

Retirement Plan Assets

Or can any asset really be a “bad” asset?

It's not so much whether an asset is “good” or “bad”, it's the often misunderstood baggage that accompanies certain assets when the estate planning process is being considered. Many professionals and retirees have worked a lifetime, and have accumulated a significant account balance in their 401(k), 403(b), 457 deferred compensation, profit-sharing, SEP, or IRA and don't realize that their heirs will not receive the full value of that account. The trade off for tax deferral is the penalty for use prior to age 59½ and requirement that minimum required distributions, designed to expose those deferred funds to income taxation, commence by 70½. Besides owing an income tax on these tax deferred assets during retirement, there's even an ongoing income tax on any of these inherited accounts. Like any “income in respect of a decedent” (IRD*) asset there may be an added state and federal estate tax liability for some successful savers. The net result is that, for some individuals, their accounts may be stripped of over 70% of the value due to the nature of the account.

How much money is in those retirement accounts? Estimates are in the trillions of dollars for Individual Retirement Accounts (IRA) alone, add all of the other defined contribution plans and the “bad asset” money really begins to add up. Compared to appreciated assets that “step-up” in basis at death, and pass without an income tax to heirs, there's really a reason to think of assets as good and bad. For instance, a physician, advised for reasons of asset protection against frivolous malpractice litigation to defer salary into retirement accounts, may find that passing anything to heirs will be a difficult task. With all of the estate assets tied up in a typical IRA or retirement account, even with the larger estate tax exemptions available this year, the confiscation of over half of this estate is still a significant burden.

Taxable Estate with large IRA	\$5,000,000
Federal estate tax in 2007	\$2,130,800
Applicable exclusion amount	\$780,800
Net federal estate tax	\$1,350,000
IRD subject to income tax	\$3,650,000
Federal marginal tax rate of 35%	\$1,277,500
Net to heirs	\$2,627,500

accounts instead of the IRA, there could have been an added \$1.2 million received by heirs. However, for charitably minded donors, there are easy ways to pass these assets directly to charity without an income tax by simply modifying the beneficiary designation on the account to include a favorite nonprofit organization. Since tax-exempt organizations do not normally pay income tax on inherited retirement accounts, 100% of those dollars go to work immediately for charities. Unfortunately, under current law, it's not possible to make an outright gift of retirement plan assets without triggering an immediate income tax. However, Congress periodically proposes to change these rules, stay current, as things change all the time. Should some version of this CARE Act pass, it would be an excellent opportunity to make gifts from an IRA, but for the time being, it's still best done via beneficiary designations.

For taxpayers with a desire to provide an ongoing income stream for spouses or family, it's possible to use either a charitable remainder trust or charitable gift annuity as a recipient of those retirement funds. Done properly, and with advice of competent tax planners, this is an effective means to ensure retirement security, and still determine exactly how and where the funds will ultimately pass to designated organizations.

* IRD Reg. 1.691(a)-1(b) defines it as the amounts that a decedent was entitled to as gross income, but which were not properly included in taxable income for the taxable year prior to date of death. Besides retirement plan assets, IRD might also include things like unpaid commissions for a sales representative, outstanding but unpaid professional fees, unsold farm produce in storage, savings bonds, etc.

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Tax efficient donors should consider giving away an estate's income tax liabilities to charity.