FINANCIAL ADVISOR

How Inherited Retirement Accounts Can Lead To Hefty Tax Bills

The Setting Every Community Up for Retirement Enhancement (SECURE) Act has a detail that should concern wealthy clients who want to leave money to special beneficiaries.

According to the act, individuals who are not eligible designated beneficiaries (EDBs) and who inherit a qualified retirement account, such as any type of IRA, must empty the account within 10 years.

“There is no annual withdrawal requirement until the 10th year. With the exception of Roth IRA accounts and Roth 401(k)s, distributions from such accounts are generally all taxable as ordinary income,” said Robert N. Polans, a CPA at Drucker & Scaccetti in Philadelphia. “Delaying these distributions until the last year or last few years to maximize the tax deferral will cause a bunching of income [that] for most people will drive them into a much higher tax bracket.”

There are five categories of individuals who can be EDBs: the owner’s surviving spouse; children of the owner who are younger than 18; disabled individuals; chronically ill individuals; and any others who are not more than 10 years younger than the deceased. Clients especially need to understand the nuances of who’s considered a disabled or chronically ill individual, Polans said.

Conduit or asset accumulation trusts can also be subject to the 10-year rule, so it is especially important to re-examine all retirement account beneficiary designations that include these types of trusts.

“Most clients have no idea what the rules are with regard to inherited IRAs, and they certainly don’t realize a large potential tax bill [could be] coming for their heirs,” added Dan Ruttenberg, J.D./CPA, a principal with SmolenPlevy in Vienna, Va.

Maximizing assets bequeathed to families involves balancing delaying taxes with paying taxes at the lowest rate, Ruttenberg said. “If your children will be in a lower tax bracket than you, they’ll probably want to use up their lower tax brackets over the 10-year period, as opposed to waiting 10 years and then paying taxes on it all at the highest tax bracket,” he said.

The new rule will motivate more wealthy clients to designate a charity as the beneficiary of their retirement plans, said Karen Goldberg, principal-in-charge of EisnerAmper’s trust and estate practice in New York. She recommends naming a charitable remainder trust—a tax-exempt entity—as the beneficiary of a retirement plan. Under the terms of such a trust, distributions, whether they be annual, semiannual, quarterly or monthly, are paid to an income beneficiary, such as a child.

“The distributions are either a fixed amount or a fixed percentage of the trust assets, paid to the beneficiary over a period of years or the beneficiary’s lifetime, and are subject to income tax,” she said. “When the trust term is over, whatever is left in the trust passes to charity. In effect, this permits a child to defer the income tax on an inherited retirement plan over his life. The estate tax on the retirement plan can be significantly reduced using a charitable remainder trust because a portion of the plan won’t be taxable.”

Ruttenberg agreed with the strategy to leave to traditional retirement accounts to charity “especially if they’re going to be subject to estate tax and income tax,” he said “Many people would rather leave 100 cents on the dollar to charity instead of [after-tax] cents on the dollar to their children. There are many creative ways to give to charity, including using private foundations.”

Polans pointed out that life insurance, such as with a short-term premium remittance period of 10 to 15 years, could allow the drawing down of the taxable IRA account and using that money (net of tax withholding) to pay premiums.

The strategy depends on the account. “The consequences are different if there are multiple beneficiaries than if there’s one,” Polans said. “Recommendations need to be tailored to specific facts and to how the specific client will likely react to the advice.”