

### *Is a Million Dollar Qualified Retirement Plan a Blessing or a Curse?*

For years, people have tucked away as much as possible in qualified plans with the thought that paying a dollar in tax at a later date is better than paying a dollar in tax today. Though this is true, with a substantial qualified plan the amount of tax ultimately paid may be a much greater percentage than expected.

Suppose that Dr. Smith is in the 35% federal income tax bracket and is deciding whether to contribute \$10,000 to his 401(k). If he does not make a contribution, he can invest the \$6,500, \$10,000 less the income tax associated with it, and it can grow over time. The interest or dividends on Dr. Smith's investment would be taxable each year and at the end of a twenty-five year period, Dr. Smith would have about \$50,000.

If Dr. Smith instead contributes the \$10,000 to his 401(k), it will remove that sum from his taxable income and save him \$3,500. Because the 401(k) is a qualified plan, all of the income tax on the earnings is deferred until a distribution is made from the plan. Twenty five years later, the \$10,000 can grow to \$100,000. If Dr. Smith withdraws the entire sum, it will all be subject to income tax. If he continues to be in the 35% federal tax bracket, he will pay \$35,000 in tax, leaving him with \$65,000. However, given that Dr. Smith has retired, his ordinary income has likely dropped. If Dr. Smith's federal income tax bracket were 25%, a distribution of the entire qualified plan will only generate \$25,000 in tax, leaving him with \$75,000. Consequently, regardless of his future income tax bracket, it appears to make sense for Dr. Smith to contribute the \$10,000 to his 401(k).

Dr. Smith follows this great tax advice and contributes the maximum to his 401(k) each year and when he retires his 401(k) is worth \$4.0 million. If Dr. Smith withdraws the entire sum and pays tax at 25%, he will be left with \$3.0 million. Assuming that Dr. Smith has other property in excess of the federal estate tax exemption and is a widower, the retirement plan proceeds will be subject to estate tax at approximately 50% and he can pass the remaining \$1.5 million to his heirs upon his death. Thus, 62% of the 401(k) has been lost in tax.

However, Dr. Smith does not want to pay \$1.0 million in federal income tax and wants to explore the option of simply naming his children as the beneficiaries of his qualified plan. If Dr. Smith were to die owning the \$4.0 million qualified plan, the entire sum would be included in his estate for federal estate tax purposes. Again assuming that Dr. Smith has other property in excess of the federal estate tax exemption, the inclusion of the qualified plan would result in \$2.0 million in federal estate tax. Unfortunately for Dr. Smith's children, the story does not end there. When the children withdraw the \$4.0 million from the qualified plan, the entire sum, \$4.0 million, is income to the beneficiaries. Is this double taxation? Yes and No.

The federal income tax is a tax on income after deductions over a period of time, usually a calendar year. The income earned by Dr. Smith has never been subject to this tax; consequently, when distributions are made from the plan whether to Dr. Smith or to a

named beneficiary, they must pay this tax. The federal estate tax is a tax on a person's net worth at their death if it exceeds an exemption amount. If Dr. Smith does not take any distributions prior to death, his net worth includes the entire \$4.0 million. If Dr. Smith liquidated the plan and paid the income tax, his net worth at his death would be only \$3.0 million as discussed above.

The problem with the tax systems is that the estate tax is inclusive in nature. The \$1.0 million of income tax liability associated with the plan is subject to estate tax. In an effort to remedy this problem, beneficiaries of qualified retirement plans that have been subject to estate tax are entitled to a deduction for the estate tax paid on the plan. In the case above where no distributions were taken by Dr. Smith, the beneficiaries would face tax on \$4.0 million less a deduction for the \$2.0 million of estate tax paid which at 25% would generate a tax of \$500,000, leaving them with \$1.5 million. The amount passing to the beneficiaries in both cases is the same \$1.5 million for a total tax rate of 62%.

However, the latter example is too simplistic for several reasons. First, it assumes that the beneficiaries are in the 25% tax bracket. If they are employed, their tax rates may be much higher. Second, the beneficiaries are entitled to an itemized deduction for the estate tax paid. If a beneficiary would not otherwise itemize, the benefit of the deduction is diminished. Third, as one's income reaches a certain level, a portion of one's itemized deductions are reduced. Finally and similarly, as the distribution increases the income of the beneficiaries, their personal exemptions are phased out.

Although the calculations are too cumbersome to illustrate here, there are situations where the combined income and estate tax rate on qualified plan assets exceeds 70% and possibly state tax of another 10%. Maybe you thought that leaving the children a \$1.0 million was worth a million dollars, but it may only be worth \$200,000. It is essential to consider the tax implications on your actions (and inactions) on your beneficiaries and to properly evaluate all of your estate and income tax planning opportunities. As always, you should consult competent legal and tax counsel prior to acting.

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