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Maximize the Tax Benefit of Your IRA

In 1974, Congress enacted and President Ford signed into law the Employee Retirement Security Act (ERISA). Part of this legislation created the Individual Retirement Account, or the IRA. Currently, over 45 million Americans have IRA accounts with an estimated value of \$3.1 trillion. While the IRA has helped millions of Americans in their retirement years, many do not appreciate the tax nightmare that can await the beneficiaries of these accounts. For those persons with significant estates, approximately 70% of the value of the IRA can be consumed by federal estate and income taxes. Additional state and local taxes may also be due. Adequate estate planning is required to ensure that this does not happen to you. Your IRA is useless to your family if the real beneficiary is Uncle Sam.

Wealthy individuals with significant assets may choose not to draw down their IRA accounts for living expenses during their retirement years as they will continue to enjoy its deferred tax benefits. This can continue until their death, at which time the IRA will be included in the individual's estate. Currently, the maximum federal estate tax rate is 45%. This will increase to 60% in 2011. Additionally, the assets in the IRA are subject to federal income taxes, currently at a maximum rate of 35%. If you need to invade the IRA to pay off your estate tax bill, both these taxes will be due in the same year. Let me repeat that, you may pay an effective tax rate of over 70% on the value of your IRA. If you were to die in 2011 or thereafter, up to 85% of the value of your IRA may be consumed in federal taxes.

The tax code has allowed for some excellent planning techniques to prevent this nightmare scenario. By naming a younger non-spousal beneficiary to your IRA account, your beneficiaries can postpone income taxes for significant periods of time and continue to compound gains on tax deferred basis. Federal tax law requires the beneficiary of an IRA to take a required minimum distribution each year from the IRA based on their life expectancy, with the remaining balance of the IRA continuing to grow tax free. These distributions will be subject to income taxes in the year received, unless the IRA has been designated as a Roth. For example, an IRA that is transferred to a 70 year old beneficiary will be required to take minimum distributions over an estimated 17 year period (i.e. they will be required to take a distribution of 1/17th the value of the IRA). However, if this IRA is left to a one year old grandchild, they will be only required to take a distribution of approximately 1% of the value of the IRA as their mortality is 81.6 years. This creates an additional 65 years of tax deferred compounding.

The stretching of the tax deferment is not difficult. You must simply designate a beneficiary to your IRA account. The younger the beneficiary, the longer the tax deferred compounding. This beneficiary form should be reviewed periodically, and updated as necessary. The reality is that most people do not name a beneficiary and lose this very valuable planning tool.

If you have significant assets in retirement accounts, please consider reviewing and updating your beneficiary form. This can be the difference between making your grandchildren or Uncle Sam wealthy. The choice is yours.

Over 90% of estates are consumed by the IRS or nursing homes. Please plan properly. For more information, please contact James Downey, at jmdowney@downeycocpa.com or call 781.849.3100.

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