ELECTRONICALLY REPRINTED FROM MARCH 7, 2016

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

Avoid the Dreaded Double Tax on Retirement Benefits

Proactive planning can create very compelling results

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From the very beginning of a working career, we're all encouraged to maximize what's available in the qualified plan arena. For most of us, that means deferring as much as we can into a 401(k) and/or individual retirement account. Successful savers can accumulate millions of pre-tax dollars in these types of plans.

When a retiree starts the distribution phase of life, she may have multiple sources to generate the appropriate income required for living in retirement. These could include Social Security, qualified plans, deferred annuities or non-qualified investments. A retiree under good counsel would be advised to determine the most tax effective way to distribute the income needed from the sources available. This analysis often results in the preference to distribute non-qualified assets last. Most of this has to do with income tax. Qualified retirement account distributions are taxed as ordinary income and might cause an increase in the retiree's overall marginal tax rate.

The incentive to keep assets compounding in a retirement plan can have significant tax implications if the retiree were to die. Not only would the heirs have income tax burden on the balance of the account (the highest current federal income tax rate is 39.6 percent), but also, there may be estate tax (at 40 percent). This "double tax" could result in significant erosion of an asset that represents a life's work.[1]

Other assets in the estate might be available for paying estate taxes, thus avoiding immediate taxable distributions from an inherited retirement account. However, this situation becomes precarious if the non-retirement assets aren't preferred for paying taxes. For example, heirs may not want to sell a family vacation home or long-term assets that would themselves generate associated capital gains taxes, as these may not be ideal sources of liquidity.

Example 1: Client A is single, 65 years old and has one 40-year-old daughter. He has $15 million in assets, of which $5 million is an IRA, $3 million is a family beach home and $7 million is a business interest that's liquid (but has high appreciation potential in the coming years). His non-retirement account assets are sufficient to support his lifestyle, so he doesn't anticipate using his retirement assets during his lifetime.

Client A dies in 2016 with a federal estate exemption amount of $5.45 million.

The estate owes a federal tax of approximately $3,820,000.[2] His daughter wants to keep the vacation home in the family and allow the business interest to mature to its full potential. IRA funds are used to pay the estate tax, and due to both estate and income taxes, the entire IRA is completely consumed.[3]

Could client A have been more proactive in dealing with this issue during his lifetime?

Client A would have been well advised to intentionally accelerate distributions from his IRA during his lifetime. In doing so, he would pay the income tax today while at the same time creating an irrevocable trust for the benefit of his daughter.

Introducing Life Insurance

Client A takes taxable distributions from his IRA during life, pays income tax and gives the after-tax proceeds to an irrevocable trust. The trust buys a life insurance policy on Client A, which now provides guaranteed proceeds to his family on death, free from both income and estate taxes. For example, a gift of $100,000[4] per year for 25 years could produce a guaranteed death benefit of $4,717,432, free of both income and estate taxes.[5] This can provide an extremely compelling after-tax result.

Internal Revenue Code Section 72(t)(2)

Often times, our pre-retiring clients have accumulated millions of dollars in retirement accounts from highly appreciating investments, like hedge funds or private equity. (During the last presidential election, it was speculated that Mitt Romney had a retirement account worth as much as $100 million as a result of his investments while at Bain Capital.) In cases like this, some if not all assets in the retirement plan are intended for future generations. Can someone who's under 59½ be as proactive with planning around a retirement asset?

IRC Section 72(t)(2) allows for penalty free distributions prior to age 59½ if those distributions are substantially equal periodic payments.[6] There are three acceptable methods for determining this penalty free distribution amount (required minimum distribution method, fixed amortization method and fixed annuitization method). There are a few important requirements: 1) If these distributions are from a qualified plan, not an IRA, you must separate from service with the employer maintaining the plan before the payments begin for this exception to apply,[7] and 2) If the series of substantially equal periodic payments is subsequently modified (other than by reason of death or disability) within five years of the date of the first payment, or, if later, age 59½, the exception to the 10 percent tax doesn't apply.[8]

Example 2: Client B is 45 years old, single with one child and is a successful entrepreneur and investor. His estate is worth $30 million, and due to some early investments in now publically traded companies, his IRA is valued at $10 million. His remaining estate is composed of his primary residence (which he prefers stay in the family) and illiquid start-up investments. Client B is financially secure and comfortable beginning to deal with transfer tax implications with his estate. He understands that his IRA is tax inefficient.

If he were to die today, his estate would owe $9.820 million in estate taxes.[9] In this case, nearly all of the IRA would be consumed paying the estate tax. The IRA distribution would also trigger approximately $2.376million in income taxes.[10] The surviving beneficiaries would find themselves in quite a messy situation, owing more in taxes than the amount that's liquid and available in the estate.

Client B decides to make a Section 72(t) election on the $10 million retirement account. The fixed amortization method yields $383,910,[11] the highest penalty free distribution. He pays income taxes on that amount and gifts the net proceeds every year to an irrevocable trust for the benefit of his children and grandchildren.[12] He's insurable, and the trust purchases a guaranteed life insurance contract that, on his death, will provide many millions to his trust free of both income and estate tax.

In this example, an after income tax gift of $231,881 per year for 25 years could produce a guaranteed income and estate tax death benefit of $29,252,272.[13]

Other Taxes and Future Tax Increases

This analysis becomes more compelling as we begin to factor in both state estate and income taxes where appropriate. For example, the New York State estate and income tax could add as much as 16 percent and 8.82 percent, respectively. The current political climate suggests all of the aforementioned taxes will trend higher, making the use of the aforementioned tools even more compelling.

Retirement plans are incredible vehicles for those who plan to use the assets in retirement. For those who've accumulated significant net worth outside of their retirement plan(s), more proactive planning is required to avoid an extremely tax inefficient outcome.

Endnotes

1. A beneficiary who itemizes can take an income tax deduction for federal estate tax attributable to a qualified plan/individual retirement account, which may reduce the "double tax" burden. Internal Revenue Code Section 691.

2. ($15 million -$5.45 million) x 40 percent.

3. Under IRC Section 691, his daughter is entitled to an income tax of approximately $2 million for estate taxes paid on the IRA ($5 million IRA balance x 40 percent estate tax). Thus, income taxes would be approximately $1.180 million ($3 million x 39.6 percent). The combined income tax ($1.180 million) and estate tax ($3.820 million) would be approximately $5 million.

4. Presume the client uses a combination of his lifetime and annual exemption amounts to make the gifts.

5. Prudential Universal Protector, Preferred Best Class, guaranteed to age 120.

6. IRC Section 72(t)(2)(A)(iv)

7. Section 72(t)(3)(B)

8. Section 72(t)(4)(A)(ii)

9. ($30 million - $5.45 million) x .4.

10. Assuming a tax rate of 39.6 percent and a deduction of $4 million under IRC Section 691.

11. The annual distribution amount is calculated by amortizing the account balance ($10 million) over a number of years equal to Client B's single life expectancy (obtained from Q&A-1 of Treasury Regulations Section 1.401(a)(9)-9, using age 45), at a 2.17 percent rate (January 2016).

12. Presume Client B uses a combination of his lifetime and annual exemption amounts to make the gifts.

13. *Supra* note 5.

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