The 99% Rule for Spousal Beneficiaries of IRAs

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–Jeffrey Levine, CPA/PFS, CFP®

A spouse who inherits an IRA or similar account has a couple of options available depending on what the end goals are. But in most cases, the 99% rule offers flexibility and helps preserve the stretch.

It sounds odd to say, but death is a part of life for us all. It's one of the few things that we all have in common at some point, and it's one of the few issues that must be addressed in everyone's plan.

While each situation is unique, however, and you have your own goals and objectives, the overwhelming majority of married individuals with IRAs and other similar accounts, such as 401(k)s and 403(b)s, will name their spouse as their primary beneficiary as part of their estate plans. As such, knowing the rules for when a spouse inherits an IRA is critical.

Unfortunately, the rules are not all that simple, especially when compared with the rules for when a child or other non-spouse beneficiary inherits the same account. That's because there are a slew of special rules that apply only when a spouse inherits an IRA, and those rules can greatly complicate matters.

A real life example

Consider the real-life case of Charlotte Gee, a surviving spouse beneficiary who learned this rule the hard way. After inheriting more than $2.5 million in IRA funds from her deceased husband, Gee (who was younger than 59 ½ at the time) executed a spousal rollover of the full amount.

Shortly afterward, she took a distribution of $977,888 from the IRA. Although Gee reported the amount as taxable income, she did not factor in any 10% penalty because she said she was a beneficiary.

The IRS challenged her on this, and ultimately the issue went to tax court, where Gee's argument was swiftly dismissed, leading to a penalty of nearly $100,000 on top of the tax bill she already owed! The tax court's reasoning was both accurate and succinct:

> *"Once [Gee] chose to roll the funds over into her own IRA, she lost the ability to qualify for the exception from the 10-percent additional tax on early distributions. The funds became petitioner's own and were no longer from her deceased husband's IRA once petitioner rolled them over into her own IRA."*

Perhaps if Gee had been knowledgeable about the special rules that apply to spouses, or had she worked with a professional who understood the 99% rule, this never would have happened. The 99% rule can help bring some much needed clarity to the spousal beneficiary rules if you first understand the options available.

One option is to establish an inherited IRA, similar to the way a non-spouse beneficiary does. Here a spouse must move money directly from the decedent's IRA to an inherited IRA, and properly title the account.

While the precise titling can vary slightly from custodian to custodian, the titling must include the name of the decedent, as well as indicate that the account is an inherited or beneficiary IRA. For example, an acceptable titling might look like this:

John Doe (deceased mo/day/year) IRA FBO Sally Doe

When a spouse chooses to remain a beneficiary of an IRA, he or she is able to take penalty-free distributions from the account at any age and at any time. Thus, young spouses should pay particular attention to this option. ("Young" according to the tax code in this case is anyone under the age of 59 ½.)

A second option for a spouse beneficiary, and one available only to a spouse beneficiary, is to complete what is commonly referred to as a "spousal rollover." In a spousal rollover, a surviving spouse takes a distribution from the deceased spouse's IRA, or a beneficiary IRA inherited from the spouse, and moves the funds, either directly or indirectly, within 60 days to his or her own IRA.

This is an irrevocable decision by a surviving spouse. Once the funds are deposited into his or her own IRA, they are treated as if they had always been in the account. There is no way, at this point, for the surviving spouse to change the action taken and be treated as a beneficiary once again.

A third option allows a spouse to treat a deceased spouse's IRA as his or her own. This option, though, is seldom used in the real world and has the same tax consequences as a spouse completing a spousal rollover.

Selecting a strategy

Which option is best? The answer, of course, differs depending on the unique set of facts and circumstances surrounding the surviving spouse, but surprisingly, there is a general rule of thumb that 99% of the time will give you the right answer. All right, so maybe it's not exactly 99% of the time, but you get the point. It's a pretty darn reliable strategy.

Here's the rule, in a nutshell.

> **The 99% rule.** If a surviving spouse beneficiary is under 59 ½ at the time the IRA is inherited from the deceased spouse, then 99% of time the correct planning move is to establish an inherited IRA for the surviving spouse's benefit. The funds should continue to be kept in an inherited IRA until the surviving spouse turns 59 ½. Once the surviving spouse turns 59 ½ —or if the person is already over 59 ½ when he or she inherits—a spousal rollover can be executed.

Why is this strategy right so much of the time? For the simple reason that there is almost never a downside to using it. It almost always allows a surviving spouse flexibility without hindering them in any way.

Some might dispute that notion and point to the fact that, by remaining a beneficiary of an inherited IRA, it would lead to the surviving spouse having to take required minimum distributions (RMDs) prematurely (before turning 72), but that logic is almost always flawed.

Unlike other beneficiaries, who must typically begin taking RMDs from an inherited IRA by Dec. 31 of the year after the IRA owner dies, a surviving spouse generally does not have to start taking RMDs from an inherited IRA until the deceased spouse would have been 72. Since most spouses are relatively close in age, it's a rare scenario that would force a spouse to choose between maintaining a penalty-free inherited IRA and moving the inherited IRA funds to their own IRA to avoid RMDs.

Example: Jack is married to Jill and has named her as the sole beneficiary of his IRA. Jack is 55, and Jill is 50.

Unfortunately, Jack dies unexpectedly. In this scenario, Jill should, without hesitation, follow the 99% rule and establish an inherited IRA, remaining a beneficiary until she reaches 59½. This is the only approach that makes sense here.

Consider that, as a beneficiary, should Jill need to access her inherited IRA funds for any reason, she would be able to do so without incurring the 10% penalty. Furthermore, since Jack and Jill are relatively close in age, there will never be a time when Jill would be forced to take RMDs from the inherited account.

When she initially inherits the account, at 50, Jack was just 55, much younger than the key age 72 that would require Jill to take RMDs from her inherited IRA. Similarly, when Jill turns 59 ½, Jack would still only be 64 ½, had he lived. Thus, no RMDs would be required at that time either.

In fact, by the time Jack would have been 72, triggering RMDs for the inherited IRA, Jill would already be 67. By that point, following the 99% rule, she should have already made a spousal rollover of the inherited funds into her own IRA (at age 59 ½). Following that spousal rollover, the funds would be treated as if they were always in Jill's IRA, allowing Jill to continue to delay RMDs until she turns 72 .

Preserving the stretch

Similarly, some might point out that if a surviving spouse dies with an inherited IRA, the beneficiaries will be stuck using the surviving spouse's life expectancy and will be unable to stretch distributions over their own lives.

While this is possible, thanks to another special rule for spousal beneficiaries, it once again is unlikely. That's because as long as the surviving spouse dies prior to when the deceased spouse would have been 72 (the same age RMDs need to begin), the surviving spouse's beneficiaries can still use their own life expectancy.

Let's bring back our friends Jack and Jill. Recall that Jack died at 55 and Jill, who was 50 at the time, followed the 99% rule and established an inherited IRA. Now imagine that Jill has named her children as the beneficiaries of her inherited IRA.

Unfortunately, tragedy strikes again, and Jill dies only a few years later, when she's 53. If Jill were anyone other than a spousal beneficiary, her children would be stuck using her shorter life expectancy. As a spousal beneficiary, however, and because Jack would not yet have reached 72 (Jack would only have been 58), her children will be able to stretch distributions out over their own life expectancies.

As you can see, the two biggest downsides of inherited IRAs—RMDs and the loss of the stretch IRA for future generations—are often not an issue when a spouse inherits an IRA.

The Modern Family conundrum

That said, I call it the 99% rule and not the 100% rule, because it's not always the best option. So when does the 99% rule not work? In the rare but certainly not unheard of circumstance in which the surviving spouse is significantly younger than the deceased spouse. It's what I like to call the Modern Family conundrum.

On the popular ABC sitcom *Modern Family*, the patriarch, played by Ed O'Neill, is married to a vivacious younger woman, played by Sofía Vergara. While they're not married in real life, let's imagine for a moment that they are. If O'Neill were to pass away and leave Vergara his IRA, she'd have a choice to make.

O'Neill, whose birthday is April 12, 1946, would have turned 72 in 2018. Vergara would have been 46 years old—leaving her with a critical choice to make. She could either leave the account as an inherited IRA, which would:

- Allow her to continue taking penalty-free distributions prior to 59 ½
- Force her to begin taking required minimum distributions from the inherited IRA
- Require her beneficiaries to continue distributions over her life expectancy, should she pass away while still remaining a beneficiary

Or she could execute a spousal rollover, which would:

- Make future distributions prior to age 59 ½ subject to the 10% early-distribution penalty unless another exception applied

- Allow her to delay taking RMDs until she reached 72
- Allow her beneficiaries to use their own life expectancies whenever she passes away

Now there's a good chance that if Sofia Vergara were really put in this situation and forced to make a choice, she'd opt for the spousal rollover. I have a sneaking suspicion that she wouldn't have a need to dip into the inherited IRA anytime soon. She is, after all, the highest-paid actress on TV and has been for several years now.

You and your spouse, however, may not be in the same boat. If there is even a slight chance that the surviving spouse might need money before 59 ½ , it's probably worth leaving the funds in an inherited IRA. Sure, there will be RMDs, but even a spouse beneficiary at 50 years old would still have RMDs less than 3%.

As for ability of the spouse beneficiary's own beneficiaries' to stretch distributions over their own life expectancies? While it's certainly not impossible for the surviving spouse to die before reaching 59 ½, the mortality rates for people in their 50s are relatively low and chances are it won't be an issue. Remember, once the surviving spouse turns 59 ½ and makes a spousal rollover, this is no longer an issue.

Spousal beneficiary rules can be complicated but the 99% rule can help you make an informed decision.

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