roth contribution strategy exists for clients who would otherwise be phased out, due to AGI thresholds, from making direct Roth IRA contributions. Instead, these clients typically make nondeductible contributions to a Traditional IRA and then convert the funds almost immediately to a Roth IRA. Since the contributions were nondeductible in the first place to the Traditional IRA, the Roth conversion generally has no tax impact. However, if the surviving spouse treats the inherited traditional IRA as their own account or rolls over the funds to their own IRA, a pro-rata portion of this Roth conversion may be deemed taxable.

Roth IRA Considerations

Qualified Distributions

Generally a non-spousal beneficiary of an inherited Roth IRA must (1) withdraw the entire balance within 5 years of the original owner's death or (2) begin withdraws, based upon the IRS life expectancy tables, by December 31st of the year after the original owner's death. Similar to Traditional IRAs, if the sole beneficiary of the inherited Roth IRA is the spouse of the decedent, he or she has the additional options to treat the Roth IRA as their own account or to rollover the inherited Roth funds into their own Roth IRA.

The primary planning attribute for Roth IRAs is that distributions may be tax free to the beneficiary and may also avoid the 10% penalty of Code Sec. 72(t) if they are deemed to be qualified distributions. In order for distributions from a Roth IRA to be considered qualified, they must not be made within the five-year period that starts on the first calendar day of the tax year that the taxpayer made contributions to the Roth account. From there, in order for distributions from a Roth account to be treated as qualified, they must be:

- made after obtaining the age of 59 ½,
- made to a beneficiary (spouse or non-spouse) after the death of the original Roth IRA owner,
- made due to disability, or
- a special purpose distribution specifically exempted in the IRC (such as a distribution for a first-time home purchase).

Given the above, spouses who inherit Roth IRAs can generally receive tax free distributions from those accounts provided that the five-year period is met. If the spousal beneficiary of an inherited Roth IRA is giving consideration to converting or treating that inherited Roth IRA as their own (so to avoid the typical distribution requirements of inherited Roth IRAs) he or she should be aware of some other potential issues.

It should be noted that for purposes of determining the five-year period, the beneficiary of the inherited Roth IRA should generally use the decedent's holding period in determining whether that five-year threshold was met for qualifying distributions. This carry-over period is applicable to the inherited Roth IRA only and as such if the beneficiary independently funded a Roth IRA, the accounts may have separate five-year periods for determining qualified distributions. According to Reg. Sec. 1.408A-6, Q&A 7(b), surviving spouses who take advantage of the opportunity to treat the inherited Roth IRA as their own account or choose to rollover the inherited Roth funds into their own account, may use the five-year period that permits the earliest qualified distribution date. That is to say, the surviving spouse can use the earliest beginning date from either their separate Roth account or from the decedent's Roth IRA for this five-year period test.

Other Roth IRA Considerations

If a nonqualified distribution is made from an inherited Roth IRA to a surviving spouse, it is important to understand the make-up of the inherited Roth IRA. Certain ordering rules exist and the applicability of income taxes and/or the 10% penalty on a nonqualified distribution vary if the funds represent normal contributions, Roth conversions, or earnings. Under the IRC, distributions are first ordered against normal contributions to the account, then conversion contributions (first in, first out method), and lastly earnings. As such the tax basis in the inherited Roth account is allowed to be recouped before earnings are treated as being distributed to the surviving spouse. These earnings may be subject to income tax and the Code Sec. 72(t) penalty if the distributions are deemed to be nonqualified.

With respect to the 10% early distribution penalty under Code

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Sec. 72(t), there is an important planning point to be aware of as it relates to conversion contributions. The issue here is that Roth distributions ordered against conversions (based upon the previously discussed ordering rules) have a separate five-year period test than distributions that represent typical Roth contributions. The five-year period used in determining if a distribution representing a conversion contribution is subject to the 10% penalty, begins on the first day of the tax year in which the conversion took place. As such, this may be later than the five-year period from which the Roth IRA was funded by typical contributions. This effectively prevents a taxpayer from converting traditional IRA funds to an existing Roth IRA and taking penalty free distributions from the converted funds within five years of said conversion.

Conclusion

The rules for inherited traditional and Roth IRAs are complicated and far reaching, especially for a surviving spouse. As such, due considerations should be made by the practitioners advising such clients and they should look to insulate their clients by ensuring that their entire advisement team, from the attorney, to the accountant, to the IRA custodian understand the client's objectives and the steps for implementation. It is crucial that a surviving spouse also understands the available options and chooses the strategy that best suits their needs and circumstances. The potential IRS penalties and income tax imposed on certain withdrawals can be significant, and may be avoided with the right amount of planning between the surviving spouse and their team of advisors.

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