Retirement Education

Family Conversations: Maximizing wealth for beneficiaries and heirs

You want to live a comfortable lifestyle in retirement. You also want to leave any remaining assets to your heirs and beneficiaries. There are financial planning strategies that help you do both.

Income planning creates a roadmap to help people avoid outliving their money. A sound income planning strategy includes: maximizing retirement assets, evaluating when to take social security benefits, navigating Medicare and health care expenses, and creating an effective legacy plan.

Legacy planning is oftentimes secondary to retirement planning. However, proper legacy planning can potentially save your heirs and beneficiaries substantial amount of taxes. You want maximize your assets and minimize taxes.

Many people tend to designate beneficiaries on investment and retirement accounts like 401(k)s and IRAs without careful consideration. Most name their spouse as the primary, and may not even name contingent beneficiaries, especially if they don't have children. Overlooking contingent beneficiaries is not a good practice.

If there is no contingent beneficiary on investment and retirement accounts, and the primary beneficiary predeceases the client, then the default beneficiary is often the estate. These assets will be subject to the probate process according to a state's intestacy laws. This could result in an inefficient distribution of assets and a time-consuming process that may produce unwanted consequences.

People who name contingent beneficiaries often just assign assets equally. For example: Child 1 gets 50%, Child 2 gets 50%. They may do this for their 401(k)s, IRAs, nonqualified investments, and life insurance. It's simple and seemingly fair. Not necessarily.

Consider this hypothetical example. Joe names his spouse, Jane as the primary beneficiary of all his investment accounts and life insurance. Joe dies, so Jane is now the account owner. Their two children, Andy, a teacher, is in the 12% marginal federal income tax bracket. Denise, a doctor, is in the 37% marginal federal income tax bracket.

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Let's look at what that means if they inherit a $300,000 traditional IRA. The 50/50 split creates a $73,500 tax liability at current tax brackets: 12% x $150,000 + 37% x $150,000 = $73,500.

On the other hand, if Andy was the sole beneficiary, the amount could potentially be taxed at 12% if Andy takes distributions in installments. The total federal income taxes could be only $36,000 ($300,000 x 12%) versus $73,500. That's $37,500 less.

Beneficiary	Tax rate	IRA distribution	Federal income tax
50/50 split of a $300,000 traditional IRA			
Andy:	12%	$150,000	$18,000
Denise:	37%	$150,000	$55,500
			$73,500
Beneficiary in low tax bracket inherits entire $300,000 traditional IRA			
Andy:	12%	$300,000	$36,000
			$37,500 less in taxes

But what about Denise? Denise would be better off taxwise to inherit either life insurance proceeds (income tax-free) or assets that allow a step-up basis. Certain assets can get a tax adjustment once the owner dies that may result in potentially lower taxes. These type of assets greatly benefit those who are in the highest marginal tax brackets like Denise.

As you can see, a 50/50 split could have a substantial impact on the overall taxation of inherited assets. That's why it's important to make informed decisions about beneficiaries, including thinking about their tax brackets, where they live, and what they'll do with the money. It makes sense for you to talk to your beneficiaries about inheriting money.

Where do the beneficiaries live and work? State income tax rates vary. For example, California state income tax rates can exceed 13%—Florida and Texas have no state income taxes. There can be a big difference in taxes among beneficiaries on IRA (or other IRD) assets.

How will the beneficiary take a distribution? Will a beneficiary take a lump sum or large distribution? That could potentially translate to a large tax liability. This is an opportunity to have a candid discussion about whether you should create a trust to help ensure that assets can be passed on as tax-efficiently as possible, especially if the assets are substantial. You may consider having a conversation with your beneficiaries about what they need to know when inheriting investment and retirement accounts.

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