

A More Generous Way to Leave Your IRA to Your Heirs

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Are you wondering what will happen to the assets that you have accumulated in your traditional IRA or similar retirement account if you die? Do you know the options available to you and to your heirs regarding these accounts? If you are unsure of how to answer these questions, you are not alone. Many people contribute to these accounts to help provide for their retirement without considering or understanding what will happen to these assets if they are not used up during the retirement years. They know that they can defer the income tax on these assets until their retirement, but they are not sure what options that their heirs will have.

The most common way retirement accounts are transferred to children or other heirs at death is by specifically naming heirs as the beneficiaries of the account. This may be the simplest way to ensure these assets are distributed to your heirs. However, it leaves all of the responsibility of how to best handle the accounts with the heirs. What many people do not realize is that their heirs do not have the option to fully defer the distributions and the resulting income tax like the original owner of the account had. Also, the heirs often do not realize that they do have the option to defer some of the distributions. Very often, the result is that the heirs simply take a full distribution of the account. This can result in the heirs paying income tax on the full account almost immediately.

For example, if mom names her daughter as the beneficiary of her \$200,000 IRA, the daughter would become the owner of the assets at mom's death. If daughter liquidates the IRA, she will owe income tax on every dollar of the account. At a 30% tax bracket, daughter would owe \$60,000 in income taxes, leaving her with \$140,000.

On top of the income tax issues involved with IRAs, the full value of these accounts are includable in your estate at your death for determining the amount of estate tax that your estate will have to pay. The good news is that an income tax deduction is allowed for the amount of the estate tax attributable to the IRA when the new beneficiaries take distributions from the account. The bad news is when combined, if the beneficiaries take an immediate, full distribution, the beneficiaries could lose 60% or more of the account to taxes.

In other words, in the example above, if the value of mom's other assets make her estate taxable, estate tax will be owed on the \$140,000 daughter receives. At a 45% bracket, the estate would owe an additional \$63,000 in estate taxes. Combining income and estate taxes on the IRA, the daughter only nets \$77,000 of the original \$200,000 - \$123,000 is lost in taxes.

So what other options do you and your heirs have to maximize the benefit of these accounts that you have worked so hard to build?

If you name your heirs as the beneficiaries of the account, they will have the option to “stretch” distributions from the IRA over their life expectancy. This allows much of the account to continue to enjoy tax-deferred growth. Also, with the possible deduction if there were estate taxes that were paid because of the value of the account, some of the distribution in the first years may not be taxable. However, after the deduction is used up, the full distributions for the life of the account will be taxable as ordinary income. Also, because distributions are tied to the beneficiary’s life expectancy, there is the possibility that the beneficiary may outlive the distributions by several years.

For example, if daughter is 50 years old when mom dies, she could choose to begin taking distributions based on a percentage of the account value. The percentage daughter must take each year depends on her life expectancy when she inherited the IRA. According to the IRS Uniform Life Table, the life expectancy of a 50 year old is 34.2 years. Therefore, daughter will have to withdraw at least 2.92% (1 divided by 34.2) of the \$200,000 in the year after she inherits the IRA. The next year, she will have to withdraw at least 3.01% (1 divided by 33.2) of the remaining assets. Each succeeding year, daughter has to withdraw a higher percentage of the remaining account until she reaches her IRS-determined life expectancy, age 84.2 years, when she will be forced to withdraw any remaining funds from the inherited IRA. At any time, daughter could withdraw any amount she desires from the inherited IRA. Any distribution she receives from the inherited IRA will be fully taxed as ordinary income.

For those who have some charitable inclination, there may be an even better option. The account owner can create a Charitable Remainder Unitrust that will receive the distribution from the IRA at the owner’s death. The Unitrust will pay an income to the beneficiary, possibly for the lifetime of beneficiary, and then distribute the remainder of the assets to charity at the end of the trust term. This “Stretch Unitrust” seems very similar to the beneficiaries electing to stretch distributions from the IRA, but it may provide some additional benefits. The Unitrust option allows the owner of the account to choose to have distributions “stretched” instead of giving complete control to the beneficiaries. Also, since the distributions from the trust may be tied to a beneficiary’s lifetime, as opposed to their life expectancy, the payments will continue even if the beneficiary lives a long life.

There may also be tax benefits in using a “Stretch Unitrust.” Since, the remainder of the Unitrust assets will eventually go to charity at the end of the beneficiary’s life, an estate tax deduction is allowed that may reduce potential taxes and get more assets to the heirs immediately. Also, with proper investment by the trustee of the trust, payments in the later years of the trust, after an amount equal to the value of the account is distributed, may be taxed as capital gain income at lower capital gains rates, instead of being taxed at the higher ordinary income tax rates. The deduction that is allowed for the estate tax attributable to the account is not applied to the initial distributions as with the “Stretch

IRA” option but it does reduce the amount of principal in the trust that is treated as ordinary income when it is distributed. Thus, while more tax may be paid on early distributions, the deduction allows the trustee to more quickly begin distributing capital gain income to the beneficiary.

The final additional benefit to using to using the “Stretch Unitrust” option to distribute your IRA to your heirs is, of course, the charitable contribution that will be made at the end of the trust. You can not only leave a beneficial inheritance to your heirs with this option, you can also make a very generous contribution to your favorite charity or group of charities.

Continuing our example from above, mom could create a Charitable Remainder Unitrust and fund it with her \$200,000 IRA at her death. The Unitrust could pay daughter a 6% income for as long as she is alive. Assuming the assets inside the trust earn at least 6% each year, daughter will receive an annual income of \$12,000 as long as she is alive, even if she lives past 105 years of age. While all of the income daughter receives initially would be fully taxed at her ordinary income rates, the distributions in the later years could be taxed at capital gain rates. At daughter’s death, any assets remaining in the Unitrust will be distributed to charitable organizations.

Many people want to help charitable organizations quicker than a Unitrust allows or like the simplicity of leaving their IRA outright to beneficiaries, so they can control the funds better. Using beneficiary designations, an IRA owner can do both. On beneficiary designation forms, you could name your heirs and charities as the beneficiary of a specific percentage of the account. At your death, the specified percentage of the IRA will be distributed outright to the charities you name and the rest can be stretched as described above.

Leaving assets to charity directly from an IRA is actually one of the most efficient ways to give. Since charity will receive the IRA assets directly from your account administrator at your death, the charity will receive the full value of the distribution; there will be no income tax lost. If you know you want to give assets to charity at your death anyway, look to your IRA first.

For example, if mom wants to give half of her IRA to her daughter and half to charity, she could name them each as a 50% beneficiary. At her death, \$100,000 would be distributed to charity with the rest going to daughter. Again, assuming a 30% income tax bracket, daughter will net \$70,000 after losing \$30,000 to income tax. If mom has a taxable estate, charity would still receive the full \$100,000, since the charitable contribution is a deduction for estate tax purposes.

Without properly considering and planning for how your IRA will be distributed to your heirs, a large portion of this hard-earned asset may be needlessly lost in taxes. By taking the initiative, you can ensure that the majority of the account provides a benefit to the people and causes that you love. Contact your professional advisor to discuss the option that works best for you.