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A Tax-Smart IRA Beneficiary Plan For The SECURE Act

JANUARY 9, 2020 • JAMES G. BLASE

The two-fold concern created by the new tax law is that not only must all of the tax on defined contribution plan benefits (which, for this purpose, includes IRAs) be paid much earlier than in the past, but the tax rate on the receipts will likely be much higher than in the past, due to the bunching of income during a period when the recipients are likely to be in their peak earning years, e.g., ages 55 through 65.

There are a number of alternatives the client can consider in order to mitigate the adverse effects of the new tax law. One idea is to pay all or part of the IRA or defined contribution plan portion of the owner's estate to lower income tax bracket beneficiaries. The theory here is that, if we have to live with the new tax law, at least minimize its effects by planning our estates in a tax wise manner.

Assume, for example, that an individual has four children, two in high income tax brackets and two not. Why not consider leaving the IRA portion of the individual's estate to the children in lower income tax brackets, with the other, income tax-free assets, to the children in the higher tax brackets? Of course, a drafting adjustment should be made for the fact that the lower tax bracket children will be receiving taxable income, whereas the others will not be. The amount of these compensating adjustments may need to be changed over time, depending on all relevant factors, including the children's anticipated future income tax situations.

This plan can be taken a step further if the individual is interested in leaving a portion of his or her estate to grandchildren and/or great grandchildren, who may be in even lower income tax brackets than the lower tax bracket children (subject, of course, to the Kiddie tax). Just because an existing plan to defer income tax on IRA assets over the lifetime of grandchildren and/or great grandchildren will no longer be possible, does not mean distributions to grandchildren and/or great grandchildren in lower tax brackets (and who are usually also more in number than children, thus spreading the IRA, etc. income over more taxpayers) is not still a beneficial income tax planning strategy, due to the lower overall income taxes which often may result.

To illustrate the potential benefits involved with this tax-wise IRA planning technique, assume that an individual has two children, A (in a 20% combined federal and state income tax bracket) and B (in a 40% combined federal and state income tax bracket), and an estate consisting of a $1 million IRA and $1.5 million in cash, investments and real estate outside of the IRA. Instead of leaving the IRA equally to A and B, the individual might decide instead to leave the $1 million IRA all to child A, with the cash, investments and real estate held outside of the IRA split equally under the individual's estate planning documents between the two children, after factoring in the IRA passing to child A outside of the individual's estate planning documents. The individual might then elect to make a specific cash gift to child A of $200,000, in order to compensate A for the income taxes A will need to pay on the $1 million IRA.

Based on the aforesaid assumptions, the individual $2,500,000 total assets would be distributed as follows:

a. Child A would receive: (1) the $1 million IRA passing outside of the individual's estate planning documents; (2) the $200,000 cash gift the individual elected to leave A to compensate for the income taxes A will pay on the IRA distributions; and (3) $150,000 cash, investments and real estate, or $1,350,000 total; and

b. Child B would receive $1,150,000 cash, investments and real estate, with no benefits under the IRA, and no compensating adjustment since B will not be paying taxes on IRA distributions.

On an after-tax basis, A receives 800K worth of IRA plus 350K [i.e., 200K + 150K] worth of cash, investments and real estate, or $1,150,000, total, net of taxes. Had there been no tax planning, A would have received $1,150,000, net of taxes, so A's situation remains the same.

B, on the other hand, now receives $1,150,000, income tax free, or $100,000 more than B would have received, net of taxes, had there been no tax planning [i.e., $750,000 cash, investments and real estate, plus $300,000 after-tax value of one-half interest in IRA].

Each child receives an identical amount, net of taxes, and the family as a whole comes out $100,000 ahead. These tax advantages could obviously be even greater if the IRA were left to grandchildren or great grandchildren in lower tax brackets, subject to the potential application of the so-called “Kiddie Tax.”

The above-outlined plan has the additional benefit of essentially treating the new tax law as an estate tax on the individual’s estate. Most individuals wish for their assets to pass equally to their children at their deaths, after all taxes. The above tax-wise IRA beneficiary plan helps carry out this intent, saving the family significant tax dollars, in the process.

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