

Equal Shares, Unequal Outcomes: Estate Planning Strategies for Parents and their Qualified Retirement Accounts



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Typically, a parent wishes to treat their children equally in their estate plan and presumes they will achieve this goal by dividing all their assets into equal shares upon their death. Accordingly, they will designate their children as equal beneficiaries of their qualified retirement accounts, such as traditional IRAs and Roth IRAs. However, doing so without considering the individual circumstances of their children may be less tax efficient and may ultimately result in one child receiving more assets after the payment of taxes than their siblings.

Traditional IRAs vs. Roth IRAs: Key Differences

A traditional IRA is funded on a pre-tax basis, with the income taxes on any appreciation deferred until assets are withdrawn from the account. Traditional IRAs are subject to requirement minimum distributions (RMDs) when the account holder attains the age of 73. A RMD is the minimum amount that must be withdrawn from the IRA each year. Contributions to a Roth IRA, on the other hand, are made with after-tax dollars, and the distributions are withdrawn tax-free. In addition, there is no RMD requirement for a Roth IRA during the lifetime of the account holder.

The Ten-Year Rule

When the account holder dies, most beneficiaries must take distributions pursuant to the “ten-year rule,” which requires that the beneficiary withdraw the account assets in full within ten years from the date of death of the original account holder. During this withdrawal period, the beneficiary must take RMDs in each year that the inherited account is open. As these withdrawals are made, the beneficiary must pay the deferred taxes based on their individual income tax bracket. Notably, withdrawals from a Roth IRA account remain income-tax free to the beneficiary, and are not subject to the RMD requirement.

Tax Benefits for Eligible Designated Beneficiaries (EDBs)

A beneficiary that is deemed an “eligible designated beneficiary” (“EDB”) is not subject to the ten-year rule and may take distributions from the inherited account over their lifetime. Thus, the account assets may continue to appreciate tax deferred over a significantly longer period of time. EDBs include beneficiaries that are not more than ten years younger than the original account holder, surviving spouses, beneficiaries that are deemed disabled or chronically ill, and minor beneficiaries.^[1]

It will be inherently more tax efficient for a parent to name an EDB as a beneficiary of their qualified account because of the extended withdrawal period the beneficiary will have to take distributions from the account. Therefore, if a parent has two or more children, one of whom is deemed an EDB, and names each of them as an equal beneficiary of their IRA account, the child who is an EDB will ultimately receive significantly more assets than their siblings because the assets in the account will

have significantly more time to appreciate tax-deferred. In addition, because of the extended withdrawal period, the beneficiary has more flexibility in choosing when to take distributions from the account to avoid getting bumped into a higher marginal income tax bracket. Accordingly, if the parent wishes that each of their children receive as nearly equal shares of their assets as possible, and one or more of their children are deemed EDBs, it may be better to provide a greater share of their qualified accounts to the EDB beneficiaries, and the non-EDB beneficiaries with a greater share of their other estate assets.

Case Study: Tax Efficiency and Equalizing Shares

What if the account holder does not have any beneficiaries who will be deemed an EDB? Even then, the account holder should still consider their children's individual income tax circumstances. Suppose the account holder is single with a Roth IRA with \$1,000,000 in assets and a traditional IRA with \$2,000,000 in assets. The account holder has two children: Alex, who is a stockbroker, and Jamie, who is a public school teacher. We can presume that Alex has more taxable income than Jamie and that Alex has a higher earning potential in their career. If Alex and Jamie were named equal beneficiaries of the traditional IRA, it is likely that the distributions from the account would bump Jamie into a higher income tax bracket in the years that they are received, thus generating more income tax liability. Alex's distributions are almost certain to be taxed at a higher marginal rate than Jamie's.

If Alex and Jamie are named equal designated beneficiaries of the Roth IRA, the distributions would be tax-free in the year that they are received, leaving their respective income tax brackets unaffected. Therefore, naming Jamie as a primary beneficiary of the traditional IRA, where distributions will be taxed at a lower tax bracket, and designating Alex as the primary beneficiary of the Roth IRA is likely more tax efficient and most likely to ultimately result in each child receiving equal shares of the assets after payment of income taxes.

As this example illustrates, naming each child as an equal beneficiary of a qualified account may not result in equal distributions after the payment of taxes, frustrating the intentions of a well-meaning parent. Therefore, careful consideration must always be given to the individual circumstances of an account holder's intended beneficiaries.

^[1] Minor beneficiaries become subject to the ten-year rule once they attain the age of 18.