How Coordinating Beneficiary Designations Can Increase Your After-Tax Legacy

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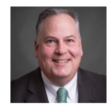

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KEY INSIGHTS

- Leaving wealth to the next generation involves income taxes—in many cases, more than estate taxes. Assigning different beneficiary percentages across accounts can potentially increase the after-tax legacy.
- This strategy can be valuable if your beneficiaries will have very different tax rates; a balanced mix of assets also helps the strategy work well.
- Successful execution of this beneficiary designation strategy should include thoughtful coordination with estate documents and flexibility to account for changing tax rates and asset values.
- This strategy aims to improve the amounts received after taxes by each beneficiary, as opposed to equalizing after-tax inheritance.

Three developments have made income taxes for beneficiaries increasingly important, relative to estate taxes, in recent decades.

- The use of tax-deferred retirement accounts, such as 401(k) plans and Traditional individual retirement accounts (IRAs), has grown dramatically, whereas defined benefit pensions (which don't usually pass to the next generation) have declined in popularity.
- Estate taxes are only relevant to a small fraction of households due to the sharp increase in the federal exclusion.[1]
- The SECURE Act of 2019 generally eliminated the ability to stretch IRA distributions over a beneficiary's expected lifetime, which potentially increases the tax rate paid on those distributions.

If your beneficiaries will likely have significantly different marginal tax rates, it would increase the total after-tax estate value if lower-rate beneficiaries received more tax-deferred assets, and higher-rate beneficiaries received more tax-free assets. Typically, tax-deferred assets, such as retirement accounts, are passed via beneficiary designations (outside the will, or "nonprobate") and may be largely taxable as ordinary income upon required withdrawal. In contrast, investments passed via estate documents (such as wills or trusts), including real estate or taxable investments, may be tax-free due to the step-up in basis. Therefore, it may seem sensible, from an after-tax inheritance

[1] As of January 1, 2023, the federal unified lifetime gift and estate tax exclusion amount is $12,920,000 per person or $25,840,000 for a married couple.

perspective, to designate inheritance of your “nonprobate”, tax-deferred assets to your child who is a teacher or social worker, and your “probate,”, potentially tax-free assets to your child who is a corporate executive or doctor.

Note that for simplicity we’ll often refer in this article to wills and probate assets that are distributed via wills. However, the use of trusts, which generally avoid probate, can also be a good approach for assets that do not have beneficiary designations.

Implementing an after-tax estate planning strategy, however, has some challenges.

- First, you need to carefully modify two types of documents in tandem: beneficiary designation forms for retirement accounts and the will or trust that governs how other assets are passed. Plus, other documents such as transfer on death (TOD) designations need to be reviewed to ensure they don’t undermine the strategy.
- Second, it may not be as simple as leaving 100% of an account to the lower-income child and 0% to the other. The specific percentages in beneficiary designations need to be well thought out.

After initial implementation, the strategy needs to be reviewed and maintained over time, requiring a plan with flexibility. That way, the plan can still work as intended if beneficiary tax rates and asset values are different from assumptions made in the estate planning process.

This strategy makes the most sense for people whose beneficiaries will have starkly different tax rates. In addition, it is for people who are concerned with dividing their assets in a “fair” manner. Based on insights shared by estate attorneys, most people consider the “default” strategy—simply splitting everything equally without considering taxes—to be fair. Therefore, the strategy in this article aims to improve upon that approach for all beneficiaries.

Example

Consider a situation where a parent’s estate is expected to be $1 million, evenly split between a taxable account and a tax-deferred account. There are two children: Jennifer, who is a corporate attorney with an expected 43% marginal income tax rate (federal and state), and James, who is a graphic designer with a 24% marginal rate. The taxable account receives a full step-up in basis at death, so there are no income taxes on that portion of the inheritance. (Throughout this article, we’ll assume there are no estate taxes—just income taxes.)

If the parent divides both accounts equally (before taxes), the distribution would be as shown in Figure 1.

Clearly, total taxes would be lower if James receives more of the tax-deferred account and Jennifer gets most of the

Two-Beneficiary Example Using Equal Pretax Division of All Assets

(Fig. 1) This division results in some tax-deferred assets taxed at the higher 43% rate.

	Jennifer	James	Total
Expected marginal tax rate	43%	24%	
Tax-deferred (TD) account	$250,000	$250,000	$500,000
Taxable account	$250,000	$250,000	$500,000
Pretax total	$500,000	$500,000	$1,000,000
Income taxes on TD account	$107,500	$60,000	$167,500
After-tax total	$392,500	$440,000	$832,500

For illustrative purposes only.

A key objective here is 'do no harm.'... we focus on improving after-tax inheritance for everyone (from a 'fair' starting point), not equalizing after-tax inheritances.

— **Roger A. Young, CFP®**
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taxable account. What is a fair and practical way to do that?

What Is Fair?

First things first: What is the objective of a tax-aware estate strategy?

Previous research[2] on this topic points out that the common approach used above—apportioning the face value of all assets equally, without regard to income taxes—can result in inequal after-tax values to the beneficiaries. If there are any tax-deferred assets (subject to income tax for beneficiaries), a beneficiary with a higher marginal tax rate (Jennifer) will receive less, after taxes, than other beneficiaries. Those researchers suggest that this does not align with the parents' intent to divide assets equally.

In one article (see Note 2), the proposed solution is to allocate taxable and IRA assets differently to equalize after-tax inheritance and reduce taxes paid. However, in the illustration of that solution, the beneficiary in the lowest tax bracket actually receives *less* after taxes than he would have received under the common approach of equal pretax division! If you were the lower-earning sibling in that situation, you would probably consider that solution unfair, especially when you already earn less income each year than your sibling.

People can have different views on fairness in this situation. That said, several estate attorneys have suggested that, for family harmony purposes, it is usually advisable to divide the pretax estate value equally, regardless of income disparities among your children. If that's the case, and you aren't trying to compensate for income disparities in your estate plan, compensating for tax rate disparities on that income seems counter to the goal of fairness.

Therefore, we start with the premise that equal pretax division of assets will be considered fair by most parents and children. It's easy to explain, and estate attorneys generally find that people don't complain about that approach.

Solutions we describe are designed so they do not reduce after-tax inheritance for any beneficiary, as compared with the conventional method of equal pretax division across all asset types. A key objective here is "do no harm." Put another way, we focus on improving after-tax inheritance for everyone (from a "fair" starting point), not equalizing after-tax inheritances.

Two-Beneficiary Example, Continued—Allocations to Equalize After-Tax Inheritances

(Fig. 2) This division improves after-tax inheritance, but only for one beneficiary.

	Jennifer	James	Total
Expected marginal tax rate	43%	24%	
Tax-deferred (TD) account	$0	$500,000	$500,000
Taxable account	$440,000	$60,000	$500,000
Pretax total	$440,000	$560,000	$1,000,000
After-tax TD account	$0	$500,000 x (1-.24) = $380,000	$380,000
After-tax total	$440,000	$440,000	$880,000
$ Change from conventional method	+$47,500	+$0	+$47,500
% Change from conventional method	+12.1%	+0%	+5.7%

For illustrative purposes only.

[2] See Potts, Tom L., and William Reichenstein. 2015. "Which Assets to Leave to Heirs and Related Issues." *Journal of Personal Finance* 14 (1): 9–16; and Vnak, Brian. 2019. "Equal Shares for Heirs? Not Unless You Take Taxes into Account." Kiplinger.com. https://www.kiplinger.com/article/retirement/t021-c032-s014-equal-shares-for-heirs-take-taxes-into-account.html. Specific example refers to the Vnak article.

Continuing the Two-Beneficiary Example

For Jennifer and James, if the goal was to equalize after-tax inheritance, the distribution would be as shown in Figure 2.

There are several concerns with this approach. First, and most glaring, is that Jennifer gets all of the incremental benefit. It doesn't technically violate the "do no harm" rule, but James has no reason to be excited about this "improvement" over the simpler approach, especially since Jennifer already earns more income.

The second concern involves implementation and sensitivity to changes in the situation. There needs to be language in the will to apportion the taxable assets to ensure equitable treatment. Unfortunately, specifying a dollar split (like above) is impractical because the future value is uncertain. A percentage split (88% and 12% in this case) would be inequitable if the values turned out to be meaningfully different. Jennifer would ultimately receive too much if the taxable account grew and too little if it shrank.

Similarly, if the projected tax rates turn out to be incorrect, one of the siblings could be worse off after taxes than under the equal pretax division method. For example, suppose all assumptions were correct, except that James's income situation improved and his tax rate turned out to be 28% instead of 24%. That four-point change costs him $10,000 more after taxes if he gets 100% of the tax-deferred account than if all assets were divided equally by the conventional method (as in Figure 1). He would be worse off, which violates the "do no harm" principle.

An Improved Approach to Fairness Used by Estate Attorneys

A few estate attorneys[3] shared how they handle real-life situations where nonprobate assets such as IRAs are divided unequally. The method essentially has three steps:

1. The value of all assets that are passed outside of the will is added to the probate asset value to arrive at an "adjusted estate" value. Importantly, tax-deferred account values are modified to reflect expected income taxes.

2. The adjusted estate value is divided by the number of beneficiaries (assuming the intent to divide assets equally).

3. For each child, that share of the adjusted estate is reduced by nonprobate assets received outside the will (modified for expected taxes as in the first step). The resulting amount is that child's share of actual probate, step-up eligible assets.

This raises a key question: How do attorneys or financial professionals specify the tax rate when modifying nonprobate asset values in the first step? There are a few possibilities, but the one many attorneys tend to prefer is to select one "assigned" tax rate and apply it for all beneficiaries in the calculation. Continuing the example above, Figure 3 shows how the distribution would play out using an "assigned tax rate" of 33.5%—the midpoint of the two beneficiaries' projected rates.

By using an assigned tax rate, a parent can allow both children to benefit from the strategy. Again, the goal is improvement, not equal after-tax inheritance. From a communication standpoint, this may also make the conversation with children easier—the calculation is the same for everyone, which is, in a sense, fair. And showing how it should benefit everyone certainly helps make the case that a novel approach is worth the effort.

[3] Two attorneys, Jeffrey Renner and Cristin Lambros, provided valuable insights on this topic, including descriptions of how estate documents can implement strategies with nonprobate assets. Both, as well as attorney Jeffrey Condon, shared important considerations around charitable strategies, family dynamics, and real-world estate planning challenges. Note that their assistance should not be interpreted as an endorsement of the specific strategies in this article.

Two-Beneficiary Example, Continued—Using the "Assigned Tax Rate" Method

(Fig. 3) This method improves after-tax inheritance for both beneficiaries.

	Jennifer	James	Total
Expected Marginal Tax Rate	43%	24%	
Tax-Deferred (TD) Account	$0	$500,000	$500,000
Assigned Marginal Tax Rate	33.5%	33.5%	
After-Tax TD Account (Based on Assigned Tax Rate)	$0	$500,000 x (1-.335) = $332,500	$332,500
Taxable Account Total Value			+$500,000
Adjusted Estate Total and Split	$416,250 (50% of $832,500)	$416,250 (50% of $832,500)	=$832,500
Adjust for Assigned After-Tax TD Value Above	-$0	-$332,500	-$332,500
Taxable Account Split	=$416,250	=$83,750	$500,000
After-Tax TD Account (Based on Expected Tax Rate)	+$0	$500,000 x (1-.24) = +$380,000	+$380,000
Total After-Tax Inheritance	=$416,250	=$463,750	$880,000
$ Change from Conventional Method	+$23,750	+$23,750	+$47,500
% Change from Conventional Method	+6.1%	+5.4%	5.7%

For illustrative purposes only.

Different assigned tax rates can enable this while still improving after-tax results for everyone. The key consideration to remember: *The higher the assigned rate, the more benefit that goes to the lower-rate child.*

Anticipating Changes

As noted earlier, beneficiary tax rates and asset values can change. Therefore, beneficiary designations and assigned tax rates should be determined in a manner likely to prevent problems across a reasonable range of scenarios.

Tax Rate Changes

There are many life changes that can affect someone's marginal tax bracket, including career, marital status, retirement, state of residency, etc., not to mention statutory changes. The strategy fails to improve results if the assigned rate isn't actually between the higher-rate child's marginal rate and the lower-rate child's marginal rate. Therefore, to mitigate the risk of harming any beneficiary, consider these steps:

- Wait to implement this strategy until the beneficiaries are relatively settled, career- and tax-wise.
- Discuss the plan with all beneficiaries, both for buy-in and to reasonably understand their tax situations.
- Only implement the strategy if there is a significant difference in beneficiaries' expected tax rates.
- Set the assigned tax rate near the midpoint of the two expected marginal rates—or at least one bracket away from each beneficiary's expected rate. Keep in mind that the higher the assigned tax rate, the more incremental benefit the lower-rate child will realize.
- Execute the beneficiary designations and estate documents at the same time.
- Revisit the plan anytime a beneficiary has a major life event. This might be implemented just by changing beneficiary designations but could also require a change to the assigned

tax rate in the will. Many attorneys advocate updating estate plans every five years.

Changes in Asset Values

This strategy relies on having some assets that pass via the will—not just assets with beneficiary designations. Those probate assets, such as real estate and taxable accounts, enable the equalization described in the approach described above.

If taxable assets represent a higher proportion of total assets at death than expected, that doesn't present a problem. However, if taxable assets are significantly depleted relative to accounts with beneficiary designations, that could cause a major issue. There might not be enough probate assets to counterbalance the tax-deferred assets passed to a lower-rate child. Then the higher-rate child would be out of luck.

In the example above, suppose $250,000 is unexpectedly withdrawn from the taxable account before death. All other assumptions stay the same, including 100% of the tax-deferred account going to James. In this case, Jennifer ends up $17,500 worse off than she would have if assets were split by the conventional method of 50-50 before taxes. In that scenario, the plan fails the "do no harm" test.

One way to mitigate this risk is to build "cushion" into the calculation of the split in the beneficiary designation. In this example, allocating the tax-deferred account 87% to James and 13% to Jennifer (instead of 100% and 0%) would enable an equitable split. Note that the cushion has a cost: Total after-tax value improvement decreases from $47,500 to $35,150. That's because $65,000 of the tax-deferred account is taxed at a rate 19% higher.

In addition to building in cushion, there are other actions that can mitigate the risk of an inadequate taxable asset balance.

- Consider your full financial plan, especially your retirement income strategy, when estimating future asset values.
- Perhaps even more regularly than with the tax rate risk, revisit the strategy often to account for asset value shifts.
- Include language in the will that clearly explains what happens if there is a shortfall in taxable assets.

How Much Does This Improve the After-Tax Inheritance?

We evaluated the impact of this strategy for beneficiaries across many different combinations of beneficiary tax rates and asset mixes. (See information below Figure 4 for more details.)

There are two types of numbers that need to be determined when implementing this strategy. As described above, we used this method:

1. The assigned tax rate equals the midpoint of beneficiary rates (like in the example above).
2. The beneficiary designations are chosen to allocate as much of the tax-deferred account to the lower-rate beneficiary as possible. However, it is set below 100% if necessary, so that neither sibling is worse off, even if the taxable account value is cut in half. After setting the tax-deferred designations, as much of the tax-free account goes to the higher-rate beneficiary as possible, also subject to that "do no harm" rule.

Figure 4 shows the dollar benefits for different combinations of assumptions. Employing the strategy improved after-tax value to beneficiaries by 1.3% to 10.3% compared with the conventional method of dividing all asset types equally before taxes.

It is not surprising that results generally improve as the tax rate gap widens (moving to the right). It is less intuitive that results would start to tail off after

Average After-Tax Dollar Improvement for a $1,000,000 Estate (in Total for Both Beneficiaries)

(Fig. 4) The benefit of the strategy grows as the beneficiary tax rate gap widens

Percentage Tax-Deferred	Marginal Tax Rates of Beneficiaries (Sorted by Difference, Shown Below Rates)					
	38%–28%	38%–24%	43%–24%	47%–24%	43%–12%	47%–12%
	10%	14%	19%	23%	31%	35%
30%	$15,000	$21,000	$28,500	$34,500	$46,500	$52,500
40%	$20,000	$28,000	$38,000	$46,000	$62,000	$70,000
50%	$22,761	$31,449	$43,393	$53,266	$67,478	$77,726
60%	$18,657	$25,362	$35,714	$44,574	$53,448	$62,057
70%	$13,060	$17,754	$25,000	$31,202	$37,414	$43,440

Beneficiary marginal tax rates evaluated were 12%, 24%, 28%, 38%, 43%, and 47%, based on current federal rates from 12% to 37%, plus hypothetical state marginal tax rates ranging from 0% to 10%. Pairs of these rates with at least 10 points between them were tested (but not all are shown above). Three types of assets were considered, using increments of 10% for the asset mix. Those three types were tax-deferred (30% to 70% of the total value at death before taxes); tax-free, such as Roth accounts (0% to 50% of the value); and a taxable account, passed via a will or trust[4] (20% to 70% of the value). Tax-deferred accounts are taxed at each beneficiary's marginal rate. Tax-free and taxable accounts pass tax-free (the latter due to a full step-up in basis). Calculations of beneficiary designation percentages included "cushion" so that taxable account values would be adequate even if the account decreased by 50% versus the original assumption. Dollar amounts in the table represent average total improvement, across all relevant combinations of tax-free and taxable asset percentages for a given tax-deferred percentage.

tax-deferred assets increase to beyond 50% of the portfolio. More tax-deferred assets would appear to mean more opportunity for shifting to a lower rate. Recall, however, that if there's not enough money in other accounts to compensate, the percentage of the tax-deferred account left to the lower-rate child needs to be reduced.

The numbers in Figure 4 are directly scalable for different estate values (assuming the marginal tax rates are still accurate). For example, someone leaving a $3 million estate (50% in tax-deferred accounts) to beneficiaries whose tax rates are 23 percentage points apart could improve after-tax legacy by nearly $160,000 ($53,266 x 3 = $159,798). Investors need to evaluate whether the benefit is worth the effort and risks, but the potential improvement can be meaningful.

More Than Two Beneficiaries

As the number of beneficiaries increases, the strategy gets harder to implement. The benefits can also be significantly smaller than for comparable two-beneficiary cases. And if you're not careful, a child in the middle (in terms of tax rate) could get shortchanged.

One simple way to implement the strategy for three beneficiaries is to treat the middle child like either the high- or low-rate child (whichever has the closer rate). The assigned tax rate is the midpoint between the middle rate and either the high or the low rate (whichever is further). For example, if Jennifer and James had another sibling with a 28% expected tax rate, you'd use 35.5% (the midpoint of 28% and 43%). In this example and many three-beneficiary cases, the children all benefit, but do not share the improvement equally. It can still work out, but the more beneficiaries, the more chances someone will end up disappointed.

Additional Considerations: Estate Planning Factors

Estate planning is complex, and this article does not address all of the factors that should be considered. However, three specific factors are worth mentioning—and discussing with a financial professional.

[4] For purposes of this strategy, a health savings account should be considered tax-deferred, because a non-spouse beneficiary pays ordinary income tax on the inherited value. Life insurance death benefits are usually tax-free and are distributed based on beneficiary designations, like a Roth IRA; however, regarding tax treatment after inheritance, they are more like a taxable account.

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>
> **— Roger A. Young, CFP®**
> *Thought Leadership Director*

- Large inheritances can significantly change the beneficiaries' tax rates, particularly with the 10-year distribution requirement for most non-spouse beneficiaries under the SECURE Act. This factor should be considered when deciding whether to implement a beneficiary designation strategy and, if so, in determining the assigned tax rate.
- There are other strategies that could address the tax burden on tax-deferred accounts, such as donating tax-deferred assets to charity, having a beneficiary disclaim certain assets, and Roth conversions from tax-deferred accounts to tax-free accounts. These each have pros and cons and can be complex to execute.
- The best laid plans can be inadvertently derailed by well-meaning advisors in the future. One example is that advisors often recommend TOD designations to avoid probate and simplify transfer of assets. Unfortunately, adding a TOD designation to an account that is required to balance out the adjusted estate could undermine this strategy.

Conclusion

If you have a diversified mix of probate and nonprobate assets, and beneficiaries in significantly different tax brackets, this strategy can generate meaningful tax savings. Using information in this article, you can work with an estate attorney and financial professional to implement a plan, using an assigned tax rate in the will that is between the beneficiaries' expected marginal tax rates. The allocation percentages specified in beneficiary designations can direct more of the tax-deferred assets to those with lower tax rates. By choosing those numbers carefully, you and your advisors can split the benefit of the strategy among beneficiaries and reduce the risk that any beneficiary will be worse off as a result of this approach.

However, this strategy does have risks and is probably inappropriate for many people. The conventional alternative is easy, and you probably won't consider it unfair—simply allocate all accounts equally using gross (before-tax) values.

This checklist of factors can help you evaluate whether the strategy is worth pursuing. You probably want to check all or most of these boxes.

- Large tax rate gap between beneficiaries
- Somewhat stable beneficiary tax rates and established retirement income plan
- Relatively balanced asset mix (tax-deferred versus other assets)
- A family willing to discuss finances, including views on fairness
- Confidence in your ability to execute plans and make necessary adjustments
- An estate attorney who buys into the strategy (and will quickly execute codicils to change the assigned tax rate if needed)
- Strategy to avoid conflict with other planning techniques being employed, such as TOD designations.

You and the professionals you rely on must also stay on top of changes and be willing to forgo the strategy if the benefits don't seem commensurate with the risks and effort. It needs to be well documented, so that everyone involved—now or in the future–understands the strategy.

Finally, remember that the value of family harmony should not be underestimated! If this or any complex strategy threatens to cause ill will, that's a risk you should probably avoid.

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