How to eliminate the "double tax" at death

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By naming a non-profit charitable organization as the beneficiary of the IRA, the “double tax” on the IRA can be reduced to $0. Here's how.

Many estate owners hold large **IRA accounts** as part of their taxable estates. With the growth of the equities markets over the last five years since the financial crisis of 2008-2009, IRA account values of $1 million or more are common.

Depending on the value of the taxable estate, a “double tax” may exist when the IRA owner dies. Under current law, a **federal estate tax** of 40 percent and a federal income tax on the IRA beneficiary upwards of 39.6 percent could be levied at death.

There is a federal income tax deduction for any federal estate taxes attributed to the IRA as “income in respect of decedent” (IRD). This means the IRA could shrink by a combined net tax of about 60 percent. State income taxes and state death taxes could deplete the IRA even further.

Many **wealthy estate owners** have a significant charitable motivation to provide both current and deferred gifts to the non-profit charitable organizations of their choice. In fact, IRS statistics clearly show that the wealthier the individual for which a Form 706 U.S. Estate Tax return is filed, the greater is the chance that significant charitable gifts will be made at death.

By naming a non-profit charitable organization as the beneficiary of the IRA, the “double tax” on the IRA can be reduced to $0. There is a 100 percent charitable estate tax deduction, which eliminates estate taxes on the IRA. And charitable organizations do not report “income in respect of decedent” (IRD), which eliminates any income taxes on the IRA.

Since the IRA owner will continue to own the account until death, required minimum distributions (RMD) must be distributed to the IRA owner starting at age 70½. The after-tax cash flow from IRA distributions could be used to fund gifts for a life insurance policy owned by an Irrevocable Life Insurance Trust (ILIT).

This insurance will provide a “wealth restoration” fund for the heirs to offset the value of the IRA, which will pass to the charity at death.

In summary, 100 percent of the IRA account passes to the charity at death … TAX FREE! And 100 percent of the life insurance in the ILIT passes to the heirs … TAX FREE! Take a look at the fact pattern on the following page for the case design structure.

Facts and taxation of current plan:

- Assume a wealthy widow, age 72, currently has a gross estate of $7.25 million in 2015 of which $2 million is in a spousal rollover IRA, which she received from her deceased husband. She received her first RMDs from the IRA last year. The RMDs are not needed for retirement spending and are simply reinvested back into her non-qualified accounts.

- She would like to make a significant deferred gift to a local charity and also leave an inheritance to her two adult children.

- The taxable RMD for her age (72) is scheduled to be about $78,125 ($2 million divided by the Uniform Distribution Table factor for age 72 of 25.6). The IRA owner can always take out more than the RMD if desired.

- If she left the IRA to her two children, the federal estate tax on the $2 million current IRA value would be about $728,000 and the potential net federal income tax to the heirs (IRD) in a 35 percent federal income tax bracket would be about $445,000. That means the potential federal “double tax” on the IRA would be $1.17 million, which is a combined federal tax of about 59 percent. State income taxes and any state death taxes could increase the combined tax up to near 70 percent.

- So, after the combined federal and state taxes on the IRA are paid, only about 30 percent of the IRA would remain for the heirs if death occurred in 2015.

Charitable case design and insurance solution:

- Name the local charity as beneficiary of the IRA instead of her two children.
- During her lifetime, the client controls the use of the IRA account.
- Use after-tax withdrawals from the IRA to make gifts to the ILIT each year for the benefit of her two children. The IRA owner withdraws about $100,000 per year from the IRA.
- The trust is the applicant, owner, and beneficiary of a $2 million no-lapse Universal Life (UL) policy from a competitive carrier (age 72 female standard N/S) with an annual no-lapse guaranteed premium of about $65,000 per year. This death benefit will be paid to the ILIT and will offset the $2 million IRA, which will be paid to the charity at death.
- The Internal Rate of Return (IRR) on the tax-free death benefit at life expectancy (age 87) is 8.56 percent. Assuming a 30 percent tax bracket, the pre-tax equivalent IRR is 12.23 percent. These after-tax IRRs are very competitive when compared to other fixed financial assets in the continuing low interest rate environment.
- At death, the IRA passes to the charity with no income or estate taxes to the client. And the insurance proceeds from the ILIT pass income and estate tax free to her children.

Many wealthy estate owners have a serious desire to benefit charitable organizations of their choice. Certain estate owners may even wish to create their own charitable Private Foundation to carry out their charitable intentions. For wealthy families with other sources of income (rental, interest, dividends, capital gains, K-1 “pass-through” from S Corps shares, LLC shares, or irrevocable trusts), the heavily taxed IRA may be the best source of funds to make a significant deferred charitable donation.