MarketWatch

From a Contributing Expert

Are You Leaving Your Family a Tax Time Bomb?

***Legacy**. It's something many of you think about.*
But, what kind of financial legacy will you really leave your family?

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Let's back it up a bit. Remember all those years ago when you first began saving for your retirement? Back in the '70s? Starting with the introduction of traditional **Individual Retirement Accounts** in 1974, you were encouraged to save for your retirement in the new tax-deferred IRAs. Every single dollar you contributed to the IRA was an income tax deduction on the front of your income tax return. Of course, we liked that idea. And, even better, those contributions you made and deducted would grow without any income tax inside those accounts during the rest of your working years.

Those who encouraged you to contribute to those accounts all sang the same refrain: take the income tax deduction today when you put your money into the tax-deferred account, because when you begin to take withdrawals from them during your retirement years you'll be in a lower income tax bracket.

The advent of IRAs was followed by the introduction of 401(k) accounts in 1978. Again, tax-deferred investing for your retirement years. The money contributed to the 401(k) out of each paycheck was deducted pre-tax from your income-taxable wages. You were told that when you take withdrawals from these accounts during your retirement years you will, of course, be in a lower income tax bracket. Sound familiar?

So, what does tax-deferred mean? Simply stated it means that the money deposited into the IRA, 401(k), TSP, or other tax-deferred account is deducted from taxable income at the time it's contributed to the account during your working years. It becomes taxable income as you take each dollar out during your retirement years.

Now, don't get me wrong, I'm not saying you shouldn't use these accounts. In fact, most of today's retirees would probably not have nearly as much saved for their retirement years if they had not decided to save in tax-deferred accounts. So, saving in the tax-deferred accounts can often make the difference between having a comfortable retirement and wondering if you'll ever be able to retire.

And, many of you have done a stellar job of saving. Depending on how much and how long you contribute, as well as the investment growth you experience, tax-deferred retirement accounts can grow to a million dollars and more.

Those wonderful benefits of tax-deferral eventually come to an end when you discover you have a partner in your retirement accounts. That previously silent partner who makes all the rules, Uncle Sam, has been waiting patiently for you to reach 70 ½ years old when you're required to begin taking taxable distributions from your IRA, 401(k) and other tax-deferred accounts. So, assume hypothetically that you'll be paying 30% federal income taxes each year, if you have a $1,000,000 account today, Uncle Sam is potentially entitled to $300,000—leaving you with $700,000. Yes, taxes do matter.

But, what if you don't need it and don't want to take a required minimum distribution? Too bad. If you miss taking what's known as a required minimum distribution,or RMD, at the appropriate time, you'll be subject to a 50% penalty. That's right: 50%. So, if your RMD is $30,000 for the current year and you miss taking it by the deadline, your penalty will be $15,000. And, you'll still have to pay income taxes, too. So, if you assume 30% taxes plus the 50% penalty for taking the distribution late, you could end up paying $24,000 to Uncle Sam leaving you with $6,000 in your bank account.

Keep in mind that once you reach 70 ½, you'll be required to take distributions from your traditional IRAs, 401(k), thrift savings plan (TSP) and other accounts every year for the rest of your life.

And, remember the plan that you'd be in a lower income tax bracket when you retire? Think about that. Do you really plan to reduce your lifestyle and living expenses to something well below your current income when you retire? No? That's what I thought, and see it with the retirees I meet every day. Most of them don't intend to cut back on their lifestyle and spending when they retire. In fact, many people often spend more now that they have time to do the things they put off for so many years. That means taxable income will probably stay the same or increase.

Remember the old saying: nothing is certain except death and taxes? Well, it applies here too: when you die, taxes on those tax-deferred accounts will still be due. No, they don't go away.

Many retirees (erroneously) assume that once they pass on to the hereafter, their heirs will be able to cash out whatever remains of their IRAs and other tax-deferred accounts without any taxes due. Unfortunately, that's just not true. The technical term for the income from these accounts is Income in Respect of a Decedent, which in simplistic terms means: if it would have been taxable income to you before you died, it will still be taxable income to those who inherit and receive it after you're gone. Make sense? Well, even if it doesn't it's the way the tax law works today. And, this rule also applies to other assets like those savings bonds stashed in the safe that you thought you'd leave to the kids. They've been accruing interest that's never been taxed, but it will.

Let's see what this tax rule looks like in a hypothetical example: Say that you have $1.2 million left in your IRA when you die. You named your three children as the beneficiaries of these accounts and they each decide to cash the accounts out immediately. Sounds great! $400,000 to each child.

A wonderful gift from mom and dad, until tax time arrives. That's when each child discovers they're now paying a combined 35% federal and state income tax on the $400,000 distribution. That means each child will owe $140,000 and gets to keep $260,000. The government gets to keep (three times $140,000) a total of $420,000 which is more than any one of the three children received to begin with.

So, can you do anything to avoid this tax time-bomb? Depending on your individual circumstances there may be some great options.

First, you can save in Roth IRA or Roth 401(k) account during your working years. You don't get an income tax deduction for contributions to those accounts, however, (and this is the great part) those accounts grow tax-free. (Note: There are income limits with a Roth.) When you take qualified distributions from them after holding them for five years and reaching age 59½, you won't owe any income taxes. (Tell your kids about this.)

Or, you can embrace the opportunity to convert your IRAs or 401(k) to Roth accounts. You can convert them all at once, or just a portion over several years, paying income tax on the dollars you convert to a Roth. There can sometimes be a sweet spot of time to do this conversion between the date you retire and before you reach age 70 ½. The Roth accounts can grow over time—forever tax-free.

It gets better. For your own Roth IRA, there are no required minimum distributions. You can leave your money invested as long as you'd like.

Remember the earlier example of your three children inheriting a $1.2 million IRA? If that had been a Roth IRA, they could have cashed it in and each kept their entire $400,000 share without any income taxes owed.

There are other choices that may also be available, depending on your circumstances, such as taking IRA distributions over time and leveraging them into tax-free life insurance that may potentially provide income tax-free living benefits to you during your lifetime for and income tax-free death benefits at your death for your heirs. This can be a powerful strategy for many.

A word of caution: Don't try this on your own. Always consult with your CPA or a specially trained financial professional who can help you evaluate the tax and financial consequences of any of the alternatives included in this article.

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