The $740,000 Mistake:

Why many IRAs should not be allocated equally between the children.

By Alan S. Gassman, JD, LL.M., AEP®

Many parents assume that the best estate plan is the one that divides everything equally. If you have three children, it feels natural to leave one-third of the estate for each child. If you have one large individual retirement account, one large brokerage account, and a valuable home, the simplest answer appears to be: "We'll divide it evenly and let them sort it out." But from a tax standpoint, such assets are not created equal.

Here is the math:

A $2 million taxable brokerage account and a $2 million traditional IRA look identical on a net worth statement, but in the hands of your heirs, they could not be more different.

But here is what keeps estate planners up at night:

- A child who receives a $2,000,000 taxable brokerage account with a fair market value income tax basis can sell it with no capital gains.
- A child who inherits a $2,000,000 traditional individual retirement account (IRA) receives approximately $1,260,000 of after-tax value, assuming a combined 37% federal and state income and Medicare tax bracket.
- The difference is $740,000 — but this can be fixed with the right planning.

The 10-year rule: How the SECURE Act created this problem

With the passage of the SECURE Act in 2019, the "lifetime stretch IRA" was effectively eliminated for most non-spouse beneficiaries, forcing inherited IRAs to be fully distributed within just over 10 years from the IRA owner's date of death.

Before that law, a child who inherited an IRA could stretch distributions over their own lifetime, allowing tax-deferred growth over decades. Today, most inherited IRAs must be fully distributed — and fully taxed — under the 10-year rule.

It is worth noting that a properly drafted will or revocable trust can direct the IRA to a trust or trusts for a child or children at death and still qualify for the 10-year rule, provided the documents and procedures comply with applicable law. This structure can protect a child's inheritance from creditors, divorce, and estate tax at the child's level.

Leaving a large traditional IRA to high-earning children in their peak earning years is a tax disaster waiting to happen. If your children are professionals, executives, or business owners already in the 37% or higher bracket, forcing $2,000,000 of ordinary income onto their tax returns over a decade generates approximately $740,000 in federal income tax, plus it also can be subject to the 3.8% Medicare tax. That is money that could have been preserved with better planning.

By contrast, a taxable brokerage account or appreciated real estate held until death receives a full step-up in cost basis under Internal Revenue Code Section 1014. Children who inherit these assets take them with a fair market value tax basis. The built-in capital gains vanish so that only the post death growth in value will be taxed upon sale. The chidlren inhereit at current fair market value with no embedded tax liability.

The "Best asset to the best beneficiary" principle

One solution is to allow an independent trustee to allocate the IRA and other assets among the children's trusts other than equally, taking tax brackets into account.

Over the 10-year term, the trustee can distribute IRA proceeds to the lower-income children, and a proportionally smaller share of the non-IRA assets to the higher-income children, so that they come out fairly close in net inheritance after taxes and the IRS gets less.

This structure is known as the "teapot trust" arrangement because the trustee pours the IRA amounts and other assets in the best combination to reduce income taxes and equitably serve the children. This "best asset to the best beneficiary" concept is often more important than the client's testamentary percentages.

A simple charitable solution

This technique works well for charitably inclined parents and/or children with charitable interests.

In this case, some or all of the IRA can be directed to one or more charities favored—and perhaps influenced — by the children, while the brokerage account is allocated to equalize the inheritances.

In other words, instead of leaving the IRA to the children, the parents can name a charity as the beneficiary of the IRA. The charity can receive the IRA moneys income tax free and may direct them as recommended by a child or the children or others.

The charity can be a family foundation that is formed before or after the death of the IRA owner, or a donor advised fund or community foundation account that may be managed by a particular child or children, who in some circumstances may be compensated for genuine charitable activities sponsored by a family or community foundation.

This is not about giving children less. It is about giving children more after tax. The family receives the same total value from the estate, but the IRS receives substantially less.

The difference between a good plan and a great plan is often not the documents. It's which asset goes where.

Some families resist this initially because it feels uneven on paper. If one child sees that the IRA went to charity and the brokerage account went to the family, it may look lopsided.

That is where communication matters. The goal is not to make the documents look equal. The goal is to make the after-tax outcomes as equal as possible.

The NIMCRUT strategy: Charity and family in one vehicle

For families who want to benefit both children and charity, or at least have a longer than 10-year stretch in distributions using retirement assets, there is a hybrid strategy known as the "net income with makeup charitable remainder unitrust" (NIMCRUT) as well as a simpler version known as a charitable remainder unitrust (CRUT) that is very popular.

The concept: Instead of naming a child directly as IRA beneficiary, the client names a charitable remainder trust (CRT) as beneficiary. The IRA passes to the CRT at death, the CRT is tax exempt, and the deferred income tax on the IRA is stored up at the trust level.

The NIMCRUT can then be structured so that the individual beneficiary need not take any distributions for many years. This can be based on 20 years or the child's lifetime.

Once the child finally receives the distributions, those amounts are taxable, but the child may be retired and in a lower income bracket when the distributions are received.

If a traditional charitable remainder unitrust is used, payments are made to the beneficiary every year based on a percentage of the trust's value – for a fixed term of up to 20 years or the child's lifetime, as selected. There can be one CRT that benefits more than one child.

As well-respected CPA Robert Keebler and others have demonstrated, the portion that ultimately flows to charity is often fully "paid for" by the income-tax deferral savings that the individual beneficiary enjoys during the trust's term.

The client achieves both objectives: significant benefit to a child or grandchild, and meaningful support for a chosen charity, while substantially reducing the income tax that would otherwise have been owed on the IRA.

The administration warning

A charitable remainder trust is not a set-it-and-forget-it tool. A CRT must be operated in strict compliance with the tax laws, from formation through final distribution.

One federal appellate court allowed the IRS to deny a charitable deduction entirely, notwithstanding sound drafting, because the trust failed to make required annuity payments during the grantor's lifetime.

That case, Estate of Atkinson v. Commissioner, 309 F.3d 1290 (11th Cir. 2002), remains the classic warning that charitable vehicles must be fully compliant with applicable law and payment obligations.

The bottom line

In many estates, the biggest improvement does not come from rewriting the entire plan. It comes from reviewing your beneficiary designations and asking one question: "Am I leaving my most heavily taxed asset to the people who will pay the most tax on it?"

If the answer is yes, and if you are charitably inclined, the fix is straightforward:

- Leave retirement assets to charity (or to a properly structured CRT);
- Leave basis-adjusted assets to children; and
- Communicate the logic so beneficiaries understand why.

Always match the highest-taxed asset (IRAs) or highly appreciated assets with the most efficient tax vehicle —qualified charitable deductions, CRTs, CLATs, or IRC §642(c) trusts — rather than distributing cash to charity while heirs absorb the embedded tax burden.

About the author

Alan S. Gassman is a Board Certified Specialist in Estate Planning and Trust Law and the founder of Gassman, Denicolo & Ketron, P.A., a Clearwater, Florida law firm serving high-net-worth families, business owners, and physicians in estate planning, trust design, taxation, asset protection, and business succession planning. With more than 35 years of experience, he advises clients on sophisticated estate, trust, tax, and wealth transfer strategies. He has served as an expert witness in estate planning, tax, and asset protection matters. He also is a nationally recognized author and speaker, having written numerous books and hundreds of professional articles on estate planning, taxation, and asset protection topics. Gassman holds a J.D. and an LL.M. in Taxation from the University of Florida. He is a past President of the Pinellas County Estate Planning Council, has chaired numerous Florida Bar continuing education programs, and has served as an adjunct professor at Stetson University College of Law. He is Board Certified by The Florida Bar in Estate Planning and Trust Law, an Accredited Estate Planner (AEP®), and a member of the Estate Planning Hall of Fame.