The "Widow's Penalty"

Wednesday, November 22, 2023

Take-Away: When counselling a married couple be mindful of the 'widow's penalty' which might lead the couple to seriously consider a Roth IRA conversion.

Background: The name '*widow's penalty*' is, as the name suggests, the tax cost that occurs when a surviving spouse goes from a tax filing status from 'married filing jointly' to a 'single' taxpayer. In some situations, it is possible that when one spouse dies, the surviving spouse might pay double the amount of federal income taxes.

Cause of the '*Widow's Penalty:'* The *widow's penalty* primarily arises due to two changes after the death of one spouse. First, one of the two spouse's Social Security retirement benefits disappears; fortunately, the surviving spouse is entitled to take the larger of the two Social Security retirement benefits, but the loss of one results in less income that is available to the survivor to support herself. Second, the Standard Deduction and Personal Exemption is cut by 50%; the loss of one half of the Standard Deduction then results in less tax-free income to the surviving spouse.

Example: Fred and Wilma are married. They are each age 73 and therefore they are subject to taking required minimum distributions (RMDs)from their retirement accounts. While married their combined RMDs from their IRAs are $60,000. Fred's Social Security retirement benefit is $48,000 a year. Wilma's Social Security retirement benefit is $24,000 a year, for a combined $132,000 in taxable income [they are in the 22% marginal tax bracket.]. The total federal income taxes that Fred and Wilma pay is $11,053 on this combined amount of their reported income. Assume Fred, being overweight his entire life, dies first. Wilma inherits Fred's IRA. Accordingly, Wilma will continue to take RMDs of about $60,000 a year. Wilma will lose her Social Security retirement benefit ($24,000) but she will now be entitled to claim Fred's Social Security retirement benefit since it was larger of the two Social Security amounts. After Fred's death, Wilma's income will still be the $60,000 in RMDs and $48,000 in Social Security retirement benefits, or $108,000 combined income that Wilma will report [she is in the 24% marginal tax bracket.] Wilma loses access to the $24,000 that she and Fred's lifestyle was based upon. Added to this problem is the fact that Wilma, who claims the Standard Deduction, has that Deduction reduced from $27,700 when she and Fred were married, down to $13,850 as a single taxpayer. The result is that Wilma will pay a federal income tax on her $108,000 taxable income of $17,141. To summarize, after Fred's death, Wilma will have $24,000 less income (i.e., she lost her Social Security retirement amount) and she will pay $6,088 more in federal income taxes due to the loss of 50% of her Standard Deduction. The combination of the two, a loss of $24,000 in income and an additional $6,088, or $30,000, represents the *widow's penalty.*

Planning: There is not too much a married couple can do to 'plan' for the *widow's penalty.*

> Awareness: Perhaps the first step is to simply to be made aware that the *widow's penalty* exists so that it does not come as a complete surprise in the year after a spouse's death while the survivor is still in their grieving period.
>
> Maximize Social Security: The next step a married couple can take is to extend the time when the higher earning spouse claims Social Security benefits. The delay in taking Social Security retirement by one year increases that benefit by 8%. The delaying in taking Social Security to age 70 could increase the final retirement benefit amount by upwards of 32%. The goal is to ensure that the surviving spouse will be left with the highest possible Social Security retirement benefit possible.
>
> Roth Conversion: The last step, considering the ever-increasing RMDs as the married couple ages, is to convert their traditional IRAs to Roth IRAs. This should be explored while the federal income tax rates are relatively

low and while the couple is still married and capable of exploiting lower federal income tax brackets with the ‘doubled’ Standard Deduction.

Conclusion: The *widow’s penalty* is not really a ‘trap’ since we are all aware of it. Unfortunately, not too many married couples plan for the *penalty.* For wealthy married couples, the *penalty* is probably more of a financial irritant than a major problem. But for married couples of modest wealth, the *penalty* can be a major financial drain to the surviving spouse.