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Spouse as Beneficiary of Traditional IRA or Retirement Plan

O'KEEFE INVESTMENT MANAGEMENT

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What is it?

Naming a beneficiary for your traditional IRA or employer-sponsored retirement plan may be one of the most important financial decisions you ever make. The beneficiary (or beneficiaries) you name will receive the funds remaining in your IRA or plan after you die, so you should certainly consider your loved ones' future needs. However, choosing the right beneficiary is often more complicated than that. Your choice could have an impact in one or more of the following areas:

- The size of the annual required minimum distributions (RMDs) that you must take from the IRA or plan during your lifetime
- The rate at which the funds must be distributed from the IRA or plan after your death
- The combined federal estate tax liability of you and your spouse (assuming you are married and expect estate tax to be an issue for one or both of you)

If you are married, one of your options is to designate your spouse as the primary beneficiary of your IRA or retirement plan. Naming a spouse is very common, because it is the most logical beneficiary choice in many cases. (In addition, a retirement plan may require such a designation, as discussed below.) However, to make certain that this is the best beneficiary choice for your situation, you should consider all of your options and consult a tax professional.

> **Caution:** This discussion applies only to traditional IRAs and employer-sponsored retirement plans. Choosing a beneficiary for a Roth IRA involves different considerations. For more information, see Beneficiary Designations for Roth IRAs.

The law may give your spouse certain rights in your retirement plan

If you want to name your spouse as the primary beneficiary of your employer-sponsored retirement plan, there is generally no problem with doing so. Simply complete the necessary beneficiary paperwork with your IRA custodian or plan administrator. However, if you are married and want to name a primary beneficiary other than your spouse, there may be restrictions on your ability to do so. No matter which state you live in, federal law may require that your surviving spouse be the primary beneficiary of your interest in some employer-sponsored retirement plans (such as 401(k) plans), unless your spouse signs a timely, effective written waiver allowing you to name a different primary beneficiary. You should consult your plan administrator for further details.

IRAs are not subject to this federal law, although your state may impose its own, similar requirements. For example, if you live in one of the community property states, your spouse may have legal rights in your IRA regardless of whether he or she is named as the primary beneficiary. In addition, if your roles are reversed (your spouse is the IRA owner or plan participant, and you are the primary beneficiary) and you die first, state law may prevent your surviving spouse from changing the beneficiary designation after your death (unless you grant your spouse the power to make these changes in a will or other document). You should consult an estate planning attorney for details regarding these and other state issues.

Naming your spouse as beneficiary may not affect required minimum distributions (RMDs) during your life

Under federal law, you must begin taking annual RMDs from your traditional IRA or retirement plan by April 1 of the calendar year following the calendar year in which you reach age 70½ (your "required beginning date"). With employer-sponsored retirement plans, you can delay your first distribution from your current employer's plan until

April 1 of the calendar year following the calendar year in which you retire if (1) you retire after age 70½, (2) you are still participating in the employer's plan, and (3) you own 5 percent or less of the employer.

Under the final IRS regulations issued in April 2002, naming your spouse as beneficiary generally will not affect the calculation of your RMDs unless your spouse is your sole designated beneficiary for the entire distribution year, and he or she is more than 10 years younger than you (see below for details).

Naming your spouse as beneficiary generally provides the maximum options and flexibility in terms of how the IRA or plan funds can be distributed after your death. See below (Advantages of naming your spouse as beneficiary) for a discussion of the post-death distribution options that may be available to surviving spouse beneficiaries.

> **Caution:** You and your spouse are generally considered married for an entire year if you are married on January 1 of that year and do not change your beneficiary during the year. If you divorce and then change your beneficiary before the end of the year, you are not considered married for the entire year. If your spouse dies before the end of the year, you are still considered married for the entire year, even if you change your beneficiary before the end of the year.

> **Caution:** The calculation of RMDs is complex, as are the related tax and estate planning issues. For more information, see Required Minimum Distributions and consult a tax professional.

Advantages of naming your spouse as beneficiary

Naming your spouse is one way to provide for him or her

You probably want to be certain that your surviving spouse will be financially secure after your death. One way to accomplish this goal is to designate your spouse as the primary beneficiary of your IRA or retirement plan assets. Naming your spouse as beneficiary ensures that he or she will receive the remaining funds after you die. Those funds will pass directly to your surviving spouse without having to go through probate first (unlike possibly assets left to your spouse in your will), and your spouse will generally have more than one post-death distribution option to choose from (see below).

However, bear in mind that your surviving spouse will typically have to pay federal (and possibly state) income tax on distributions of the inherited funds. The income tax treatment of post-death distributions from an IRA or plan is generally the same as for distributions that you take during your lifetime. In both cases, the portion of a distribution that represents pretax or tax deductible contributions and investment earnings is subject to federal income tax, while the portion that represents after-tax contributions is not.

Naming your spouse may minimize RMDs during your lifetime

If your spousal beneficiary is more than 10 years younger than you, the distribution rules provide you the option to spread your lifetime RMDs over a longer period of time (i.e., over the actual joint and survivor life expectancy of you and your spouse) than would otherwise be allowed. This can benefit you in several ways. First, a longer payout period reduces the size of the annual required distributions, resulting in less income tax each year while you're alive. Also, the longer the funds remain in the IRA or plan, the more time they have to continue growing in a tax-deferred environment. Finally, a longer payout period may preserve more of the funds for your surviving spouse after you die.

Surviving spouses have more post-death options than other beneficiaries

The main reason to consider naming your spouse as your IRA or plan beneficiary is that he or she will generally have more options and flexibility in terms of post-death distributions. Under the final regulations distribution rules, one of your surviving spouse's options may be to take required post-death distributions over his or her remaining life expectancy (in some cases, over your remaining life expectancy, if longer). This could result in a long payout period and significant tax deferral if your surviving spouse is relatively young. Of course, your surviving spouse could always withdraw more than required in any year.

> **Tip:** In addition, the rules favor spousal beneficiaries in that the way a spousal beneficiary

calculates life expectancy tends to allow distributions to be taken over a longer period of time than a nonspousal beneficiary of the same age.

> **Tip:** If you die before your required beginning date with your spouse as your sole beneficiary, distributions to your spouse under the life expectancy method can generally begin as late as the year you would have reached age 70½. With other designated beneficiaries, such distributions generally must begin no later than the end of the year following the year of your death.

Your surviving spouse may also have two other options that are not available to other beneficiaries. A surviving spouse may generally opt to roll over inherited IRA or plan funds into his or her own traditional IRA or plan, regardless of your age (or your spouse's age) when you die. Or, your surviving spouse may generally opt to simply leave the funds in an inherited IRA, and treat that account as his or her own account. In either case, the potential may exist for significant estate planning and income tax benefits. This is because your surviving spouse may defer taking distributions of the inherited funds until his or her own required beginning date and also designate new beneficiaries of his or her choice (your children, for example) who could later stretch out distributions even more after your spouse's death.

> **Caution:** Certain restrictions may apply to some of your surviving spouse's post-death distribution options. For example, your surviving spouse cannot roll over RMD amounts (distributions required in the year of your death).

> **Caution:** In the case of post-death distributions from a retirement plan account, the plan may specify the distribution options available. Those options may or may not be identical to the allowable options set forth in the IRS distribution rules. You should consult your plan administrator for details, as this could have an impact on your choice of beneficiary.

> **Tip:** The 2001 Tax Act expanded the ability of a surviving spouse to roll over IRA or plan funds. As of January 1, 2002, the surviving spouse of a deceased participant in a 401(k) or other qualified retirement plan is able to make a tax-free rollover to another qualified plan, a 403(b) plan, or a Section 457 plan (in addition to doing a rollover to an IRA).

Naming your spouse may delay or eliminate estate tax on retirement assets

When you die, your entire interest in an IRA or retirement plan is added to your other assets to determine if any federal estate tax is due. (State death tax may also apply, so check the laws of the applicable states.) When you designate your spouse as sole beneficiary of your IRA or plan, however, your estate may qualify to take an unlimited federal marital deduction for the amount of tax on retirement plan funds. What this means is that even if the value of your taxable estate exceeds the federal applicable exclusion amount ($2 million for 2007 and 2008), no federal estate tax will be due on the IRA or plan funds on your death.

However, federal estate tax may be due from your surviving spouse's estate when he or she eventually dies. If your surviving spouse does not consume all of the retirement funds during his or her life, the remaining funds will be added to your spouse's other assets to determine if any federal estate tax is due (see below--Disadvantages of naming your spouse as beneficiary).

> **Tip:** If your surviving spouse is not a U.S. citizen, a special type of trust called a QDOT (qualified domestic trust) may be utilized to take advantage of the unlimited marital deduction. However, there are special rules and requirements that must be met for this strategy to work. Consult an estate planning attorney for details.

> **Caution:** Estate planning for retirement assets is a highly technical area. Be sure to consult an estate planning attorney for assistance.

Disadvantages of naming your spouse as beneficiary

Your surviving spouse may be in a high income tax bracket

As mentioned, after you die, your surviving spouse beneficiary will generally have to pay federal (and possibly state) income tax on distributions of the inherited IRA or plan funds. The rate at which a post-death distribution is taxed will depend upon your surviving spouse's income tax bracket for the year of the distribution. If your surviving spouse is in a high income tax bracket due to substantial job earnings, investment income, or other factors, he or she may lose a significant portion of the inherited funds to income taxes. In this case, it may be advisable to consider other possible designated beneficiaries for your IRA or plan. Naming your children, grandchildren, or others as beneficiaries may result in the retirement funds being taxed at a lower income tax rate after your death.

Other beneficiaries may be able to take post-death distributions over more years

Although a surviving spouse beneficiary has more post-death distribution options than any other beneficiary, that does not necessarily mean that he or she would enjoy a longer payout period than other possible beneficiaries. Under the final regulations distribution rules, any individual designated as an IRA or plan beneficiary (not just a surviving spouse) is generally allowed to take required post-death distributions over his or her remaining life expectancy, even if you had already reached your required beginning date when you died. (Again, with a retirement plan, check with your plan administrator regarding the available distribution options.)

This means that if you name a young nonspousal beneficiary (such as a child or grandchild) for your IRA or plan, that individual may be able to distribute the inherited funds over more years than your surviving spouse could. In some cases, this may be true even if your surviving spouse were able to exercise one of the other post-death distribution options described above (such as a rollover of the inherited funds into your spouse's own IRA or plan). It depends upon the relative ages of your spouse and other possible beneficiaries. This is something to consider if your goal with your retirement funds is to reduce income taxes and prolong tax-deferred growth after your death.

There may be unfavorable estate tax consequences in the future

One possible downside to naming your spouse as the primary beneficiary of your IRA or plan is that the combined federal estate tax owed by your estate and your surviving spouse's estate may be higher than necessary. This is because the unlimited marital deduction allows you to leave all of your assets to your surviving spouse free from federal estate tax at your death and defer the tax, if any, until your spouse's death (depending on the size of your spouse's estate), so your applicable exclusion amount may be wasted. When your surviving spouse dies after you, the marital deduction will not be available, so your spouse may have only his or her applicable exclusion amount as a shelter against estate tax. If your surviving spouse's taxable estate exceeds that amount, then federal estate tax (or more of it) will be due at your spouse's death. This is more likely to happen if you designate your spouse as beneficiary of your IRA or plan, particularly if the IRA or plan has significant assets.

> **Tip:** Depending on the size of your taxable estate for federal estate tax purposes, an estate-tax-saving trust (known as a credit shelter trust, B trust, or exemption trust) could allow your surviving spouse to benefit from the assets in the trust, while minimizing the amount of your assets to be included in your spouse's taxable estate for estate tax purposes. A downside to this approach is that funding a trust that is exempt from death tax with assets that have a built-in income tax liability reduces the net amount really in this trust. Consult an estate planning attorney for details regarding this and other possible strategies, as estate planning for retirement assets is a highly technical area.

You often cannot control the funds after your death

If you name your spouse as the beneficiary of your IRA or retirement plan, your surviving spouse will be free to use the inherited funds as he or she wishes after your death. This may not be a concern if the two of you trust one another and have agreed in advance on how the funds are to be used after one of you dies. However, nothing is certain. For example, it is possible that your spouse could remarry and then name a new spouse rather than your children as the primary beneficiary (unless restrictions prohibit such a designation after your death).

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