Retirement Daily

Your Money

The 'Widow's Penalty': What It is and How to Plan

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By William Harris

Grief is an unpredictable process, moving at a different speed for each of us. Both ups and downs seem to come out of nowhere and take on a life of their own. Many widows and widowers speak of the second year being worse than the first, as reality becomes harder to ignore, before a newfound purpose has had the time or focus to take hold. The second year is also when widows and widowers alike find themselves grappling with new financial issues.

Marriage Brings a Double Whammy

The IRS seems to have marriage in its crosshairs. Many of us remember that, as newlyweds, we were penalized when we first filed "married jointly." With our new partners, we paid more income tax than two single individuals would on the same total income. It was referred to as the "Marriage Penalty."

And now, when we lose a spouse, instead of recapturing those lost benefits when we go back to filing single again, the federal income tax code is stacked against us. Now the tax rates for married couples filing jointly can be far less onerous than for single people. And this is called the "Widow's Penalty."

To be clear, this disadvantage is an equal-opportunity offender: it affects both widows and widowers alike, as well as people at various income levels.

The Widow's Penalty

So, what exactly is the Widow's Penalty? Let's look. Retirees typically live on their various sources of fixed income: Social Security benefits, pensions, and distributions from qualified retirement plans. (These may be in the form of Required Minimum Distributions, or RMDs).

As a widow/widower, you will presumably continue receiving the same investment and property rental income, for example, so the main impact on your gross income will be the loss of the smaller Social Security check, if you and your spouse had each been receiving benefits.

The reduction in taxable income from losing the Social Security check will likely be partially or fully offset when the joint standard deduction you are accustomed to taking is replaced by the smaller single standard deduction.

Your taxable income may actually end up higher than before. But even if it is the same, your taxable income as a widow/widower will now be taxed at the rates on the tax tables for singles, where thresholds to the next tax bracket occur at much lower dollar values.

For example, $40,000 of taxable income is in the lower half of the 12% tax bracket for married filing jointly, but already in the 22% bracket for singles. And $165,000 is at the very top of the 22% tax bracket for married filing jointly, but already into the 32% tax bracket for singles.

The only momentary reprieve a widow or widower has is that for the year in which a spouse dies, the widow or widower can still file a tax return using the more generous "married filing jointly" tax status.

Social Security's Tax Torpedo

How much of your Social Security benefits are taxed depends on an IRS formula called "combined income." Somewhere between 85% and 0% of your benefits could be counted as taxable income. Here again, an IRS rule affects a widow/widower negatively.

If you are married filing jointly, and your joint income is over $44,000, 85% of your Social Security will be taxable. Between $32,000 and $44,000, 50% is taxable. Below $32,000, none is.

But when you are filing single, and your income is over just $34,000, 85% of your Social Security will be taxable. Between $25,000 and $34,000, 50% is taxable. Below $25,000, none is.

So, even if your Social Security benefits are reduced by losing the smaller of the two checks you were receiving, changing from joint to single status can bump you up from one taxable income range to another, and cause more of your Social Security to be taxable. This is referred to as being hit by the Social Security "Tax Torpedo."

The RMD Hit

The loss of a spouse does not lessen your requirement to take minimum distributions each year from all tax-sheltered retirement plans. Because withdrawals are mandatory, you lose the flexibility of being able to withdraw less one year to lower your tax burden.

Robert Powell writes: Under the Setting Every Community Up for Retirement Enhancement Act of 2019, better known as the SECURE Act, IRA account owners who reach age 70½ in 2020 now don't have to take an RMD until they reach age 72. [*Read more here.*]

Surtax on Net Investment Income

The 3.8% surtax on net investment income -- a provision of the Affordable Care Act to fund Medicare -- is another wrinkle. Married couples are only affected at modified adjusted gross income (MAGI) over $250,000. For single filers, it is over $200,000. So, a widow/widower's $210,000 MAGI can trigger the surtax, whereas the couple's $245,000 did not.

Medicare Piles On

Surviving spouses are not only affected on their taxes but on Medicare premiums, too. Income levels determine monthly Medicare Part B (medical insurance) and Medicare Part D (prescription drug coverage) premiums.

If, as a married couple, you had a MAGI of $165,000, your Part B premium in 2019 would have been the $135.50 standard monthly premium, or $271.00 for the two of you. At a similar MAGI, as a single individual, your Part B premium in 2019 will be the $135.50 standard premium + $297.90 extra, or $433.10 for you alone.

The Part D monthly premium for each of you would have been simply the cost of your selected plan. Now the premium will be the cost of your selected plan + $70.90.

The Solution: Planning Ahead

Widows and widowers are equally disadvantaged by IRS and other legislation. With that in mind, as a married couple, it is essential that you run tax projections, both under the "married filing jointly" and "filing single" scenarios, projecting out 10, 15, and 20 years.

This planning is effective when done while both spouses are alive and preferably before the primary breadwinner has retired. The earlier, the better, in terms of having more options and more time to implement them. The two major areas to explore are (1) Roth IRA conversion strategies, and (2) Social Security claiming strategies.

Roth IRA Conversion Strategies

The ideal time to withdraw funds from traditional IRAs is likely to be once age 59½ has been reached, as they can be withdrawn without the 10% early distribution penalty. And, if done before starting to take Social Security benefits, income might be at the lowest possible tax rate. (Projections will confirm the best timing.) Having both partners alive also means benefiting from the couple's preferential married filing jointly tax rates.

If those withdrawn funds are put into Roth IRAs, the conversion will be coming at a low tax cost. After conversion, those funds will then enjoy tax-free withdrawal status, which will reduce future exposure to taxable RMDs. Also, while this will provide greater withdrawal flexibility on the part of the owner, it will be even more valuable for the surviving spouse to control the impact of the Widow's Penalty.

By planning well in advance, conversion can take place in a series of small transactions over the age 60-to-70 timeframe, scheduling to take advantage of the lowest tax brackets.

Social Security Claiming Strategies

Couples may be anxious to start receiving Social Security benefits. However, the longer they wait, the higher the benefits will be, with the largest payout coming by waiting to age 70. Not only will waiting increase the lifelong payout for a surviving spouse, but if all other income is meticulously timed, the taxable portion of the Social Security benefits may be held down into one of the lower brackets (0% versus 50% versus 85%) for relief from the Widow's Penalty.

Maximizing the Social Security benefit of the highest earner in a couple by waiting as long as possible gives a surviving spouse the highest long-term income since that is the benefit that will survive.

Deferring Social Security claims may require supplementing available funds with the careful withdrawal from traditional IRAs after age 59½ to fund living expenses at an advantageous tax rate. Other funding mechanisms, like a reverse mortgage line of credit or life insurance policy loan, should also be explored.

The key is to examine all possibilities in terms of timing, total payouts, flexibility, and tax implications when determining Social Security claiming strategies.

Some Breaks for Widows and Widowers

Not everything about the tax code is negative for widows and widowers. The following are a handful of available breaks.

- First-year exemption: You are allowed to file a joint return for the year in which your spouse died, using the more generous "married" tax rates and the standard deduction applied in the past.

- Insurance policy proceeds: These are not taxed, regardless of whether the policy was personal or employer-paid. You do not report the proceeds as part of your taxable income.
- Stepped-up asset basis: You can "step up" the basis of most assets you inherit to the value of that property on the day your spouse died. Gains and losses will be calculated based on this new value, with the IRS forgiving the tax on any appreciation before the death of your spouse. Jointly owned assets will benefit from a stepped-up valuation on 50% of the asset, except in community-property states, where 100% would be stepped up.
- Rental property: Rental property inherited from a spouse enjoys the same benefit of stepped-up assets, above. This will increase the allowable depreciation deductions and reduce the taxable capital gains if you should ever sell the property.
- Capital gains on the sale of your home: Couples can exclude $500,000 of capital gains if they meet the IRS's homeownership and use test. (Individuals can only exclude $250,000.) As a surviving spouse, you can access the $500,000 exclusion if you sell within two years of your spouse's death.

Minimizing the Widow's Penalty is not a simple task. Whether you do it on your own or engage a financial adviser to help with careful retirement planning details, the benefits cannot be overstated.

About the author: Bill Harris is a certified financial planner practitioner and retirement management adviser. He is the former chairman of the Financial Planning Association of Massachusetts and an Ed Slott Elite IRA Advisor. He is a co-founder and principal of WH Cornerstone Investments in Duxbury and Kingston, a firm dedicated to helping mid-life widows rise up, get back on their feet and navigate their path forward. Bill is passionate about empowering widows with their financial future and his award-winning email newsletter offers helpful advice and articles for widows looking to rebuild their financial and personal life. He can be reached at www.whcornerstone.com, or on Twitter @whcornerstone or @billmharris.