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WEALTH MANAGEMENT

Monthly Insight

The "Widow's Tax": How You Can Reduce Costs Through Advance Planning

It's the ultimate insult-to-injury situation: Bereaved spouses, already deprived of the companionship of their life partner, also find themselves facing a higher tax bill from the IRS because of disadvantages built into the U.S. tax code. As if that weren't bad enough, this often happens despite a reduction in the surviving spouse's income. We see this situation played out in our clients' lives all too often — and when it happens, for many of our clients, it's like having to exhume their deceased loved ones and re-bury them, all over again.

For years, frustrated taxpayers have been asking their elected representatives to remove this patently unfair obstacle to financial wellbeing, and it appears that, for widowed spouses of military service members, at least, some help may be on the horizon.

But there are some other steps almost everyone can take to avoid at least some of the worst effects of this problem inherent to the tax code. First, we'll gain an overview of the problem, and then we'll discuss the steps and planning needed to mitigate at least some of the worst effects.

What Is the Widow's Tax?

First, it's important to understand that the U.S. tax code treats single taxpayers much differently than married couples who file joint returns.

For example, under the latest revision of the tax laws, the 2019 standard deduction for a married couple filing jointly is $24,400. For the typical couple, this is much more than they would be able to subtract from their taxable income by itemizing deductions (especially with the loss of many deductions under the latest revisions to the tax laws). But for single taxpayers, the standard deduction for 2019 is only $12,200.

This especially impacts retirees, because the vast majority of them are not operating businesses that afford them other deductible expenses. Furthermore, most retirees depend to some degree on fixed income from sources such as Social Security benefits, pensions, and distributions from qualified retirement plans. These sources of income don’t allow for much in the way of tax deductions.

Next, widowed spouses are allowed to continue filing jointly only in the year in which their spouse passes. After that, they must file singly, making them subject not only to the lower standard deduction but also to less advantageous tax brackets. For example, in 2019, the income of married couples filing jointly is taxed at a 12% rate from $19,401 up to $78,950. At $78,951, it becomes taxable at a 22% rate. But for single individuals, the 22% bracket starts at just $39,476 of income. Therefore, a widowed taxpayer who was accustomed to being taxed at a much lower rate on more of her income is suddenly looking at nearly a doubled rate, even though her income may have been reduced.

Speaking of income sources, the next problem facing newly single, retired taxpayers is the loss of their spouse’s Social Security benefit. The good news here is that Social Security benefits are only partially taxable. But the worse news is that the surviving spouse has only two choices with regard to continuing Social Security benefits: They can take either their spouse’s benefit or their own. For most women — especially those of the baby boomer generation and earlier — their deceased husband’s benefit will be higher. But by taking that benefit, they will be foregoing their own benefit for the rest of their lives. No matter how you slice it, the Social Security benefit to the household is going to be reduced.

Additionally, in most cases, more of the Social Security benefit will be taxable for a single taxpayer than for married taxpayers filing jointly. So, not only will the widowed taxpayer be getting less Social Security income than before, but they will probably also be paying taxes on more of what they do receive.

So far, we’ve been talking about matters that are not only disadvantageous to the newly single taxpayer but also largely out of their control. You can’t control your tax filing status (single vs. joint), you can't do much about your tax bracket, and you have little leverage over how much Social Security income you'll get or the rate at which it will be taxed.

But there is one important area in which, with some advance planning, you can take back a little control over the amount of total income you'll pay taxes on following the death of a spouse.

Cost-Reduction Strategy: The Roth Conversion

Most of the clients we work with have spent a lot of years funding 401(k)s, IRAs, and other tax-qualified accounts, looking forward to the day when those assets would afford them greater financial security in retirement. And here is where some forward thinking can give you back a measure of discretion over your tax situation in retirement, even if you are faced with the difficult transitions following the death of a spouse.

Traditional IRAs, 401(k)s, and 403(b)s have, for many years, been a staple of retirement planning and saving. You make pre-tax contributions to these accounts (you don't pay taxes on the money you deposit during the year) and enjoy tax-free growth until you begin withdrawing income in retirement, at which point you pay taxes on the withdrawals as ordinary income. Also, these accounts mandate a required minimum distribution (RMD), starting when the owner reaches age 70 ½.

But there's an alternative. A Roth IRA, 401(k), or 403(b) requires you to pay taxes on the money you deposit each year, but unlike the traditional alternative, the money you withdraw in retirement is not taxable. More important for our current discussion, though, is the fact that Roth accounts do not have the RMD. In other words, with a Roth plan, you control the amount of income you receive in any given year. This can be a powerful tool for newly single taxpayers who are concerned about their tax liability on income over which they have no control or the percentage of their Social Security benefit subject to taxation. The other good news is that you can convert a traditional IRA, 401(k), or 403(b) to a Roth account.

The only sticking point is that when you convert a traditional account to a Roth account, you must pay taxes on the converted funds as ordinary income. For many of our clients, who have substantial sums invested in traditional accounts, that could add up to a steep tax bill for the year in which the conversion takes place. But this is where advance planning can help.

Working with your tax advisor, a qualified, professional financial planner can help you schedule your Roth conversions so that the tax burden is spread out over several years. Not only that, but a Roth conversion can be just as beneficial to a married couple filing jointly as it is to a single taxpayer. So, even if your spouse is still living and healthy, a Roth conversion can still make a lot of sense. And then, in the unhappy event of the death of a spouse, the survivor will have greater control over the amount of income received during a given year, and thus more control over the amount of taxes that must be paid.

Do you have questions about Social Security survivor benefits, taxation of retirement income, or whether a Roth conversion makes sense for your situation? We would love the opportunity to discuss these and other matters with you and help you come up with a solution uniquely tailored to your financial needs.

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