

CHAPTER VII

Beneficiaries and Taxation

By Robert W. Stibbs, CPA, CFP

The assumption is that unless you have millions, your beneficiaries aren't subject to any type of taxation once they receive your assets. This is rarely the case, and it involves a little more review.

IRA accounts, 401K's, and annuities are unique. They allow you to earn an investment return without having to pay any taxes along the way. Granted, you'll eventually get to a point where you need to begin withdrawing funds, however, most investors still leave a substantial portion of their net worth in a retirement plan once they pass. For purposes of this discussion, we are only discussing the *regular* IRA, since Roth IRAs carry other tax advantages that will be discussed through another chapter.

There are two major tax classifications that people should be aware of: Estate taxation, and Income taxation. Estate taxes generally apply to estates with values in excess of \$2 million. Income taxes apply to any amounts that have yet to be taxed. This includes balances (for the most part) within your IRA and 401K accounts. Annuities may contain a portion that is tax-free, however, the majority of annuity proceeds are generally taxable. Income taxes apply to these assets, regardless of their size, and they are taxed based on the tax bracket of the beneficiary.

Income taxes can be significant and if you have a large enough estate, estate taxes may apply also. The combined effective tax rate can be in excess of 70% on an IRA, assuming the application of both estate and income taxes. While retirement accounts and annuities can provide benefits for the owner, they are generally regarded as 'ticking tax time bombs' for individuals who pass them along as a wealth transfer vehicle. IRAs, 401K's, and annuities can make poor estate transfer vehicles, since they 'tie up' interest only to be taxed at a later date.

Common stocks and mutual funds carry different taxation at the death of the account owner. Any and all gains that may have been made during the lifetime of the owner will be exempt from both income tax and capital gains taxes. Estate taxes may apply, however, there is no income taxation to the beneficiary. An individual could have invested \$1, later turning it into \$100,000. The profit, if the accountholder passes away, is exempt from taxation to the beneficiary.

The tax system isn't easy to understand. For those people who are caught off guard, it can be an expensive lesson. Planning can make the difference in ensuring that your beneficiaries are provided the best possible after-tax result, while keeping the tax system out of your estate plan.

Robert W. Stibbs, CPA, CFP is the Chief Financial Officer at Old Mission Investment Company in Traverse City, Michigan. He is a member of the investment committee at Old Mission, and provides guidance and counsel to clients based on investment-related matters concerning taxation and beneficiary designation recommendations. Bob is a co-founding member of Old Mission Investment Company, a Registered Investment Advisor.

