Case Study: The Consequences of Failing to Plan

by ElderLawAnswers.com

George Parrot (not his real name) died in January 2001 with an estate of $1.6 million, of which $1 million consisted of tax-deferred retirement plans. At first blush, it would appear that Mr. Parrot did quite well and should have left each of his four children a substantial nest egg. But that's before taxes.

First, every dollar above the $675,000 each American can give away tax-free (in 2001) is subject to state and federal estate taxes. (This amount will increase annually until it reaches $3.5 million for those dying in 2009, and as things stand now the estate tax will be eliminated entirely for those dying in 2010.) The tax on Mr. Parrot's estate will total approximately $380,000.

Second, after Mr. Parrot's wife died, he did not change the designated beneficiary on his retirement plans to his children. Therefore, the retirement plans are payable to his estate. If the children failed to change the beneficiary designation to themselves before December 31, 2002, they will have to withdraw the funds from the plans within five years of his death. Upon withdrawal, they will have to pay taxes on the income. Assuming a 30 percent average tax rate, this will come to approximately $180,000 in income taxes after taking a deduction for the estate taxes paid.

The combined taxes will total approximately $560,000, reducing the estate that will pass to Mr. Parrot's family from $1.6 million to $1,040,000, and each child's share from $400,000 to $260,000. This is an effective tax rate of 35 percent.

Could this have been avoided? Yes, at least in part. With careful planning, the effective tax rate could have been brought down to less than 20 percent, and possibly even lower.

Reducing Estate Taxes
The easiest way to limit estate taxes is to reduce the size of one's estate. This can be done by spending money, by making gifts -- either during life or at death -- to charity or to children (or others). Gifts of $10,000 or less a year per recipient do not need to be reported to the IRS. If Mr. Parrot had given each of his children $10,000 a year for the 10 years prior to his death, he would have reduced the size of his estate by $400,000 (not counting the earnings on his money, which during that time would have gone to his children instead of being added to his estate). This would have cut the estate tax by approximately $160,000.

If Mr. Parrot was uncomfortable about giving his children this money outright, he could have put the gifts in trust for their benefit. Often, such trusts purchase life insurance so that if the parent dies before substantially reducing the size of his or her estate, at least the life insurance proceeds (which will not be subject to estate tax if held in a properly-drafted trust) help offset the estate tax due.

Reducing Income Taxes
There are two steps Mr. Parrot could have taken (or his children could now take) to reduce or postpone the taxes due on his retirement plans. First, if his four children are named as the designated beneficiaries, they will not be under the five-year rule. Instead, they can withdraw their shares over their projected life expectancies. For instance, a 30-year-old with a 45-year life expectancy need not withdraw -- and pay taxes on -- any more than 1/45th of her share this year, 1/44th next year, and so on. She cannot avoid the tax forever, but the longer she can put off withdrawing the funds, the longer the account will grow tax free.

Unless his income was too high to qualify, Mr. Parrot also could have converted some or all of his retirement plans to Roth IRAs. Doing so would have forced him to pay taxes on the converted funds at the time, but they would have continued to grow tax-free indefinitely. And his children would not have to pay taxes on their withdrawal of funds from the Roth IRAs they inherited. This approach has the added advantage of reducing Mr. Parrot's estate by the amount of the income tax paid, thus reducing the amount subject to estate taxes.

If, for purposes of example, Mr. Parrot converted $500,000 to a Roth IRA and if he paid taxes at an average rate of 30 percent on this amount (this might be reduced by spreading the conversion out over several years) he would pay $150,000 in income taxes. By decreasing his estate by this amount, the estate taxes would have been reduced by approximately $60,000.

Putting It All Together

If Mr. Parrot had taken all of these steps -- gifting $400,000 over 10 years, converting $500,000 of his IRA, and designating his children as beneficiaries on his remaining IRAs -- he would have increased the amount passing to his children from $1,040,000 to approximately $1.3 million (with $500,000 still subject to deferred taxes during his children's lifetimes).

The gifts to the children would have reduced Mr. Parrot's estate to $1.2 million. The taxes he would have paid on converting his Roth IRAs would have reduced it by another $150,000, to $1,050,000. The tax on an estate of this size would be approximately $145,000 instead of $400,000. And if the gifts to Mr. Parrot's children had been in trust and the trust had purchased life insurance, even this $150,000 tax would have been covered.

What Should You Do?

Whether you make gifts, convert your IRA, or buy life insurance depends on your goals and your tolerance for these measures. While it might make sense for tax planning purposes to reduce your estate through gifts or to pay taxes on your IRA now rather than later, these can be difficult steps to take. Meet with a qualified professional to work out the best plan for your circumstances and for you.