GENERATION SKIPPING IRA TRANSFERS

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ABSTRACT

Undistributed balances in individual retirement accounts, and other defined contribution accounts, are generally transferred to a beneficiary upon the owner's death. The beneficiaries could be living persons, certain trusts, or charities. While most people leave these accounts to their surviving spouse or to their children, this paper analyzes the effects of naming a grandchild, or other younger person, as the beneficiary in light of the generation skipping tax and other statutes.

Keywords: Generation skipping transfer, Individual retirement account, defined contribution plan

INTRODUCTION

When a person dies, in most cases, Individual Retirement Accounts (IRAs), and other similar vehicles, such as § 401(k) and § 403(b) accounts, are typically passed to the surviving spouse, or if there is no surviving spouse, to the decedent's children. This is usually accomplished by naming the selected recipient(s) as primary and secondary beneficiaries. A second way that this transfer is accomplished is by naming the decedent's estate as the beneficiary, and then, the individual beneficiaries are designated in the decedent's will, or, if there is no will, by state law. In some cases, a charity, or certain trusts, may be named as the beneficiary of certain retirement plan vehicles.

While this order of transfers may be best for the majority of families, it is entirely possible that for some other families a different ordering of beneficiaries might be more beneficial. For instance, the decision regarding who should inherit may be entirely different when the money isn't needed [1]. And, in other situations, the value of marginal income may differ significantly among the potential heirs [2].

In this paper, we examine things that affect decisions regarding whom to name as beneficiaries of IRAs. That includes looking at strategies to minimize tax effects, as well as other financial and non-financial considerations. When deciding whether to name beneficiaries from younger generations, attention needs to be placed on key tax laws that change when certain birthdays are attained [5]. The conclusions describe what might be accomplished under existing legal, economic, and social conditions.

REQUIRED MINIMUM DISTRIBUTIONS FROM TRADITIONAL ACCOUNTS

Qualified retirement plans, including IRAs [3, § 401(a)(3)], must provide that distributions over the life expectancy of the owners start by April 1 of the calendar year following the year the owner reaches age 70½, or the year they retire, whichever is later [3, § 401(a)(9)(C)].

Generally, owners will designate a beneficiary for any balances remaining at their deaths. If the decedent began distributions while alive, distributions continue to the beneficiaries at the established rate. If the beneficiary is the surviving spouse, distributions are not required to start before the owner would have reached age 70½ [3, § 401(a)(9)(B)(iv)]. In fact, a surviving spouse has the additional options of designating herself as the owner or rolling the account into an IRA or other retirement plan.

For non-spouse beneficiaries, the entire balance must be distributed within 5 years of the owner's death unless the beneficiary arranges to spread the distribution over his/her life expectancy and begins distributions within one year of the owner's death [3, § 401(a)(9)(B)]. Owners or beneficiaries of IRA's can sometimes name /rename beneficiaries to stretch the distributions and minimize the tax effect of the RMD, even when a new set of taxes get in the way. These taxes are discussed below and are incorporated in the situational illustration that follows.

Estate and Gift Taxes

The federal estate and gift taxes are unified transfer taxes generally based on the fair market value of assets at the date of transfer [3, §§2001 and 2501]. They are "unified" in that taxable gifts are added to the taxable estate to get total transfers. The combined transfers are subject to a rate of 40% for transfers exceeding the exemption equivalent. The exemption equivalent, which is adjusted for inflation, is $12,200,000 [7, 8, the exemption equivalent was doubled by the 2017 tax reform] for gifts and inheritances during 2018.

Generation Skipping Tax

To prevent owners of large estates from bypassing the estate tax for one generation (the second generation), Congress instituted a generation skipping tax [3, §§ 2001 and 2501]. The GST applies to transfers to someone who is a family member who is more than one generation after the transferor or is more than 37.5 years younger than the transferor [3, § 2613)].

A SITUATIONAL ILLUSTRATION

To illustrate, on March 31, 2018, Fran M., a widow, age 71, was discussing her 2018 federal and California income tax returns with her tax preparer, a California CPA. The major change in Fran's 2018 taxable income from prior years was a $90,000 required minimum distribution (RMD) from a traditional IRA [4]. Funded with her deductible annual IRA contributions and a rollover from her deceased husband's retirement account, the IRA had increased to $2,466,000 of previously untaxed income at the end of 2017.

Fran's concerns were focused on whether there were any strategies that could minimize the current tax effects of the RMD. The CPA who was her tax preparer knew a great deal about her family's financial situation and wanted to know whether Fran had changed the named beneficiaries of the IRA when her husband died.

Fran said that when she had originally named the beneficiaries of the IRA, she had named her husband as primary beneficiary and her son, Daryl, as secondary beneficiary. But, yes, she had changed the beneficiaries when her husband died. At that time, she changed Daryl's designation to primary beneficiary and designated his children, Dick and Jane, as secondary beneficiaries.

The CPA explained to Fran that, because Daryl was already quite wealthy and his marginal income was being taxed in the top brackets for both Federal and California income tax purposes, she might want to designate her grandchildren as the primary beneficiaries of her IRA. The CPA also explained that all non-spouse beneficiaries must receive either a total distribution from an inherited IRA within five years from the year of death (YOD), or, starting with the first year after the YOD, receive annual distributions based upon the beneficiary's life expectancy.

In 2018, Daryl was age 50, his son Dick was age 15, and his daughter Jane was age 12. Therefore, because the grandchildren were the youngest, utilizing the longer life expectancies would result in lower annual required minimum distributions (RMDs) and defer much more income into future years [4]. Additionally, although the distributions might still be subject to the parent's higher tax brackets because of the Kiddie Tax provisions, eventually, as the children age, the income would be taxed at the children's rates.

Additionally, there were several other possible tax savings. First, because of Daryl's wealth, any assets transferred to Daryl and then on to the grandchildren would be subject to the Unified Transfer Tax (UTT) when Daryl died. On the other hand, because of Fran's lifetime exclusion of a certain amount of transferred assets from the UTT ($11,200,000 in 2018) [7, 8], there would be no tax at Fran's death. This would be so, whether Fran's assets were transferred to Daryl or to the grandchildren. Second, if the grandchildren could claim to be emancipated, they might be able to use their own standard deductions.

REPORTING TAXABLE DISTRIBUTIONS FROM AN INHERITED IRA

All individual beneficiaries other than a spouse are treated the same way when they inherit the undistributed assets in certain taxable retirement accounts:

(1) They may withdraw the entire balance in the account by the end of the 5th year following the year of death of the account owner, or
(2) They may calculate Required Minimum Distributions (RMDs) using the Single Life Table [4]:
   (a) If the owner was already receiving RMDs when she died, the beneficiaries may calculate their RMDs using the longer of their remaining life expectancy determined in the year following the owner's death, reduced by one for each subsequent year, or the owner's remaining life expectancy at death, reduced by one for each subsequent year.
   (b) If the owner died before she received her first RMD, the beneficiaries may calculate their RMDs using their remaining life expectancy determined in the year following the owner's death, reduced by one for each subsequent year.

These minimum distribution rules apply to virtually all kinds of traditional inherited defined contribution retirement plans. In addition to traditional IRAs, these plans include: SEP IRAs, SIMPLE IRAs, § 401(k) plans, § 403(b) plans, § 457(b) plans, profit sharing plans and other defined contribution plans.

KEY POINTS TO REMEMBER

If the owner of the IRA died after starting her RMDs, beneficiaries may elect to calculate their RMDs by using their own ages or by using the owner's age in her year of death. While this option might never apply in generation skipping transfers, it may be advantageous in situations where the owner was younger than the designated beneficiary. In the following years, this life expectancy factor would be reduced by one for each subsequent year.

If the owner of the IRA died before starting her RMDs, beneficiaries also have the option of distributing their inherited IRA under the five-year rule. This rule allows beneficiaries to take distributions any way that they like so long as all assets from their inherited IRA account are entirely distributed by the end of the fifth calendar year following the owner's death.

If there are more than one non-spouse beneficiaries, it is important to separate each one's share of the decedent's IRA into a separate account. Each account should be listed under the individual's name and the first RMD taken by December 31, of the year following the owner's death. If this deadline is not met, RMDs for all of the beneficiaries will be based on the oldest beneficiary's life expectancy.

When you establish an inherited IRA, be sure the IRA custodian registers the account properly. The account registration should include the name of the original owner of the IRA, a designation that the account is an IRA beneficiary distribution account, and the beneficiary's name.

Once the assets have been transferred to a separate account designated as an inherited IRA in the name of the beneficiary, the beneficiary can limit distributions to annual RMDs or take additional distributions. If the beneficiary does not have an immediate need for the money, leaving the assets in the inherited IRA would continue their potential tax-deferred growth.

If a designated beneficiary decides to refuse to accept all or part the assets of an IRA, the assets will pass to the other designated beneficiaries. If there are no other designated beneficiaries, the assets will be distributed in accordance with the provider's contractual defaults. It is important to note that a decision to disclaim the assets of an IRA must be made within nine months of the original owner's date of death and before taking possession of the assets.

It is important to remember that IRA beneficiary designations supersede a will. Therefore, keeping the list of designated beneficiaries of an IRA up to date can help avoid some potentially costly mistakes. The most beneficial list of beneficiaries can often change when events like marriages, divorces, and deaths occur.

Always, when transferring funds from one IRA account to another IRA account, request a trustee-to-trustee transfer [6]. Non-spouse beneficiaries do not qualify for a 60-day rollover period when inheriting the assets of an IRA. If a non-spouse beneficiary receives a check from the assets of an inherited IRA, the money generally will be taxed as ordinary unearned income. The check would also be ineligible to be deposited into another inherited IRA account that the beneficiary might own at a different firm or even back into the inherited IRA account that it was withdrawn from.

THE CASE OF THE UNMARRIED UNCLE

Jim Dorcie had never married and had no children, either naturally born or adopted. However, Jim did have a married sister, Dorothy, age 65, who was the mother of Kate and William. Kate, age 35, and William, age 30, were also married with children. Kate had a son, George, age 5, and William had a daughter, Rose, age 1. Because these people were Jim's only living relatives, he wanted to leave at least some of his assets to them in the most advantageous way, considering their ages, life's needs, tax effects, other sources of income and their ability to manage their own financial matters.

Jim's assets included: a traditional IRA with an investment account valued at $250,000; a Roth IRA also with an account balance of $250,000; and one million dollars of non-retirement account investments in stocks and bonds. Jim's only other asset was 5,000 acres of Wisconsin woodland surrounding a beautiful navigable small river that wandered though this property for about 20 miles before it entered the Mississippi River near the cities of St. Paul and Minneapolis, Minnesota, which continued on its way to New Orleans and the Gulf of Mexico. The woodland had been appraised at a fair market value of $25,000,000.

Jim was very concerned because the original designated beneficiary of the two IRA accounts was his mother, who had previously passed away. Therefore, Jim knew that if he were to die without a will, all of his property would pass by state law to his sister Dorothy, whom he considered to be financially irresponsible. In fact, both his sister and her husband were now retired and, because they had never accumulated any savings or retirement accounts while they were working, were living on their combined social security benefits of $50,000 a year. Jim's other concern was that Kate and her family lived in California and had no personal interest in the Wisconsin woodland. And, if they inherited it, would most likely just sell the property to a real estate developer and spend the money that remained after the payment of a very hefty federal estate tax of more than seven million dollars.

Because Jim never wanted the woodland to be commercially developed, but instead, remain environmentally in its intact pristine condition, he knew that it had to be passed to some qualified charitable organization in order to avoid the federal estate tax, that would necessitate its sale and development. Jim's choices were: a small local college, whose mission was to manage such property in the best environmentally and sustainable way; a large national similar organization, such as the Nature Conservancy; or the Department of Natural Resources (DNR) of the State of Wisconsin.

Because Jim decided to pass the woodland to a charitable organization, he had eliminated a major tax problem: there would be no federal estate tax due on the assets passed to his family (in 2018, federal estate tax applies only to taxable transfers in excess of $12,200,000) [7, 8].

The next issue that Jim had to contend with was how to avoid any high income tax rates on RMDs from the traditional IRA. Because both Kate and William were high-income individuals, any income that they might receive from the traditional IRA would be taxed at their highest marginal tax rates. Additionally, because their children were young, any income that George and Rose might receive from the traditional IRA would also be taxed at the highest marginal tax rates of their parents because of the Kiddie Tax rule. But, because Dorothy and her husband had no income other than their social security benefits, the RMDs from the traditional IRA would be taxed in the lowest tax rates and some most likely not taxed at all.

However, if Dorothy were to withdraw large amounts or all of the traditional IRA in any one year, she could trigger a liability for large tax payments. Therefore, because limiting her withdrawals to the RMDs

over her life expectancy would virtually eliminate any taxes, this might provide an incentive for her to follow this approach as opposed to withdrawing the entire amount and spending it.

Jim decided to designate George and Rose as beneficiaries of the Roth IRA. Because they were the youngest, spreading the RMDs over their life expectancies, would allow for the greatest amount of earning accumulations that would never be taxed. At that time, Jim also split the Roth IRA into two separate accounts: one for George and one for Rose. Jim was afraid that Rose's guardian might fail to separate the Roth IRA account within the first year following his death and, in that case, Rose would also be required to take RMDs over George's life expectancy, because he was older.

Jim decided to leave the one million dollars of stocks and bonds to Kate and William. Although there would be no federal estate tax to be paid, these assets still would be stepped up to fair market value at Jim's date of death. Therefore, Kate and William, whom Jim considered financially responsible and knowledgeable, could also sell them, if they wished, and incur no capital gains or income taxes.

SUMMARY AND CONCLUSIONS

Following the descending generations order of designating the beneficiaries of traditional IRAs and Roth IRAs may not be the most advantageous when considering other important situational, economic and tax issues unique to families. Therefore, while this first order of transfer may be best for the majority of families, it is entirely possible that in some families, a different ordering of beneficiaries might be more beneficial.

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