Solving Widow's Tax Woes

By Mark Fried

If a decent portion of your retirement income comes from individual retirement accounts, your tax burden might suddenly skyrocket after your spouse dies.

My firm recently worked with a couple who noticed that upon either of them dying, the annual income tax liability for the surviving spouse rises to over $7,500 per year – about $6,000 more than they are paying now.

While they are both alive, they file tax returns jointly. This status gets some of the most lenient treatment in the entire tax code. But, when one dies, the survivor files as a single taxpayer. This is one of the harshest tax situations.

A decent portion of their income came from retirement plans. IRAs and other retirement vehicles, like 401(k)s and 403(b)s, can cause significant tax challenges for surviving spouses.

Their story illustrates a very common issue, and it may apply to you.

So what should you do about it? First, you need to find out what a tax return might look like for the surviving spouse. If you find out that you have this problem in the future, there is a really simple fix that normally isn't on your list of options.

You can withdraw some extra income out of your IRA or other retirement plan today, and each year thereafter, while you and your spouse are both alive and enjoying lower taxes. If you do this, your tax burden while you are both alive is higher, but that additional tax doesn't really affect your current lifestyle.

Then, take the after-tax amount of the distribution each year and use it to fund a life insurance policy on both your life and the life of your spouse. True, life insurance is more expensive for older folks, but surprisingly, due to increasing life expectancies, life insurance pricing dropped considerably in recent years. As a result, planning like this can be very effective.

When the first spouse passes away, the surviving spouse receives a big tax-free check from the life insurance company. He or she can use that check to convert the traditional IRAs to Roth IRAs. A Roth conversion requires you to pay tax on the appreciation of the assets in your retirement account. The survivor pays the tax from the life insurance proceeds.

Then all income the Roth IRAs generate after that is 100% tax-free. Another alternative: pull some additional income from the life insurance proceeds. The widow can even give the tax-toxic traditional IRA money to the kids, and live off of the life insurance proceeds if the policy is large enough.

Adding a large tax-free check to the list of assets that a surviving spouse has to work with can make a huge difference. For the surviving spouse, any additional income tax affects his or her lifestyle more than it does for a couple filing taxes jointly.

So take some time to look into the future for you or your spouse, and give this strategy a try if you find that the survivor can expect to face much higher taxes in widowhood. **LL**

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