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Survivors' Biggest Mistakes

Widows and Widowers Often Lose Money Needlessly; the IRA Rollover Penalty

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A larger share of people's savings is winding up in IRAs—even as estate-tax rules are getting trickier and the markets are growing more volatile.

All of this is making life more complicated for widows and widowers, and could cause them to make significant mistakes with their money.

"There's so much fear and anxiety, even if you have everything in place," says Karen Altfest, a certified financial planner in New York who often works with surviving spouses.

One big problem: Standard advice that doesn't fit your situation—such as rolling your spouse's individual retirement account into your own. Don't follow any rules of thumb before weighing them against your own circumstances.

Here are some of the most common mistakes that widows and widowers make while sorting out their inheritance:

Paying unnecessary IRA penalties. If you inherit an IRA from your spouse, you can roll it over into your own IRA. In fact, some IRA custodians and 401(k) plans automatically do that unless the surviving spouse's financial planner intervenes. Such a "spousal rollover" generally makes sense if you are at least 59½ years old, the age at which you are allowed to start tapping an IRA without paying a 10% penalty on early withdrawals—though you will still owe income tax.

But the median age for women widowed the first time is 59.4, according to the U.S. Census Bureau. That means many widows are younger than 59½, and if they need to tap IRA assets to supplement their income or cover other expenses, they would have to pay that 10% penalty.

People under 59½ often are better off transferring the money into an "inherited IRA," which remains in the deceased spouse's name, and then transferring it into their own IRA when they hit the age when withdrawals are penalty-free, says Michael Lynch, a certified financial planner with MetLife's Barnum Financial Group in Shelton, Conn.

With an inherited IRA, most beneficiaries have to take a required withdrawal every year based on their life expectancies. But if the deceased spouse was not yet 70½, the surviving spouse doesn't have to take any required distributions until the year the deceased spouse would have

turned 70½. (With an inherited Roth IRA, you still would have to follow the same withdrawal schedule, but you generally wouldn't owe any income tax.)

One 50-year-old widow who Mr. Lynch worked with recently already had planned to quit her job to go back to school when her husband died, so he encouraged her to use IRA withdrawals for tuition and living expenses. That way, her income, and her corresponding tax bracket, would be relatively low while she wasn't working.

"So often all the focus is on deferring taxes, but you're going to pay taxes [on IRA withdrawals] eventually," Mr. Lynch says. "It's better to do it when you're in a lower bracket."

Portfolio paralysis. What about the investments inside the inherited IRA, or inside any inherited brokerage accounts? The portfolio should reflect the survivor's circumstances, Ms. Altfest says, not the couple's.

She says she has had clients come to her because their deceased spouse frequently traded stocks or owned lots of high-risk commodities they knew little about.

Ms. Altfest suggests widows assess their own risk tolerance, seeking help from a financial planner to do so if they need it, and then redeploy the assets in investments with which they are comfortable.

"Find somebody who's sympathetic and interested in teaching you as you go along what to ask about," she says.

Forgoing future estate-tax breaks. Under federal law, spouses can use what as called "portability" to double the $5 million estate-tax exemption to $10 million.

But there is a catch: Even if the first spouse's estate is valued at less than $5 million, that estate still has to file a federal estate-tax return and elect portability to use the leftover exemption in the future, says Paul McCawley, an estate-tax lawyer at Greenberg Traurig in Fort Lauderdale, Fla. (The law, enacted late last year, expires after 2012, though many tax-policy experts think Congress may make the portability perk permanent.)

Say the wife dies first with a $1 million estate, which doesn't necessarily have to file an estate-tax return. But the husband runs a growing business and someday could wind up with a multimillion-dollar estate. His wife's estate should file a tax return electing portability, Mr. McCawley says, so that down the road the widower's heirs could add the remaining $4 million exemption to his $5 million one.

Still, filing an estate-tax return when isn't required is a bit of a hassle, especially with portability's future uncertain. An estate-tax return "can easily cost a few thousand dollars," Mr. McCawley says, and there are often extra appraisal costs.

An estate also can get hit by state-level estate taxes in about a dozen states with estate-tax thresholds that are less than $5 million, says James Cundiff, a partner at McDermott Will & Emery in Chicago. Such taxes can apply when the first spouse dies and again when the second spouse dies. Trusts can help defer such taxes.

In Illinois, for example, the amount exempt from estate tax is $2 million. So if your spouse leaves you $5 million in a trust, you would owe Illinois estate tax on $3 million. To defer that tax until you die, you could divide the trust into two—one a $2 million trust and the other a $3 million trust—and make what is called a "qualified terminable interest property" election, Mr. Cundiff says.

If Illinois eliminated that tax before the second spouse's death, the estate might never have to pay it, he says.

Collecting Social Security too soon. Surviving spouses are allowed to start collecting Social Security survivor benefits at 60—but, as with Social Security retirement benefits, they would get a smaller amount each month than they would if they waited until their full retirement age. For more information, go to ssa.gov/retire2/agereduction.htm and ssa.gov/survivorchartred.htm.

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