



FEATURE: RETIREMENT BENEFITS

By **James Lange**

Optimizing IRAs and Retirement Plan Distributions

Can marriage make a difference in wealth?

In my article in the September 2014 issue of *Trusts & Estates*,¹ I discussed how marriage affects the Social Security benefits available to a couple addressing their retirement and estate-planning options. Let's expand on that idea and see what happens to retirement plans and individual retirement accounts when a couple marries. There can be significant advantages if your client leaves an IRA or retirement plan to his spouse, as opposed to his unmarried partner.

Table 1 vs. Table III

Traditionally, married couples have always enjoyed the security of knowing that they have the ability to extend the tax deferral of their deceased spouse's retirement accounts by doing a trustee-to-trustee transfer or rolling them into their own IRA. For example, if the beneficiary of an IRA or retirement plan is age 60, he's able to maintain his deceased spouse's retirement plan in a tax-deferred status until age 70½, at which point he'll be forced to begin required minimum distributions (RMDs)—even if his deceased spouse had already started withdrawing her RMDs. The surviving spouse is entitled to use the Internal Revenue Service's Table III—Uniform Lifetime Table²—when calculating his own RMD, which yields a longer life expectancy, lower RMDs and the maximum tax deferral possible.

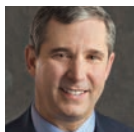
Unmarried beneficiaries don't enjoy the same privilege. In the absence of a legal marriage, the beneficiary of an IRA will receive a unique asset called an "inherited IRA." It's quite different from an IRA that one spouse inherits from another, because beneficiaries of an inher-

ited IRA can't roll the account into their own IRA. Beneficiaries of an inherited IRA are required to begin taking RMDs from the inherited IRA by Dec. 31 of the year after the owner's death, regardless of their own age. In the first year, they must use the IRS' Table I—Single Life Expectancy Table³—to calculate the RMDs. This data yields a shorter life expectancy and a higher RMD than that in Table III. For the non-spousal beneficiary each year thereafter, the divisor used in calculating the first RMD must be reduced by 1.0. These factors result in a significant acceleration of income taxes, which forces the non-spouse beneficiary to deplete his inherited IRA far more quickly than the spouse beneficiary.

Unmarried Couple

Assume Beverly is age 78 and not married to her partner, Sandra, whom she's named as the beneficiary of her IRA. Beverly is taking only the RMDs from her account based on Table III and, because of the longer life expectancy it allows, will still have almost \$500,000 in the IRA when she's 100 years old. If she lives to be 115 and takes only the RMD each year, she'll receive a total of \$2,177,076 from her IRA. (See "Beverly's IRA," p. 17.)

Assume Sandra is age 72 when Beverly dies at age 78, the day after Beverly takes her RMD for the year. As the owner of an inherited IRA, Sandra must use Table I to calculate the RMD she must take from Beverly's IRA. Sandra's first distribution has to be withdrawn by Dec. 31 of the year following Beverly's death and is calculated based on how old Sandra will be at the time the withdrawal has to be completed. Sandra will be 73 when she has to make the first withdrawal from Beverly's IRA, and Sandra's life expectancy, according to Table I, is 14.8 years. With dividends and gains, the value of the inherited IRA has grown to \$1 million again, so Sandra's first RMD will be \$67,568. Because of the shortened life expectancy of Table I, Sandra must

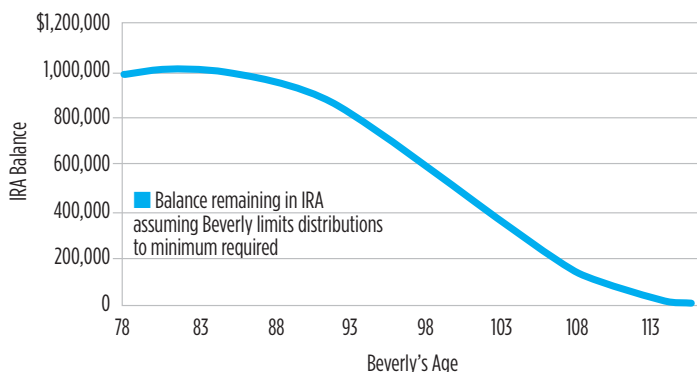


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Beverly's IRA

Remaining balance if she only takes minimum distributions



— James Lange

withdraw all of the money from Beverly's IRA by the time Sandra reaches age 87. The accelerated distribution rate caused by using Table I also reduces the total amount of distributions from the Beverly's IRA from \$2,177,076 to \$1,542,148.

Legally Married Couple

Now let's assume that the couple is legally married at the time of Beverly's death. As the legal surviving spouse for federal tax purposes, Sandra can roll Beverly's IRA into her own IRA. Sandra's still required to take RMDs, but they'll be calculated using the more favorable Table III. This table yields a maximum life expectancy of 24.7 years. The longer life expectancy will result in a smaller RMD every year, allowing more money to stay invested in the tax-deferred IRA. The total distributions that Sandra could receive from the IRA inherited from Beverly if they are married would be \$2,573,350. (See "An IRA Comparison," p. 18.) None of these illustrations take into consideration such factors as inflation, the time value of money or additional earnings if Sandra's spending needs are less than the annual distributions from the IRA. I wanted to demonstrate only the difference in the outcome depending on which table is used to determine the beneficiary's life expectancy.

Impact on Second Generation

While beneficial for the first generation heirs, mar-

riage can have an even greater impact on the second generation of heirs. Let's assume that Beverly and Sandra weren't married at the time of Beverly's death and that Sandra had a child, Eric, from a previous marriage. Sandra designates Eric as the beneficiary of the IRA that she inherited from Beverly. Sandra dies five years later, and Eric, age 50, becomes the new owner of Beverly's IRA. Because the asset that Sandra owned was an inherited IRA, Eric is required to continue taking distributions from the account based on his mother's, not his own, life expectancy. We know that Sandra took distributions from her inherited IRA for five years. According to "An IRA Comparison," the balance left in the inherited IRA as of Dec. 31, 2020 is \$886,122. Eric's RMD is calculated by dividing \$866,122 by what would have been his mother's projected life expectancy, or 9.8, less 1.0 for each year thereafter. This requirement means that, during the year after his mother's death, Eric is required to withdraw \$90,421 from Beverly's IRA. By the time he receives his last distribution, at age 59, he'll have received a total of \$1,161,263.

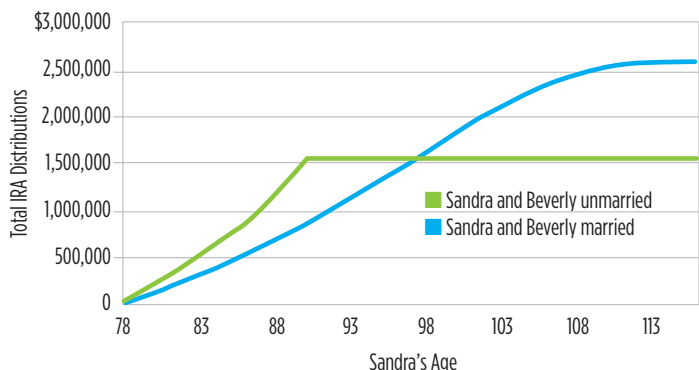
Now look at how Eric's inheritance would be affected if Beverly and Sandra had married. When Beverly died, Sandra wisely elected to treat the \$1 million IRA as her own IRA—so in this scenario, Sandra doesn't own an inherited IRA. Because Sandra is age 72, she'll be required to take RMDs from the IRA, but the amounts of the distributions are based on the more favorable Table III. If Sandra takes only the RMDs from the IRA for five years, the account will have a balance of \$1,069,940. This number is much higher than the balance in the unmarried example. And, when Sandra dies after five years, Eric receives a first generation inherited IRA. He's required to take RMDs from the inherited IRA, even though he isn't age 70½, but the distributions are calculated based on his own longer life expectancy. The first distribution he's required to take after his mother's death is \$32,130, as compared to \$90,421 if his mother hadn't married Beverly. The life expectancies of Table III allow more money to remain in a tax-deferred status for a longer period of time, until the account is depleted when Eric reaches age 83. And, as you can see in "Second Generation IRA Beneficiary," p. 18, the total amount of distributions that Eric could receive simply because his mother married Beverly is \$3,193,604,



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An IRA Comparison

Total distributions are higher for married couples



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instead of \$1,161,263.

Much Younger Spouse

Let's look at another scenario. After his divorce, Charley began a relationship with Amanda, who's much younger than he is. They have a child together, PJ. Charley dies at age 80 after taking his RMD for the year, and Amanda, age 65, is the sole beneficiary of his IRA. What happens to Charley's IRA at his death, depending on if the couple had married or remained single?

Even though she's not yet 70½, as an unmarried beneficiary, Amanda must continue taking RMDs from Charley's IRA based on his life expectancy. If she takes only the minimum, the total distribution she'll receive from the IRA is about \$1.9 million. If the proposed legislative changes take effect (see below) and she's forced to liquidate the IRA in five years, the total she'll receive if she lives to be 100 is about \$1.2 million.

If they marry, the outlook is much brighter. Because his spouse is so much younger than he is, Charley can use Table III when calculating his RMDs during his lifetime, which extends them over the longest period the IRS allows. After Charley's death, Amanda can roll his IRA into her own and then defer RMDs until her own age 70½. If she lives to be 100 and with-

draws only the minimum each year, the total she'll receive is more than \$3 million. (See "Amanda's Distributions," p. 19.)

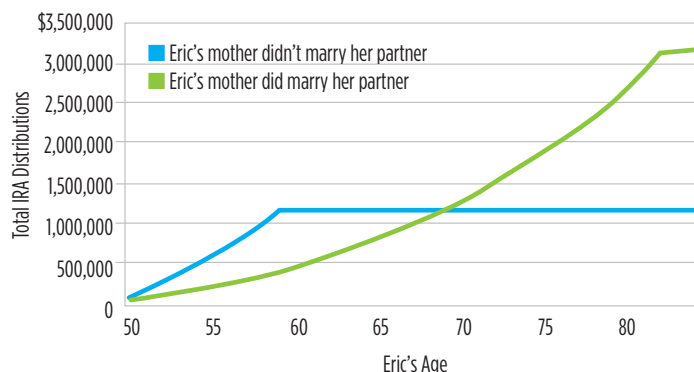
Their son will realize the greatest financial benefit from their marriage. Suppose Amanda takes only the RMDs, totaling \$346,995, from the IRA from age 70½ until her death at age 75. PJ, who's age 38 when she dies, will be required to continue taking RMDs from the account, but because the asset he now owns is a first generation inherited IRA, the distributions will be based on his own life expectancy. If he takes only the minimum every year, he'll receive over \$7.8 million by the time he reaches age 84. The marriage of his parents made a difference of almost \$6 million in PJ's inheritance. (See "PJ's Distributions," p. 19.)

Proposed Legislation

The technique of limiting distributions from inherited IRAs to only the RMD is often referred to as the "stretch IRA" and, in the near future, its use as a valuable estate-planning tool may be greatly restricted. In 2012, Senate Finance Committee Chairman Max Baucus (D-Mont.) proposed limiting the benefits of the stretch IRA for a non-spouse beneficiary to five years after the death of the original owner. Thankfully, that proposal was

Second-Generation IRA Beneficiary

Eric receives greater distributions if his mother is married



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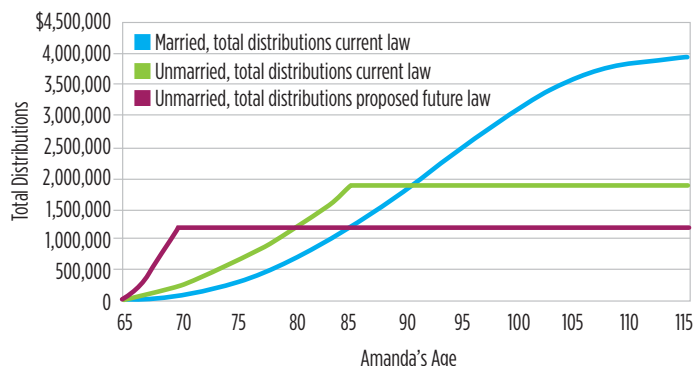
withdrawn for lack of support. The idea reappeared in President Obama's budget proposals in 2013, though, as part of a bill to reduce future student loan debt. Eliminating the tax benefits of the stretch IRA, the administration felt, would provide the revenue necessary to reduce student loan interest rates—albeit for just one year. That proposal died in the Senate, but only by a vote of 51-49. It's becoming increasingly clear that this measure, or a similar one, may eventually pass. The finite term that's being considered now is five years, and many think that this change will take effect in 2015 or shortly thereafter. If this outcome happens, an unmarried individual who inherits an IRA will have to withdraw the entire balance of the inherited IRA by the end of the fifth year after the death of the original owner. These are the same distribution rules that apply currently if there's no designated beneficiary on the IRA or if the designated beneficiary is an estate or a charity.

If these proposed legislative changes regarding inherited IRAs do occur, there will be even more compelling financial incentives for committed unmarried couples to tie the knot. Marriage isn't always an option, however, so we're exploring several alternative strategies that look extremely promising. A charitable remainder trust can be drafted and named as the beneficiary of the IRA or retirement plan. If a trust is put in place and the IRA beneficiary designations are properly completed, the IRA will pass to the trust at the owner's death. A child or unmarried partner can be named as the beneficiary of the trust, receiving income for her lifetime, and a charity of the owner's choice would receive the remaining balance at the beneficiary's death. Life insurance would also become more attractive if these laws are changed.

In summary, marriage affords a great opportunity to stretch the IRA or retirement plan over the life of the surviving spouse, and currently, the life of the survivor's children or even grandchildren. With the threatened demise of the stretch IRA legislation looming, the case for getting married to maximize the inheritance of IRAs and retirement plans

Amanda's Distributions

There's a much brighter outlook if she's married



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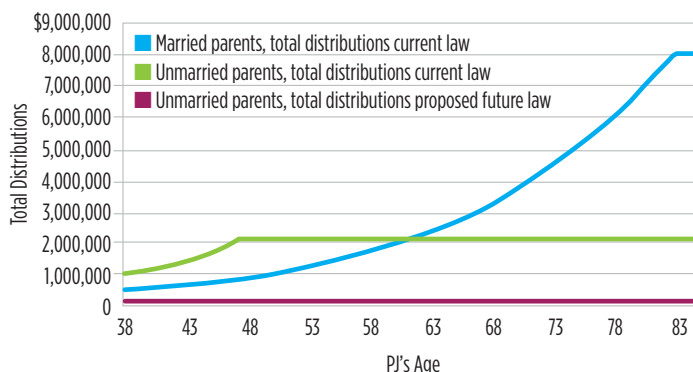
is even stronger. When you add the advantages of marriage for Social Security purposes, the argument for unmarried clients who are in their 60s or older to tie the knot becomes compelling.

Endnotes

1. James Lange, "Optimizing Social Security Benefits for Unmarried Couples," *Trusts & Estates* (September 2014) at p. 40.
2. www.irs.gov/publications/p590/ar02.html.

PJ's Distributions

He benefits financially from his parent's marriage



—James Lange