A TAX BILL OR A LEGACY: WHICH WILL YOUR HEIRS INHERIT?

If your objective is to leave as much as possible of your retirement accounts to your heirs, then it's important that you consider how the recent legislation significantly alters what your heirs may receive.

If you've accumulated a nice nest egg in your employer qualified plan and/or IRA as well as developed a significant portfolio of other investments, you may plan to delay taking distributions from your qualified assets until the age when you are required to take money out (now age 72) because this strategy allows your qualified assets to continue to grow on a tax-deferred basis.

Alternatively, if you're already over the age where you are required to take distributions from your qualified assets, and you are taking money out only because the government requires you to do so, you're likely just taking the required minimum distribution (RMD) amount so the balance can continue to grow tax-deferred.

In both situations, when your heirs inherit your qualified accounts, they will be hit with a tax bill. That tax bill just got larger because of recent legislation.

Prior to the recent legislation, when an IRA owner died the remaining balance of their retirement account could be distributed to heirs such as children or grandchildren in annual installments over the life expectancy of the beneficiary. The new law completely changed this scenario. Now, most nonspouse beneficiaries must take distributions within 10 years. The difference in the after-tax amount received by the heir can be staggering.

For example, prior to the recent legislation an IRA left to a 40-year old child could be distributed over 45.7 years. If the 40-year old child inherited a $500,000 IRA, the first distribution would be $500,000/45.7 or about $10,941. Depending on the beneficiary's other income s/he would pay federal income taxes anywhere from no tax (if RMD is the only income) to $4,048. At a 6% growth the inherited IRA would grow to $901,788 in 20 years, even as the child takes annual distributions, and would remain over the $500,000 inherited for most of the child's life.

The new law completely changed this scenario.
Now the child must distribute the entire balance within 10 years. If the child amortized the $500,000 over 10 years with the same 6% growth factor the distribution would be $64,089. That change would push the child into a higher tax bracket with income tax between $7,274 (if RMD is the only income) to $23,713 annually. At the end of 10-years the child will pay between $72,740 to $196,650 more in income taxes and the IRA would be depleted.

PUTTING YOUR IRA TO WORK

That's why today IRA owners and qualified plan participants are looking for alternative ways to transfer their account balances to their children and grandchildren, while reducing the amount the IRS will take. We introduce you to three proven strategies you may want to consider for protecting or helping to enhance the value you pass to your heirs.

STRATEGY #1: OFFSET INCOME TAXES

Example Assumptions: Our example, while purely hypothetical and only for illustrative purposes, will demonstrate how the alternatives might work for you. We assume the strategies involve an individual, age 65 who owns an IRA that has a current account value of $500,000. We assume a 6% growth rate for the IRA and a combined federal and state tax rate of 26% for the IRA owner and 43% for his children (IRA beneficiaries). The example assumes the IRA owner begins taking required distributions at age 72 and no other amounts are withdrawn.

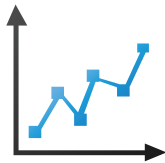
Overview

If a beneficiary receives IRA proceeds due to the IRA owner's death, the beneficiary must pay income taxes on the full amount. The offset income tax strategy involves using life insurance to help pay/offset the projected amount of income taxes your beneficiaries will owe.

How it works

STEP 1.

Determine the projected value of the IRA at a point in the future when you might expect to transfer the IRA to your heirs.



Most people would project a transfer age that approximates their life expectancy, or you can simply select an age such as 80, 85, 90 for illustrative purposes. We assume the projected IRA value at age 85 for our example. Using our 6% annual growth rate for the IRA, the projected value at 85 is $847,073 assuming the IRA owner only takes withdrawals of the RMD amount.

STEP 2.

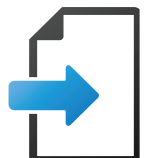
Estimate the income tax your beneficiary will owe if the IRA owner is inherited as a lump sum when you turn age 85.

If your beneficiary inherits the IRA as a lump sum, income taxes will be assessed on the entire amount as follows:

Estimated Value Age 85	x	Estimated Beneficiary's Tax Rate	=	Taxes Owed by Beneficiary
$847,073	x	43%	=	$364,241

STEP 3.

Purchase a life insurance policy.



You may want to consider using a portion of your IRA to purchase a life insurance policy with a face amount equal to the beneficiary's estimated taxes ($364,241) on the inheritance of the IRA at your age 85. If you are concerned about what would happen if you needed care for an extended period of time, you might want to consider adding a rider to the life insurance policy which will help pay the cost of care.

Since life insurance death benefits pass to a beneficiary income tax-free, naming your IRA beneficiary as beneficiary of the life insurance policy will help your beneficiaries pay the income taxes associated with receiving the IRA. This enables the beneficiaries to receive an inheritance equal to the pre-tax of the IRA.

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STRATEGY #2: SPOUSAL ROTH CONVERSION

Overview

The recent legislation has caused an increase interest in Roth conversions by IRA owners, especially owners interested in intergenerational wealth transfer who find themselves in a lower income tax bracket than their younger generation heirs who must take distribution of the funds within a 10-year period. Roths have a couple of interesting features that make them a useful planning tool.

- While the younger generation heirs must distribute the funds within a 10-year period the distributions are income tax-free.
- Unlike traditional IRAs where the owner must take distributions starting at age 72, a Roth IRA owner is not required to take distributions. So, assets within a Roth can continue to grow tax-free for an extended period of time.

Despite the advantages of Roth IRAs, people are reluctant to convert because at the time of conversion taxes must be paid. What if you could be provided the money to pay the taxes on conversion to a Roth IRA? One popular planning technique that can help manage the taxation on a future Roth conversion is the Spousal Roth Conversion strategy.

How it works

STEP 1.

The IRA owner designates his or her spouse as the sole beneficiary of the IRA.

Unlike other beneficiaries when a spouse is the sole beneficiary s/he can role over the IRA and take it as his/her own. The spouse can then convert the IRA to their own Roth. Since the spouse is considered the owner s/he is not required to take distributions. However, when the spouse converts the IRA to a Roth income taxes are due.

STEP 2.

Project the value of the IRA at the point in the future when you might expect the IRA to pass from the owner to the surviving spouse.

As mentioned previously, the value of the IRA at the owner's age 85 is projected to be approximately $847,073.

STEP 3.

Estimate the income tax the surviving spouse would owe to convert the traditional IRA to a Roth.

Unlike the younger heirs the surviving spouse may not be in as high of a tax bracket. If the conversion is done in the year of the IRA owner's death the spouse will still qualify as married filing joint return.

If we assume the spouse does a lump sum conversion of the Roth in our example she will likely be in the top tax bracket so we will assume a combined bracket of 43%. Taxes owed will be:

Estimated Value Age 85	x	Estimated Beneficiary's Tax Rate	=	Taxes Owed by Beneficiary
$847,073	x	43%	=	$364,241

STEP 4.

Purchase a life insurance policy insuring the IRA owner's life.

You may want to consider purchasing life insurance on the IRA owner's life with the spouse as beneficiary with a face amount equal to the spouse's estimated taxes ($364,241) on conversion to a Roth at age 85. Since the death benefit passes to the beneficiary income tax-free, this will provide the spouse with funds to help pay the income taxes associated with converting the IRA to a Roth.

STEP 5.

At the death of the spouse the Roth passes to the younger beneficiaries income tax-free.

STRATEGY #3: ELIMINATE INCOME TAXES

Overview

If you have a charitable interest, this strategy is designed to use life insurance to help reduce any income taxes that might be associated with a beneficiary inheriting an IRA while providing an amount approximately equal to the value of the IRA at the owner's death as a death benefit to the beneficiary.

How it works

STEP 1.

Project the value of the IRA at the owner's assumed death at age 85.

As mentioned previously, the value of the IRA at the owner's age 85 is projected to be approximately $847,073.

STEP 2.

Purchase a life insurance policy.

You may want to use some of the IRA to purchase a life insurance policy that names your heirs as beneficiary with a face amount equal to the projected value of the IRA at age 85 ($847,073). Again, if you are concerned about what would happen if you needed care for an extended period of time, you might want to consider adding a rider to the life insurance policy which will help pay the cost of care.

STEP 3.

Name a charity as beneficiary of the IRA.

When a charity is named beneficiary of the IRA the charity does not pay income taxes on the proceeds because charities are exempt from paying income taxes. In addition, naming a charity as beneficiary of the IRA may also help reduce overall estate value and consequently any applicable estate taxes.

Now that more IRA and retirement plan beneficiaries are likely to inherit a larger up-front tax bill, life insurance may help alleviate some of that cost.

Now is the time to take steps toward managing the taxes. Life insurance can be used to replace the legacy your children and grandchildren might have otherwise received had the stretch remained a planning option.

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