BENEFICIARY DESIGNATIONS: WHAT TO DO WITH A SPOUSE'S IRA

By David J. Drucker, MBA, CFP

One of the most confusing areas of financial planning concerns IRA distributions. Yet, for many couples, the decision isn't planned for but rather creeps up suddenly when minimum distributions are required to begin. But with a spouse's IRA, you may get a second chance.

One of the most highly technical and challenging areas of financial planning is making the best decision about distributions from individual retirement accounts (IRAs) and other retirement plans. The likelihood of making a mistake, or at least failing to make the optimal decision, is probably greater here than in almost any other area of planning. And establishing the correct beneficiary designation is an integral part of this decision-making process.

Yet for many couples, this decision isn't planned for; instead it creeps up suddenly when they are required to take their first minimum distribution.

As with so many things, the IRS provides a number of alternatives for computing the minimum required distribution, and, therefore, how much tax must be paid. This provides flexibility and ways to save on taxes for the well-advised, but it also adds complexity and tax traps for the unenlightened. With proper planning, you can learn how to defer the payment of these taxes as long as possible; needless to say, the later you pay, the more your own money can grow, both on a before- and aftertax basis.

DEFAULT DECISIONS

What are some of the traps that people fall into? Probably the worst and most common is the result of inaction until minimum distributions are required. Typically, at this point, a combination of two defaults will occur—the first is the default of the IRA or plan to using the recalculation method of determining the IRA owner's minimum required distribution; the second default is the IRA owner's own failure to designate a beneficiary, which causes his estate to be his default designation.

The recalculation method, in and of itself, can be a good thing—it guarantees that you will not run out of income during your lifetime. To determine your minimum distribution using the recalculation method, you take your outstanding IRA balance and divide it by the appropriate life expectancy factor; under the recalculation method, you can revise your life expectancy factor each year to reflect your life expectancy at your current age (or the life expectancy of you and your beneficiary), ensuring that you will never be forced to distribute the entire IRA within your lifetime. (The alternate method is to use your life expectancy in the first year and reduce it by one in each subsequent year.) The problem with the recalculation method, however, is that without a living, breathing designated beneficiary, the mechanics of the recalculation method come to a grinding halt at your death—since there is no remaining life expectancy over which to calculate the further deferral of the distributions, they are all accelerated in the year following the IRA owner's death, sometimes with disastrous results.

As an example, let's take a retired couple for whom the husband's IRA

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represents their primary source of retirement income, and let's say he was employed by a company with a defined-contribution plan in which he had accumulated $800,000. At age 70 he retired, rolled this balance to an IRA with no named beneficiary, and began taking his minimum required distribution, which matched the amount of funds he and his wife needed to live on. However, neither he nor his wife understood that the amount distributed to them in his first year of retirement, $50,000, was based upon the plan's default method of determining minimum distributions, the single life recalculation method: $800,000 divided by a factor of 16.0 in the first year, which is the single life expectancy of a 70-year-old according to Table V, IRS Reg. 1.72-9. After paying taxes at a 28% rate (assuming they live in Florida, where there are no state taxes), they net $36,000.

The following year, even after the distribution, the portfolio grew to $825,000 and the new single life expectancy factor of 15.3 (for a 71-year-old) gave the couple an income of $53,922, or $38,824 after taxes. Not bad—inflation-protected income *and* their asset base was growing, not declining.

However, on December 30 of that year, the husband died. Because he had defaulted to a single-life recalculation method of determining the minimum required distribution and because his IRA beneficiary was his estate, the wife was required to take distribution of his *entire* IRA in the following year.

This problem is sometimes referred to as qualified plan "meltdown."

Let's see what happens when she does that. By the last day of the required distribution, the IRA is worth $850,000; the ordinary income tax on that amount is about $310,000. Whereas the couple was paying tax on each annual IRA distribution at the 28% rate prior to the husband's death, the $310,000 represents a blended rate of 36.5% because approximately $570,000 of the $850,000 is being taxed at the highest federal tax rate of 39.6%.

With the IRA completely distributed, the wife is now free to invest and spend this sum of money as she pleases. Let's assume that she continues to consume principal and interest along the same single-life schedule her husband was using while alive. In the year following his death, she would consume the aftertax IRA proceeds of $540,000 divided by 14.6 (her life expectancy), or $36,986. Had he lived, they would have taken an IRA distribution of $850,000 divided by 14.6 less 28% in taxes, or $41,918. By having to pay accelerated taxes on the IRA at the highest tax rate, the wife is out almost $5,000 per year in net income.

MORE DEFAULT TRAPS

Another trap that plan owners commonly fall into is one of designating the spouse as beneficiary and defaulting to a joint-life recalculation method of determining minimum required distributions. Of course, this would have been an improvement over the situation described earlier, but it is still not necessarily the best way to go. It is particularly harmful when *both* the husband and wife do this. They naturally assume they should make each other the beneficiary of their plans, but they make no specific election as to their intended method of calculating minimum required distributions. In the absence of an election, many plans default to recalculation of joint-life expectancies.

For example, assume the IRA owners, husband and wife, are each 72 and have $500,000 in each of their plans. They also have two children, twins age 45, who are not designated as either primary or contingent beneficiaries. This year they distribute a total of $52,910 based upon a joint-life factor of 18.9. Next year, with the IRAs worth a total of $1,100,000, they distribute $60,773 based upon a joint-life factor of 18.1, and so on. The problem is similar to that of the prior case—namely, that any inheritors will be forced to accelerate the payout and, therefore, the taxes due on the IRA balances. The only difference is that the "meltdown" occurs upon the death of the second spouse.

First, the surviving spouse (let's say the wife) has this experience. While she doesn't have to take a full distribution since she can roll her husband's IRA to her own, she now has only her single-life factor to rely on for calculating distributions. If he dies at 73, then the following year she must use a single-life factor of 13.2 instead of the 17.3 factor they would have used jointly. Then, in the year following her death, the children must accelerate the payout and taxation of her entire IRA, including the amount she inherited from her husband and rolled into her own IRA.

However, the wife has several options upon the death of her husband that could alter the consequences. Since she is the second to die, the meltdown will inevitably occur with her *own* IRA—once minimum required distributions start on her plan, the calculation method and the consequences at death are irreversible. But she has two options that she can take with her husband's money by virtue of being both his beneficiary and his spouse. She may either roll his IRA into hers, in which case it takes on the same constraints already applicable to her own, or she may roll it to a separate "spousal" IRA. By doing the latter, she is free to designate a new beneficiary—for example, her children—and thereby prolong the distributions and lessen the taxes on at least that portion of the family's qualified plan assets.

THE SECOND IRA

This leads to a typical problem many retired couples run into:

coordinating a spouse's IRA with an IRA in which decisions have already been made since minimum required distributions have already started.

The situation I was recently confronted with involved a husband who was four years older than his wife. His combined IRAs and other qualified plans were worth about $1.2 million while hers were worth around $500,000. He had already taken his first minimum required distribution based upon joint-life recalculation with his wife as the sole beneficiary of his plans.

The wife had just turned 71 and was now ready to designate IRA beneficiaries and elect her own minimum required distribution calculation method.

The problem is that the husband owns 70% of the family's qualified plan assets and his minimum required distribution is irrevocably set. He has elected joint-life recalculation. If he dies first, his wife can roll his plan balances to her IRA and/or a new IRA with whatever beneficiary designation and minimum required distribution calculation method she desires. However, if he survives his wife, then his plan money is taxed in its entirety in the year following his death. We've already seen how that can force his heirs to pay more income tax than is necessary. And that is the outcome the couple is trying to avoid by having the wife elect a compensating minimum required distribution methodology.

What should she do?

Here's where it gets complicated, because there are so many possible combinations of events. First, we have two possible orders of death (husband first, wife second; wife first, husband second). Next, the wife has three or more beneficiary designation possibilities. And finally, she also has at least three possible minimum required distribution calculation methodologies to choose from.

Where should she start? Let's start with the options that she can eliminate immediately.

First, she should eliminate one of her minimum required distribution calculation choices—joint-life recalculation with her husband, since we've already seen how this can undermine a couple's best intentions.

That leaves two other methods of calculating minimum distributions—the term-certain method or the "hybrid" method of calculating minimum required distributions.

Term-certain is the method whereby the wife would begin distributing from her IRA based upon her life alone, or her life and that of her beneficiary; she would use the appropriate factor in the first year of distribution from the appropriate IRS table, and in every subsequent year she would reduce that number by one. Her changing life expectancy would have no effect on this.

The advantage to this approach is that the term-certain will outlive the owner if she dies before the end of her actuarial life expectancy—the IRA owner's balance can then continue to be distributed according to the original term until that term elapses.

The hybrid method of calculating minimum required distributions is a combination of recalculation and term-certain. Typically, the IRA owner will select recalculation for himself or herself, and a term-certain calculation will be applied to the spouse's life. [For more on this method, see Question 2 in "Minimum Distributions and Beneficiary Designations," by Clark Blackman and Ellen Boling, August 1998 *AAII Journal*.] This ensures that, if the IRA owner survives his spouse, he will be able to spread his IRA over his lifetime. Also, the life of the deceased beneficiary continues to positively influence the calculation of IRA owner-required distributions as long as the remaining term certain period is greater than zero. On the other hand, if the IRA owner dies before the beneficiary, the spouse can roll the proceeds to a new IRA and designate a new beneficiary, as well as elect a new minimum required distribution calculation method.

The downsides of the hybrid method are that it is difficult to calculate and many IRA custodians don't understand it and may not act on directions to implement it. For these reasons, in this instance, the hybrid option was eliminated. In addition, it was felt that the eventual resolution gave a superior outcome. The hybrid method *could* be desirable, however, in a different set of circumstances.

The other options concern beneficiary designations. She can designate her husband, her children, or a non-family member as a beneficiary, and she can do so in varying combinations of primary and contingent beneficiaries as well. In this case, the wife eliminates a non-family member as a beneficiary, since they want the bulk of their assets to go to their children.

After eliminating the options above, she is left with naming either her husband or her children as beneficiaries and electing a term-certain method of calculating minimum required distributions.

In this situation, the husband's IRA money could (if he is second-to-die) become fully taxable after his death; the couple wants to compensate by making sure that the wife's IRA money, in a worst-case scenario, remains tax-deferred as long as possible.

The way to do that is to skip the husband entirely as beneficiary, name both children as beneficiaries on the wife's plans, and use their life expectancies in the minimum required distribution calculation.

What happens if the wife dies first and her husband doesn't get any of her IRA because it goes directly to the children? That is not a problem here because this couple's lifestyle is such that the husband can live quite comfortably on his own money. He doesn't need to inherit his wife's

TABLE 1. A SUMMARY OF SCENARIOS

	Husband and Wife Elect Joint-Life Recalculation With Each Other as Beneficiaries		Husband Elects Joint-Life and Wife as Beneficiary; Wife Elects Children as Beneficiaries	
	Husband Dies First ($)	Wife Dies First ($)	Husband Dies First ($)	Wife Dies First ($)
Present value of husband's distributions	394,116	537,678	394,116	464,056
Present value of wife's distributions	1,077,390	106,972	694,091	78,354
Present value of children's total aftertax IRA inheritance at 2nd death	407,278	722,855		709,708
Present value of children's aftertax distributions from IRA inherited from wife			1,127,771	567,259
Present value of all distributions and inheritances	1,878,783	1,367,505	2,215,977	1,819,378

Assumptions:

- Husband's plan balances total $1.2 million; wife's total $500,000
- Husband lives to age 80; wife lives to age 74 (if she dies first) or 86 (if she dies last)
- Children are twins age 45 and both live to age 85
- Investments earn 8% annually
- Blended tax rate on IRA in year following 2nd death: 45%; children's tax rate: 31%
- Discount rate for present value calculations is 5%.

money for his own welfare.

Another issue that must be considered is the size of the IRA assets likely to be inherited by her children at her death vis-a-vis the unified credit available to her. The unified credit rises to $650,000 in 1999, and ultimately to $1 million in 2006. Since the wife is 71 years old with a 15.5-year life expectancy (according to the IRS' Table V), and portions of the IRA will be distributed each year, it is probable that the balance will stay below $1 million (depending upon investment performance). If her IRA were, say, $750,000 or more, there is a good chance it would exceed $1 million by her death and a different strategy, such as leaving a portion to her husband using a joint-life term-certain minimum required distribution, might be preferable.

By naming her children as beneficiaries and using their life expectancies in the minimum required distribution calculation, the wife is forced to use the IRS' Minimum Distribution Incidental Benefit table to determine her minimum required distribution factor. This table is required for non-spousal beneficiaries whose ages fall short of the IRA owner's age by 10 years or more. The factor in the first year will be either 26.2 or 25.3, depending upon whether the wife is 70 or 71 on the last day of the year in which she turns 70½. However, in the year following her death, the children can revert to term-certain single-life factors based upon their actual ages. In many cases, this will result in distributions being taken over their entire lives from an asset that continues to grow. In other words, the wife has helped provide for the children's retirement as well as her own.

To summarize, let's see what now happens with each order of death. If the goal is to maximize the value of the IRAs for the children, then the husband dying first creates the more favorable scenario, and dying second, the less favorable scenario. If he dies second, the children must take his entire qualified plan balance, presently $1,200,000, in one year and pay taxes on it. They would also be taking the wife's IRA, presently $500,000, over their lifetimes.

However, if the husband dies first, the wife would likely want to roll his IRA into hers, with the children designated as beneficiaries, and they would then take distributions on the entire $1,700,000 (or what is left of it, which could be more or less) over their lifetimes. This is a far better outcome than if they were forced to take the husband's and wife's entire plan balances in the year following the death of the second to die, as shown in Table 1.

As we can see from Table 1, regardless of the order of death, the choice of the children as the wife's beneficiaries enhances quite significantly the value of the IRAs to the husband, wife, and children. While the benefits are substantially greater if the wife outlives her husband, either order of death results in an improvement in total values over both spouses using a joint-life recalculation minimum required distribution method and naming each other as beneficiaries.✦