A Quiet Advocacy: Preparing Clients for a Change in Tax Filing Status

by Jonathan Guyton, CFP®

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Financial planners sometimes describe themselves as advocates for their clients. In such a capacity, we advocate for current decisions and strategies that clients in their future life would want themselves to follow today if only they knew now what they will know then. Of course, none of us can know today what we will tomorrow; however, we can certainly advocate for the positions in which our clients might hope to find themselves.

Often, such advocacy—literally, "to give voice on behalf of"—champions goals, dreams, and aspirations that won't be realized for years. It is indeed inspiring stuff when we can make a small difference that helps clients see their visions coming more into focus and closer to reality. However, there are other times when this advocacy is quieter, more "defensive" and prepares clients for possible contingencies which, for some, are the stuff of nightmares.

A Matter of Quantity and Quality

Few events are more jarring—emotionally, psychologically, and even physically and spiritually—than the premature death of a spouse. It's a life transition of monumental proportions. If we've served the couple well, we will at least have prevented "financial" from appearing in the list of its jarring aspects. We tend to first think of this as a matter of quantity: will the surviving spouse have enough assets and income as they move forward with their life? But it's also a matter of quality: can the survivor's assets and income be constructed to somewhat mitigate the cruelest tax increase in our income tax code when shifting to the "single" filing status?

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Especially when a surviving spouse is well along in retirement, the toll that this tax takes—absent thoughtful planning strategies consistently applied throughout earlier retirement years—can be rather shocking over the widow(er)'s remaining life. Yet this topic seems to not get much attention in our profession's retirement planning literature, almost as if those who marry retain that tax status until their dying day. Of course they don't. And, of course, we know that planners who indeed practice planning-done-well see this as part of their client advocacy as much as they do when advocating for a client's dearest dreams. Still, some straightforward examples may be a helpful reminder of the difference our ongoing advisory attention can make.

As all U.S. financial planners know, a single taxpayer reaches each tax bracket at a far lower income than a taxpayer who is a married couple filing jointly. Most importantly, this happens twice as quickly when moving from the 15 percent federal bracket to the next bracket, 25 percent. It's the biggest jump in the tax code.

In 2016, the taxable income line separating these two brackets is $37,650 for singles and $75,300 for married couples. In other words, single taxpayers reach the 25 percent bracket with half as much income as that required by married couples—a corollary, if you will, of no "marriage penalty" at these income levels. Although this seems fair enough in the abstract, it can be a cruel surprise to the recently widowed spouse upon filing her first single tax return for the year after her beloved's death. To add insult to injury, she will almost always have a larger portion of her Social Security benefit included as taxable income than before the death of her spouse.

Imagine a married couple with $100,000 in total income, where $73,000 is taxable after deductions/exemptions. They land in the 15 percent bracket and owe approximately $10,000 in federal tax, or about 10 percent of their total income. Now imagine that the widowed spouse, on keeping the larger Social Security check and all financial assets (since you can't take it with you), still has $80,000 in total income with $61,000 taxable after deductions/exemptions. This places her well into the 25 percent federal tax bracket for single taxpayers and gives her a federal tax bill of approximately $11,000, or about 14 percent of total income; $1,000 more than when married, even with $20,000 less income.

Mitigating the Widow's Penalty

While our clients obviously must take the tax code as they find it, planning strategies can mitigate at least some impact of this "widow's penalty." The key is to lessen the amount of taxable income which, due to their spouse's death, now finds itself in the 25-plus percent marginal tax brackets for the widow's remaining years of life.

To illustrate, consider a same-aged couple with $1 million in financial assets in the first year of their required minimum distributions (RMDs). Assume that $750,000 of this are IRA assets, with the remainder in a brokerage account. Assume further that this couple rebalances annually to a 50/50 asset allocation and that each account is invested with this balance. Lastly, make the very simplistic assumption that stocks return 7 percent, and bonds return 3 percent each year as long as at least one of them is alive; thus, their portfolio earns 5 percent annually.

Their first RMD is approximately $27,400. A decade later, after withdrawing the RMD amount each year, their IRA value is $785,000. The subsequent RMD at age 80 is approximately $42,000, regardless of who is or is not living. The higher this RMD amount, the more Social Security income will also be taxable, and the more likely that taxable income will cross into the 25 percent marginal bracket. And should this year—or one just before or soon after—be the first with a surviving spouse's single filing status, she will almost certainly be over that line.

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By contrast, suppose that by age 70 this couple had completed a series of Roth IRA conversions such that 20 percent ($150,000) of their IRA assets were now in a Roth IRA. All else equal, their RMD amounts will also be 20 percent lower; the first year's is approximately $21,900, and the age 80 amount is approximately $33,600. This is not only more than $8,000 less than without this tax planning, it's likely greater because this lower amount likely allows more Social Security income to remain tax-free. And if these now-non-taxable IRA and Social Security income amounts would have otherwise been on a widow's tax return, they may be dollars on which a 25-plus percent tax is now avoided.

As an important sidenote, these conversions would most likely not have been worth doing had the Roth conversions also made significantly more Social Security income taxable in these years. However, if the couple was waiting until age 70 to claim the larger benefit, this would be a nonissue. Even if full Social Security benefits were already being collected, it still could be a worthwhile planning technique if the Roth conversions occurred while living in a state with no income tax and where a future move to a higher-tax state was likely.

Beyond this strategy, if the financial planner who was so savvy at tax planning was equally adept at thinking through the asset location aspects of investment policy, even more benefit could be reaped. Remember that at age 70, $400,000 of this couple's $1 million in assets were in Roth IRAs and non-qualified accounts. To achieve a 50/50 overall asset allocation, if $350,000 of this was in stocks (specifically, investing the Roth 100 percent in equities and giving the non-qualified accounts an 80/20 mix), the IRA need only hold $150,000 in stocks and would thus have a 25/75 allocation.

Based on our simplistic stock and bond return assumptions, the IRA would then earn a 4 percent annual return rather than 5 percent, if all accounts were invested identically. This may not seem that significant; however, it makes the age 80 RMD amount approximately $30,500—almost 10 percent less than if this asset location opportunity were ignored, and nearly 30 percent below the ongoing RMD amounts under the "naïve" approach. Not only would this further reduce taxable income going forward (likely at a 25-plus percent marginal rate absent these steps), its by-product would also give the widow (and/or future beneficiaries) notably larger non-qualified and Roth IRA asset totals from which to draw at precisely the time in life when both the surviving and deceased spouse would have wished this to be the case.

This is client advocacy in perhaps its truest sense. Certainly not very inspiring stuff, but it can make a whale of a difference in your client's well-being—even if they and their family never fully appreciate the true value of such advice. What you did was merely planning-done-well, both in its comprehensive nature and its competent execution. ■