FINANCIAL ADVISORY

Your IRA Could Be Taxed Upon Your Death

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YOUR HEIRS COULD BE PAYING INCOME TAX ON THE VALUE OF YOUR IRA UPON YOUR DEATH.

Many investors have IRA accounts that were originally started as a way to save money while growing it "tax free," (but not really – more on that later), for retirement. Us real estate investors often find that our real estate investments can pay our bills when we eventually stop working – so that we don't really need that IRA money that was saved. We'll just pass it on to our heirs then – right?

Yes but, it turns out, your IRA could be taxable to your heirs as income when it is received. So that "windfall" is decreased a bit – especially if you have multiple heirs sharing an inheritance. This month, we'll talk about this tax and suggest some ways of dealing with it.

HOW THIS WORKS

With a traditional IRA, the IRS gives you a tax break now, but charges income tax on your withdrawals from it in the future. When you die; the IRS could consider that a distribution to your heirs and will charge an income tax on it.

To understand why this is, you'll need a quick course on how the IRS thinks. The government, (state or Federal) typically always wants their money: If they can't get it now, they will generally take it later. One exception to this is the step up in basis your assets will receive at your death – therefore your built-up capital gains and accumulated depreciation taxes will all simply disappear. Stocks and bonds are generally treated the same way – so it is natural for investors to assume that their IRAs will be, as well. In this case, however, that is wrong.

Remember that the two general types of IRAs are "standard IRAs" and "Roth IRAs." (All the other IRAs out there are really just a form of one of these.) 401K accounts, for example, are funded by contributions from your paycheck before tax – that is; they are tax deductible. Your distributions from such an account, (a standard or rollover IRA), would then be taxable when you receive them. (When you take money out in retirement.)

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With a Roth IRA – your distributions will be tax-free; but you are paying tax on your dollars before you contribute them to the IRA. The IRS prefers the Roth IRA, really – they get paid first, rather than later – as with the standard IRA. Note that a Roth IRA – upon your death – would not be subject to an income tax, either.

ONE "SOLUTION" (THAT REALLY ISN'T ONE.)

One "solution" that the financial "news" web sites will offer suggests that your heirs "fix" this problem by stretching their distributions from your IRA over many years.

Would I rather cash a $2 million check today and pay taxes on it, or cash a $100,000 check every year for 20 years and pay taxes on that? If I'm paying taxes either way, I'll take the $2 million now. Even if I'm paying a higher rate on the $2 million and am left with $1 million afterwards; that will change my life significantly more than $100,000 per year for 20 years will. (Particularly if I invest that money in real estate.)

ANOTHER POTENTIAL SOLUTION – WITH A BUT

Another potential solution to create a tax-free IRA distribution for your heirs is to convert your standard IRA into a Roth IRA. This would work BUT – you'll need to pay taxes on your entire IRA to make it a Roth IRA. Pay taxes now to save your heirs from paying it later? Not such an attractive solution, after all.

HOW ABOUT USING A LIFE INSURANCE POLICY TO PAY THE TAXES?

Note that these life insurance figures are for example only – and will certainly vary according to your individual situation.

In the above example, a $1 million life insurance policy could cover those taxes. Life insurance policies are paid tax-free to beneficiaries and isn't subject to income taxes, so there is no after-tax calculation to make. For a 73 year old male and his 72 year old wife, both in average health, this $1 million policy could cost $20,200 per year in premiums. So – if husband and wife both live to 97, they have paid $505,000 for this $1 million benefit. Upon the death of the last spouse – this policy's benefit will be paid to your heirs tax-free.

This month's article isn't designed to sell any particular solution; although I don't think I'm doing my job well if I just point out problems without suggesting solutions. The goal of this article is to educate taxpayers on what happens to their IRA accounts when they die. If you're avoiding using that IRA money in order to avoid taxes; it may be time to re-evaluate that strategy. If you have any questions, my toll-free number is (877) 313-1868.

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