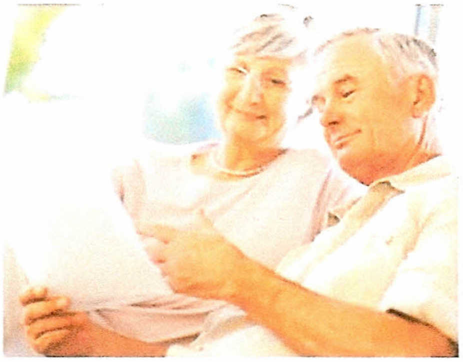
Estate Planning for IRAs and 401(k)s in a Changing Economic and Estate Tax Environment

By Kevin Carmichael, MS JD LLM CPA

In a little less than 12 months the landscape for estate planning may change radically with the expected expiration of tax cuts put in place nearly a decade ago. The expiration of these provisions, unless the US Congress acts, means that individuals with assets in excess of $1,000,000 and married couples with assets in excess of $2,000,000 will have to re-think their estate planning strategies to reduce or avoid estate taxation. The landscape is even more complicated for those whose estates consist in whole or in part of large IRAs or 401(k)s.



The complication arises from the fact that an IRA, 401(k) or other inheritable pension asset is an income tax based asset, which on the death of the participant must travel through the world of the wholly unrelated estate tax. The income tax as defined in the 16th Amendment to the US Constitution is based on increases or acquisitions of wealth from whatever source derived. The estate tax however is an excise tax on the right to transfer wealth. The statutes and regulations defining each tax are very complicated and planning choices must be made to avoid a loss of family wealth based on each person's needs and desires.

In many cases, making sure the surviving spouse is the designated beneficiary of the plan with the children as a default beneficiary is an optimal plan. But this may not be true in the case of a second marriage where there are children of the first and or second marriages. Further if the IRA or 401(k) assets comprise a large portion of the total estate it may not be possible to adequately use the $1,000,000 estate tax credit which each person will be entitled to in 2013 without the use of trusts or splitting the IRA into separate blocks.

Trusts can be Valuable Tools in IRA Succession Planning

Trusts can be an effective tool to ensure that you have the ability to use all of your estate tax credit and at the same time ensure that you are taking care of your intended beneficiaries in a way that matches your intentions. In many cases ensuring that two trusts are created on your passing is an acceptable solution. The first trust would be funded with the amount necessary to fund your estate tax credit; the second would be a trust for the surviving spouse. In most cases the primary income beneficiary of both trusts would be the surviving spouse, though it is possible to permit some benefits to your descendants in the estate tax credit trust. To get it right, you need to work with qualified advisors who understand these rules and can assist you in implementing an effective plan.

Consider the Benefits of a "stretch" IRA

If you have sufficient assets to fund your estate tax credits, without the use of your IRAs of 401(k)s, you may wish to consider alternative planning that benefits future generations. It is possible to name someone other than your spouse as the beneficiary of an IRA or if you are a surviving spouse who has rolled over an IRA you can take advantage of several forms of planning which permit a great deal of deferral for the benefit of children or grandchildren. One such planning vehicle is the so-called "Stretch IRA." If you believe you will not exhaust your IRA by the date of your passing you can name a child or a grandchild as a beneficiary of your IRA. If you have sufficient assets to adequately provide for your spouse and children giving an IRA asset to a grandchild under the right circumstances can provide decades long tax deferral until the grandchild reaches retirement age. This can turn even a relatively small amount at the end of your retirement needs into a very large benefit for a grandchild at their retirement. Again consult your IRA custodian and tax advisors to ensure this makes sense for you and can be properly implemented.

The Self-Directed IRA Alternative

One final alternative to consider in this changing economic and tax environment is to use your IRA to invest in alternative investments which can assist your descendants. While this strategy involves a great deal more risk than traditional investments, it may make sense if you have the experience and ability to understand and guide the alternative investment. This alternative investment vehicle is called a self-directed IRA. In this situation, you roll all or part of your IRA assets into a self-directed IRA which means that you will be directing an IRA custodian to invest in non-traditional assets such as equity in a small business to be acquired by a family member or in real estate or other non-traditional investments. The rules are complex but if you have knowledge and experience with similar non-traditional investments and can provide guidance; they can be an excellent way to enhance your IRA return for yourself and your family.

If your IRA or 401(k) assets make up a large part of your overall assets, you should consult with qualified tax and pension advisors to see if you have optimized your plan to save taxes, take care of yourself, your spouse and your family in the years ahead.

The comments expressed herein are intended for general informational purposes only and should not be relied upon as legal advice. Please consult legal counsel to obtain specific advice for your situation.

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