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Using Roth IRAs and Section 529 Plans as Estate-Planning Tools

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EXECUTIVE SUMMARY

While many articles focus on IRAs, Roth IRAs, and Section 529 tuition savings plans, few tackle Roth IRAs and Section 529 plans as estate-planning and tax-reduction methods for a decedent's estate and heirs. Here the authors take an estate-planning perspective rather than merely comparing the retirement vehicles.

How can you use a traditional individual retirement account (IRA), a Roth IRA, and Section 529 plans for estate planning? Is one better than another?

There are similarities between a traditional IRA and a Roth IRA. For example, contributions in both continue to grow tax-free until they are withdrawn during retirement or at age 59½ under current law—with some exceptions, such as catastrophic medical expenses. Likewise, owners of either type can pass them on to heirs.

Then what is the significant difference from an estate-planning perspective? The traditional IRA offers a tax deduction, which simply means that a taxpayer who contributes to the IRA receives a tax deduction for the tax year in which the contribution is made. On the other hand, the Roth IRA uses after-tax dollars, so no deduction is allowed from gross income when contributions are made. The distinct advantage of the Roth, however, is that none of the growth is taxed, and, assuming the age and/or other requirements in the tax law are met, the withdrawals are tax-free as well. There also are some different income limitations for the traditional IRA and Roth IRA. (For more information, visit www.rothira.com.)

The pertinent issue here is what happens upon withdrawal. With a traditional IRA, the taxpayer will need to include some or all of the withdrawal amount in gross income since he or she received an upfront deduction for the year of contribution. As a result, depending on their tax position and state tax statutes, the taxpayer or heirs may need to pay federal and/or state taxes as well. The taxes will depend on the state in which the contributor or heir is a resident when making the withdrawals.

With a Roth IRA, however, the taxpayer does not take a deduction on Form 1040 because the contributions are made with after-tax dollars. Again, the contributions continue to accrue interest tax-free, just like the traditional IRA, but qualified withdrawal amounts are not taxable. For a withdrawal to be tax-free, the owner must meet the following requirements: The owner must be age 59½, and the Roth IRA must have existed for at least five years.

A Roth IRA offers an advantage when retirement approaches. Unlike the traditional IRA, no minimum distribution rules apply to the Roth IRA, and the contributing taxpayer need not start taking distributions at age 70½. The taxpayer may choose to not access the Roth IRA at all and instead opt to leave it to heirs—again, also free of income tax.

A hypothetical example will help show the differences for those inheriting a traditional IRA vs. a Roth IRA. Then we will illustrate the difference in growth between the two and the tax advantages, as well as the benefits of a 529 Plan.

Inheriting a Roth IRA vs. a Traditional IRA

For our example, we will focus on Harry, Mary, and Carrie. Harry is married to Mary, and they have one daughter, Carrie. When Harry turned 65, he converted his traditional IRA into a Roth IRA and paid the taxes at the conversion time using other available funds. Thus he avoided a reduction in the value of his IRA, which would have occurred if he had paid the taxes from the traditional IRA. Harry named his wife as the beneficiary, lived 15 more years to age 80, and never made any withdrawals from his converted IRA. Because this is a Roth IRA, the account continues to accrue interest tax-free, and no minimum distribution rules apply as they would with a traditional IRA.

When Harry dies, his Roth IRA passes to his wife, Mary, who is 50 at the time of Harry's death. Mary treats the inherited Roth IRA as her own, retitling it in her own name, and does not need to take any minimum distributions because she has her own pension and other inherited assets.

Mary then designates her daughter, Carrie, as the beneficiary of her Roth IRA. Mary lives another 40 years, and, at the time of Mary's death, her daughter inherits the Roth IRA. When Mary dies, Carrie is 50, so, according to Internal Revenue Service (IRS) life expectancy tables, she should live another 30 years. Under the Internal Revenue Code (IRC), Carrie must start taking distributions by December 31 of the year following her mother's death; otherwise, she will have to liquidate the account after five years. (There are no minimum distribution requirements for the contributing taxpayer, but Carrie is not able to retitle the IRA in her own name as her mother could. Thus Carrie will need to take minimum distributions by December 31 of the year following her mother's death.)

Here is the math. Harry's Roth IRA accumulated interest tax-free for 15 years after he made the conversion, then it passed to his wife to grow another 40 years tax-free. Although Carrie had to start taking minimum distributions (also tax-free) over the next 30 years, she will be able to preserve the maximum tax-free accumulation allowed, i.e., the balance of the account minus the minimum distributions she had to take over the 30-year period. From the time Harry converted his traditional IRA through possibly 30 years that Carrie would be the beneficiary, the Roth IRA could potentially grow tax-free for 85 years, if not more. By proper estate tax planning, Harry and Mary created what amounted to a tax-free annuity for their daughter. They did so at a far lower cost than purchasing a traditional annuity for a similar term.

While Harry had to pay taxes on any accumulated earnings and tax-deductible contributions when he made the Roth conversion, he was paying that tax with current dollars and not with future dollars when the tax rates are likely to be higher. Here is why this move makes sense. With a U.S. national debt that is astronomical and an influx of immigrants who are receiving or will be receiving government benefits, current low tax rates will not be sustainable. Other reasons include the perilous condition of Social Security, Medicare, and other government programs. By paying the income tax at the time of conversion, one is prepaying income taxes for heirs who would otherwise be paying income taxes at a higher rate. Furthermore, in doing so, there is no need to file or pay any gift tax, and the taxpayer does not need to use any portion of the estate tax exemption of $5.43 million for the 2015 tax year, which is up from $5.34 million for the 2014 tax year. This may result in an additional reduction of the size of a decedent's taxable estate, provided such an estate would exceed the amount of the federal and/or state estate tax exemption(s). Also, the taxpayer's heirs will not need to pay income tax on withdrawals from the Roth IRA they inherited, but they would be subject to the minimum distribution rules in a traditional IRA. If the heirs do not need to access the Roth IRA at the time of the inheritance, they can take the minimum distributions and allow the remainder of the account to accrue tax-free interest for the future.

While providing a pre-tax benefit up to the allowed contribution amounts and allowing contributions to grow tax-free, the traditional IRA, 401(k), 403(b), and other qualified plans generally are not going to allow the contributor to withdraw the amounts from such accounts tax-free. In these plans, the contributor will have to start taking minimum distributions at age 70½, thus reducing the principal and interest that can be left to heirs. As with a Roth IRA, a beneficiary can be named on such accounts, but, unlike with the Roth, the contributor's heirs will pay taxes. While transferring the balance of those accounts to the named beneficiary or beneficiaries will avoid probate of those assets, thereby saving the estate potentially substantial court costs and attorney's fees, traditional IRAs and qualified retirement accounts do not have the superb estate-planning benefits of the Roth IRA or 529 college savings plans, which we will discuss later.

Investing Early: The Roth Wins

To achieve the maximum benefit from qualified retirement plans, one should start the contributions as early in one's career as possible. Doing so and maxing out the contributions allowed per year will yield the greatest benefits for retirement. Additionally, one should make maximum contributions to supplemental retirement accounts (SRAs) where allowable to provide additional funds for a comfortable retirement. They are supplemental retirement annuities that may be offered under 403(b) plans, mostly by educational institutions.

But one can achieve even greater benefits by contributing to a Roth IRA at an earlier age instead of a traditional IRA. Table 1 illustrates the total return of an individual who begins contributing to a traditional IRA vs. a Roth IRA at the age of 26. The table does not take into account a Roth IRA conversion or whether a particular state taxes retirement income because those factors vary greatly. One can see from the table that earlier contributions to a Roth IRA will generate a larger sum for the taxpayer and allow more funds to pass on to heirs tax-free as well.

As Table 1 shows, the computations from age 26 through 65—when withdrawals will begin—indicate a total accumulation in the traditional IRA of $483,209, which assumes a 4% return rate for the 40 years of contributions. We are also assuming that the taxpayer will be in a 15% tax bracket at the retirement age of 65. Thus, the accumulation of $483,209, minus the tax paid on withdrawal ($72,481), plus the tax savings from allowed deductible contributions during the 40-year period ($30,518) equals net proceeds to the taxpayer of $441,246 from the traditional IRA.

If we assume the same number of years of contributions (40) and the same rate of return (4%) for the Roth IRA, the total accumulation, likewise, will be $483,209. While the Roth IRA did not generate any tax deductions for contributions made, it did allow the IRA to grow tax-free during those 40 years. When we subtract the net proceeds of the traditional IRA ($441,246) from the net proceeds of the Roth IRA ($483,209), we see that there is an additional return with the Roth IRA in the amount of $41,963.

Assumptions for the spreadsheet calculations in Table 1 include:

- Calculations are based on 2014 tax rates. Standard deduction and personal exemptions are based on 2014 amounts.
- Taxpayer was 26 when he started contributing the maximum deductible amount allowed to a traditional IRA.
- Taxpayer married at age 30 and had two children, one at age 32 and one at 33.
- No employer-deferred plan was available.

Table 1

CALCULATION FOR 2014 IRS COMPARISONS

STATUS	AGE	SALARY	TR IRA	TRA IRA AT 4% RETURN	EXEMPTIONS	2014 EXEMP VALUE	2014 STAND DEDUCTION	TAXABLE INC BEFORE IRA	TAX BEFORE IRA	TAXABLE INC AFTER IRA	TAX AFTER IRA
SINGLE	26	60,000	5,500	5,720	1	3950	6200	49,850	8,320	44,350	6,944
SINGLE	27	62,400	5,500	11,669	1	3950	6200	52,250	8,920	46,750	7,544
SINGLE	28	64,896	5,500	17,856	1	3950	6200	54,746	9,544	49,246	8,168
SINGLE	29	67,492	5,500	24,290	1	3950	6200	57,342	10,192	51,842	8,816
MARRIED	30	70,192	5,500	30,981	2	7900	12400	49,892	6,576	44,392	5,751
MARRIED	31	72,999	5,500	37,941	2	7900	12400	52,699	6,997	47,199	6,172
MARRIED+1	32	75,919	5,500	45,178	3	11850	12400	51,669	6,842	46,169	6,017
MARRIED+2	33	78,956	5,500	52,705	4	15800	12400	50,756	-1,469	45,256	5,880
MARRIED+2	34	82,114	5,500	60,534	4	15800	12400	53,914	7,179	48,414	6,354
MARRIED+2	35	85,399	5,500	68,675	4	15800	12400	57,199	7,672	51,699	6,847
MARRIED+2	36	88,815	5,500	77,142	4	15800	12400	60,615	8,184	55,115	7,359
MARRIED+2	37	92,367	5,500	85,948	4	15800	12400	64,167	8,717	58,667	7,892
MARRIED+2	38	96,062	5,500	95,106	4	15800	12400	67,862	9,271	62,362	8,446
MARRIED+2	39	99,904	5,500	104,630	4	15800	12400	71,704	9,848	66,204	9,023
MARRIED+2	40	103,901	5,500	114,535	4	15800	12400	75,701	10,638	70,201	9,622
MARRIED+2	41	108,057	5,500	124,836	4	15800	12400	79,857	11,677	74,357	10,301
MARRIED+2	42	112,379	5,500	135,550	4	15800	12400	84,179	12,758	78,679	11,382
MARRIED+2	43	116,874	5,500	146,692	4	15800	12400	88,674	13,882	83,174	12,506
MARRIED+2	44	121,549	5,500	158,279	4	15800	12400	93,349	15,050	87,849	13,674
MARRIED+2	45	126,411	5,500	170,331	4	15800	12400	98,211	16,266	92,711	14,890
MARRIED+2	46	131,467	5,500	182,864	4	15800	12400	103,267	17,530	97,767	16,154
MARRIED+2	47	136,726	5,500	195,898	4	15800	12400	108,526	18,845	103,026	17,469
MARRIED+2	48	142,195	5,500	209,454	4	15800	12400	113,995	20,212	108,495	18,836
MARRIED+2	49	147,883	5,500	223,552	4	15800	12400	119,683	21,634	114,183	20,258
MARRIED+2	50	153,798	5,500	238,215	4	15800	12400	125,598	23,113	120,098	21,737
MARRIED+2	51	159,950	6,500	254,503	4	15800	12400	131,750	24,651	125,250	23,025
MARRIED+2	52	166,348	6,500	271,443	4	15800	12400	138,148	26,250	131,648	24,624
MARRIED+2	53	173,002	6,500	289,061	4	15800	12400	144,802	27,914	138,302	26,288
MARRIED+2	54	179,922	6,500	307,383	4	15800	12400	151,722	29,729	145,222	28,018
MARRIED+2	55	187,119	6,500	326,439	4	15800	12400	158,919	31,962	152,419	29,924
MARRIED+2	56	194,604	0	339,496	4	15800	12400	166,404	34,058	166,404	33,840
MARRIED+2	57	202,388	0	353,076	4	15800	12400	174,188	36,238	174,188	36,020
MARRIED+2	58	210,484	0	367,199	4	15800	12400	182,284	38,504	182,284	38,286
MARRIED+2	59	218,903	0	381,887	4	15800	12400	190,703	40,862	190,703	40,644
MARRIED+2	60	227,659	0	397,163	4	15800	12400	199,459	43,314	199,459	43,096
MARRIED+2	61	236,765	0	413,049	4	15800	12400	208,565	45,863	208,565	45,645
MARRIED+2	62	246,236	0	429,571	4	15800	12400	218,036	48,515	218,036	48,297
MARRIED+2	63	256,085	0	446,754	4	15800	12400	227,885	50,296	227,885	51,106
MARRIED+2	64	266,329	0	464,624	4	15800	12400	238,129	54,896	238,129	54,487
MARRIED+2	65	276,982	0	483,209	4	15800	12400	248,782	58,411	248,782	58,002
			170,000								
									879,858		849,340

TOTAL IRA CONTRIBUTIONS AT A 4% RETURN	483,209
ASSUMED TAX RATE AT 65 = 15%	
LESS TAX TO BE PAID ON IRA AT WITHDRAWAL	72,481
PLUS TAX SAVING FOR 40 YEARS	30,518
NET PROCEEDS FROM TRADITIONAL IRA	441,246
ROTH IRA AT SAME 4% RETURN	483,209
NET PROCEEDS FROM TRADITIONAL IRA	441,246
ADDITIONAL RETURN WITH ROTH IRA	41,963

NET SAVINGS FROM TRADITIONAL IRA CONTRIBUTIONS FOR 40 YEARS 30,518

- Invested IRA return is 4%.
- Tax rate at withdrawal is 15%.

By starting contributions to a Roth IRA at age 26, there is a net tax savings of $41,963 over a traditional IRA. The earlier one contributes, the longer the funds in the Roth will grow tax-free and thus the more there will be in the account that can be taken out "tax-free" at retirement. Of course, each person's results vary based on salary, tax bracket, and other financial circumstances. Converting a traditional IRA to a Roth IRA may also be advantageous at an early age, again depending on financial position. (As we mentioned earlier, if one must use funds from the traditional IRA to pay the taxes on conversion, the IRA will be depleted to that extent. Therefore, one should carefully balance the costs of conversion and potential reduction of the IRA account vs. any future benefits to heirs and potential income-tax savings.)

Section 529 College Savings Plans

In addition to Roth IRAs, Section 529 college savings plans also present some estate-planning benefits. Although there is no federal income tax deduction when contributing to a 529 college savings plan, the growth attributable to the contributions will accumulate tax-free. Additionally, some states may offer their own tax benefits for contributions to a 529 plan. For example, Ohio offers an upfront deduction up to $2,000 per child per year. Generally, withdrawals from the account are free from federal and state income tax, provided they go toward qualified educational expenses.

Additional good news for 529 plan contributors is the many options. If a taxpayer does not like the 529 plan in his or her particular state, the individual can choose another state's 529 plan and contribute to it instead. There is no limit on the number of 529 plans to which one can contribute, so parents and/or grandparents with large families and assets that might exceed the federal unified estate and gift tax credit may take advantage of the 529 plan as part of an effective estate-planning portfolio.

While there is no limit to the number of 529 plans someone can have, contributions that are excessive in relation to education costs may invite government scrutiny. Contributions for graduate schools, such as medical schools; law schools; postgraduate business degrees, such as master's or doctoral degrees; and even considerably more expensive private colleges may justify higher 529 account contributions and thus not be deemed an abuse of the account. The government does not want contributors to inflate the 529 plan account beyond what is reasonably necessary to pay educational expenses, then use the plan to accumulate tax-free interest with the contributor intending later to withdraw any substantial excess for personal noneducational use. After all, the 529 plan's purpose is to provide for educational costs, not to substitute for an IRA.

With respect to federal income tax, there is no taxable event if the money is withdrawn from the 529 plan by or on behalf of the named beneficiary. From an estate-planning perspective, the government considers a contribution to a 529 college savings plan a completed gift to the beneficiary for federal gift and generation-skipping purposes, so it will not be treated as part of the donor's estate for estate tax purposes.

The contribution also qualifies for the $14,000 annual gift tax exclusion, which applies to both the 2014 and 2015 tax years. If the contribution is between $14,000 and $70,000, the contributor can elect to treat the contribution as having been made over a five-year period. Thus the contributor (donor) can move money out of his/her estate at a more rapid pace, thereby allowing the contributor to use as much as $70,000 in annual gift tax exclusions. Now the contributor has not only the principal contributed without taxes being paid on it, but also all of the accumulated income growth from the contributions will be tax-free as well.

Ordinarily, one drawback of gifting is that when the gift is completed, the donor loses control over the gift, but the tantalizing appeal of a Section 529 plan is that the donor can maintain control over the assets and revoke the account. The Section 529 account is the only estate-planning vehicle that allows the donor to remove assets from his/her estate and yet retain the ability to take those assets back. Of course, there may be adverse tax consequences when the account, which includes accumulated growth, returns to the donor's estate. If the donor revokes and uses the account for his/her own noneducational benefit, there will be a 10% penalty on the earnings, as well as potentially taxable income attributable to those earnings.

Planning for the Future Is Vital

Proper estate planning goes a long way, especially with a Roth IRA over a traditional IRA and a 529 plan in the mix. Although most young professionals and nonprofessionals alike find it difficult, and even painful, to forgo nonessential purchases in their 20s, such as that expensive new car or impressive new home, their patience and regular contributions to tax-free and tax-deferred vehicles will provide them, and potentially their heirs, with a hefty future financial reward. ■

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Disclaimer

While the authors have made reasonable efforts to ensure the accuracy of the material contained herein, this article does not and should not be construed as the rendering of legal, tax, accounting, or other financial advice. One is cautioned to consult with a licensed attorney at law, Certified Public Accountant (CPA), or Certified Financial Planner (CFP) before implementing any estate-planning or tax-savings strategies or contributing to any of the investment vehicles we described in this article.

Further Reading

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