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The 800-lb. Gorilla

IRS statistics confirm what estate planners have been seeing: Retirement accounts are becoming a bigger chunk of more estates. Learn how to handle the resulting tax problems.

By **Christopher R. Hoyt**, *professor,*
University of Missouri-Kansas City School of Law, Kansas City, Mo.

Do you feel that you are seeing IRA and retirement accounts increase both in frequency and size in the estates of your clients? Recent statistics from the Internal Revenue Service confirm your experiences.

> In 15 years retirement accounts rose from 2.3 percent to 8 percent of all reported assets.

Just 15 years ago, individual retirement accounts, retirement plans and annuities appeared on only 25 percent of federal estate tax returns, and represented just 2.3 percent of the assets reported on those returns. For returns filed in the year 2000, they appeared on 53 percent of all returns and comprised 8 percent of reported assets (see "The People's Choice," page 17). In estates under $2.5 million they made an even bigger showing: 12 percent of reported assets (see "Who Likes Them Best" below). These are, of course, just the averages. Every estate planner has met individuals who are even more heavily invested in retirement plan accounts, some with a majority of their wealth in them.

Why the dramatic growth? It is due in large part to the fact that IRAs, 401(k) plans and other qualified retirement plan accounts are creatures of the 1980s. It was in 1981 that Congress permitted anybody who worked to contribute $2,000 to an IRA. Although this pro-

WHO LIKES THEM BEST

It was, at last count, the people with gross estates of $1 million-$5 million who were relying most heavily on retirement plans, IRAs and annuities.

All figures are estimates based on samples.

	Gross Estate		Retirement Plans, IRAs and Annuities				
	Number Of Returns	Total Assets (in thousands)	Number Of Returns	Percent Of Returns	Estate Amount (in thousands)	Percent Of Estate	Average Amount (in thousands)
Total Tax Returns for 2000	108,322	$217,402,426	56,921	53%	17,410,160	8%	
$600,000 to under $1 million	47,845	38,598,125	23,537	49	4,236,045	11	$180
$1 million to under $2.5 million	45,248	66,946,098	25,579	57	7,808,143	12	305
$2.5 million under $5 million	10,018	34,085,398	5,294	53	3,272,914	10	618
$5 million to to under $10 million	3,386	23,286,561	1,649	49	1,124,415	5	682
$10 million to under $20 million	1,129	15,253,132	544	48	594,709	4	1,093
$20 million or more	696	39,233,112	320	46	373,934	1	1,169

Source: Internal Revenue Service

THE PEOPLE'S CHOICE

The percentage of income tax returns in which retirement accounts appeared more than doubled—and annuities almost quadrupled—from 1986 to 2000.

Federal Estate Tax Returns
Retirement Plans Assets and Annuities

	Totals		Retirement Plans and Annuities			
Year Filed	Number Of Returns	Gross Estates (in millions)	Number Of Returns	Percent Of Returns	Value (in millions)	Percent Of Value
2000	108,322	$217,40	56,921	53%	$17,410	8.0%
1997	90,006	162,251	41,788	46	10,116	6.2
1995	69,772	117,735	30,938	44	6,632	5.6
1992	59,176	98,850	22,738	38	4,095	4.1
1989	45,695	77,997	14,223	31	2,309	3.0
1986	45,125	59,805	11,244	25	1,350	2.3

Source: Internal Revenue Service

vided an opportunity for younger workers, it was too late for retirees to take advantage of the option. Consequently, the estate tax returns filed in the 1980s and early 1990s reflected the fact that most of the individuals who died during those years were ineligible to establish these types of accounts.

Dealing with these accounts is destined to become an even bigger issue for estate planners in the coming years.

The situation is changing. Dealing with these accounts is destined to become an even bigger issue for estate planners in the coming years. IRS statistics give us an idea of what's in store.

In 1998, retirement accounts and annuities appeared on 47 percent of all federal estate tax returns filed for males. But break those numbers down and we see that for male decedents over the age of 65, these accounts appeared on only 43 percent of returns filed. But for men under 65, that number was a whopping 63 percent (see "Variations by Age and Gender," page 18).

There is also a notable disparity based on gender. The frequency and size of retirement accounts in estates of decedents under age 50 is about the same for men and women. But, over the age of 65, men tend to have retirement assets more frequently. Such numbers reflect the important changes in the nation's work force during the past 30 years—and suggest the shape of things to come.

Integrated Planning

Planning for retirement accounts is, therefore, a growth industry for estate planners. The challenge,

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VARIATIONS BY AGE AND GENDER

Younger men show the greatest concentration of retirement accounts. This phenomenon is likely the result of these accounts only becoming an option in the 1980s, and women entering the work force in great numbers in the 1970s.

1998 Estate Tax Returns: Retirement Plans, IRAs and Annuities

	Male		Female	
	Percent of Returns with Retirement Assets	Percent of All Assets	Percent of All Returns with Retirement Assets	Percent of All Assets
Under age 50	63%	7%	64%	6%
Ages 50 to 65	69	12	6	8
Over Age 65	43	5	28	3
All Returns	47	6	31	3
TOTALS	55,495	$112,434 (in millions)	48,487	$83,190 (in millions)

Source: Barry Johnson and Jacob Mikow, "Federal Estate Tax Returns, 1998-2000," Figures F and G

though, is that it is harder to plan for retirement accounts than for virtually any other asset in an estate. The planner needs to understand not just the estate tax laws, but also income tax laws and ERISA mandatory distributions laws—and how they all interact.

> The planner needs to understand not just the estate tax laws, but also income tax and ERISA mandatory distributions laws.

This is not something that planners are likely to have learned in school. While most schools teach separate courses on transfer taxes and income taxes, retirement accounts are the pinnacle of integrated tax planning. These accounts can trigger both significant income taxes and estate taxes.

Except for Roth IRAs, distributions from a retirement account are usually taxed in full as ordinary income—during the employee's lifetime to the employee, then after death to the beneficiaries. These accounts are wonderful for deferring income tax. But they can be an estate planning nightmare. Barring a divorce, they are virtually impossible to give away during a person's lifetime because of anti-alienation laws. A lifetime transfer or pledge of the account can be treated as a taxable distribution.[1]

At death, these accounts often magnify the size of the estate tax liability. Estate taxes must be paid on the entire retirement account balance—including the portion of the account that represents deferred income taxes. When the maximum income and estate tax rates reach their lowest point, in 2007, (35 percent income tax rate and 45 percent estate tax rate), a distribution from a

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MAKING ESTATE TAX LIABILITY WORSE

The following hypothetical demonstrates the impact of retirement accounts on estate taxes:

Assumptions

- This is the combination of estate and income taxes on income in respect of a decedent for years 2007 through 2009.
- The mother's total taxable estate is $4 million.
- All of the mother's estate will be transferred to her sole heir, her daughter.
- The probate estate will pay the entire estate tax regardless of how the daughter acquired the assets (for example, joint tenancy, etc.).

Result

If $100,000 in an IRA is immediately distributed to the daughter and if the daughter is in a 35 percent marginal income tax bracket, then the combined estate and income taxes on the $100,000 of IRA assets would be $64,250.

The amount is calculated as follows:

Beginning balance in retirement plan			$100,000
Minus: total estate tax paid by the probate estate			(45,000)
Minus: income tax on distribution gross taxable income		$100,000	
Reduced by §691(c) deduction for federal estate tax			
Total estate tax	$45,000		
State tax credit*	Zero		
Deduction for federal estate tax **		(45,000)	
Net taxable income ***		$55,000	
Times income tax rate		X 35.0%	
Net income tax on income in respect of decedent			(19,250)
Net after-tax amount to daughter			$35,750

* Treas. Reg. Section 1.691(c)-1(a) limits the deduction to federal estate tax. The 2001 Tax Act provides that the Section 2011 state tax credit will be fully repealed by the year 2007 so there is no state tax adjustment.
** The deduction is an itemized deduction on Schedule A that is claimed on the last line of the form ("other miscellaneous deductions"). It is not subject to the 2 percent-of-adjusted-gross-income ("AGI") limitation that most miscellaneous deductions are subject to. Sec. 67(b)(7).
*** The net taxable income from the IRD will actually be greater than this amount The IRD will increase the recipient's AGI by $100,000 which will decrease the recipient's itemized deductions by 3%, which would be $3,000 in this example. Sec. 68. The 3 percent reduction was omitted from this calculation in order to simplify the computation.

retirement account will be subject to a combined estate and income tax rate of over 64 percent (see above, "Making Estate Tax Liability Worse"). In 2001, the comparable rate was over 76 percent! These are the effective tax rates in states that have no state income tax. An even higher rate applies to beneficiaries who live in states with a state income tax.

It is, therefore, no wonder that many estate planners suggest charitable dispositions of these assets for people whose estates are overloaded with retirement accounts. There is increasing activity in this area.

Looking Ahead

Retirement accounts are destined to appear in more than two-thirds of the estates of the nation's more affluent citizens. In order to give the best advice, estate planners must learn all of the applicable fields of law that affect these. Estates overloaded with these assets will likely feel the pain of tax rates of 64 percent or more. A charitable bequest may be the choice that brings the parties the greatest satisfaction. ◆

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