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BE TAX SMART ABOUT LEAVING ASSETS TO YOUR HEIRS

"The way you withdraw money in retirement can affect the next generation's tax burden. Sometimes it's best to go against conventional wisdom when it comes to when to tap taxable, tax-deferred and tax-free retirement savings."

– Roger Young, CFP®

So, you've planned well enough to be able to leave some money to your children or grandchildren. But have you thought about the tax consequences of your gift?

Recently, I wrote about tax-efficient withdrawal strategies for people looking to spend down their assets in retirement while paying fewer taxes. It may also be helpful to address strategies for a tax-efficient way to leave assets to your heirs—specifically income taxes (rather than estate taxes, which affect very few people). Here are two factors to consider:

1. **Your heirs' tax rates.**
   The decision to draw from Roth or tax-deferred savings depends largely on future tax rates—yours and your heirs'. If your heirs' tax rate is likely to be lower than yours, you may want to use assets from your Roth account for spending and leave your loved ones the tax-deferred assets. That's different from the conventional approach, where you wait until taxable and tax-deferred accounts are depleted before spending Roth assets.

2. **Taxable assets with gains, which can be passed down to your heirs tax-free.**
   Under current tax law, the cost basis for inherited investments in taxable accounts is the value at the owner's death. This is known as a "step-up in basis," and it effectively makes gains during the original owner's lifetime tax-free for heirs. This benefit is why you may want to hold some taxable assets as long as possible, contrary to the conventional wisdom that suggests spending taxable assets first.

The right approach to drawing down your retirement portfolio may involve different tactics at different stages of retirement based on your marginal tax rate. Required minimum distributions (RMDs)—annual withdrawals people generally are forced to take from tax-deferred retirement accounts, such as IRAs, once they reach age 70½—limit your flexibility and can affect what tactics are best in different years.

For example, for the years—if any—that you are in the 10% or 12% tax brackets, you might take advantage of untaxed capital gains. Other years, you may want to preserve taxable assets by prioritizing either tax-deferred or Roth distributions.

How would these strategies work? Let's consider two married couples retiring at age 65 whose heirs are expected to have different tax rates after they inherit the money:

- Both couples have $2.5 million across their investment accounts: 50% taxable, 40% tax-deferred and 10% Roth;
- Both couples spend $135,000 (after taxes) each year;

- Both couples collect $50,000 in Social Security benefits annually; and
- One couple's heirs will have a 10% marginal tax rate, while the other couple's heirs will have a 24% tax rate.

The first column of the table illustrates the conventional wisdom approach—withdrawing from taxable accounts first, followed by tax-deferred accounts, and, finally, Roth assets. The other columns show the best strategies we found for the two couples.

As you'll see below, the biggest difference between the couples' strategies is that the first one depletes the Roth account fairly quickly, whereas the second depletes the tax-deferred account before the Roth. In both scenarios, the couple can preserve some taxable assets for the step-up in basis.

	Conventional Wisdom (both couples)	Strategy for Couple #1 (heirs with a lower tax rate)	Strategy for Couple #2 (heirs with a higher tax rate)
Account withdrawals	Taxable account (years 1–37); tax-deferred (starting with RMDs year 6, running out year 39); Roth (years 39 on)	Before RMDs (years 1–5), draw from taxable account plus just enough from the Roth so that capital gains aren't taxed. **Thereafter, supplement RMDs with Roth funds until depleted (year 14)**, then use taxable funds. Never take more than RMDs from tax-deferred account.	Before RMDs, follow same approach as the other couple. **Then rely on tax-deferred account until depleted (year 23).** After that, again use a combination of Roth and taxable account to keep capital gains tax-free, until Roth is depleted (year 42).
Federal taxes paid by each couple over the course of 30 years	$357,000	$314,000 (12% reduction)	$317,000 (11% reduction)
After-tax value of the portfolio to heirs	$1,315,000 (lower-taxed heirs) or $1,250,000 (higher-taxed heirs)	$1,373,000 (4% increase)	$1,343,000 (7% increase)

The chart is for illustrative purposes only and is not indicative of any specific investment. Additional assumptions: Amounts are in today's dollars and rounded; investment returns (before taxes) of 3% above inflation; taxable account generates only qualified dividends and long-term capital gains; cost basis is 25% of the taxable account value at the start of retirement; couple retires at age 65; federal taxes remain at 2018 levels; state taxes not considered. The results (taxes paid and value of the portfolio to heirs) reflect amounts at age 95, but the description of the strategy includes the possibility that the couples live longer.

A few final tips and reminders:

- Taking large tax-deferred distributions to fund spending needs (like the second couple above) can help your highly taxed heirs, but incurs a significant tax burden for you.
- While some experts often advocate Roth conversions, that approach wasn't part of the best strategies we found for these examples. They could make sense in other situations, such as people who can never utilize tax-free capital gains.
- We recommend using a tax adviser or financial planner and starting the planning process at least 10 years before you're subject to RMDs.

When planning your estate, it may not be easy to predict your kids' future financial situation, let alone their tax bracket. As you develop your retirement income strategy, it's worth taking some time to weigh the possible income tax consequences for the estate recipients versus taxes you will pay during your lifetime.

T. Rowe Price Investment Services, Inc.