

How to minimize taxes when leaving assets to the next generation

When planning to leave money to heirs, it's important to weigh the tax burdens of the account holder and the recipients.

T. Rowe Price Insights on Retirement

Key Insights

- If your heirs will have a lower future tax rate, it may make sense to leave them tax-deferred assets.
- Leaving taxable assets to heirs allows them to benefit from the step-up in cost basis, making the gains during the original owner's lifetime tax-free for the heirs.
- If you're considering passing along taxable assets to your heirs, take into account the investments' cost basis, your tax rate on capital gains, and your life expectancy.



Roger Young, CFP®
*Thought Leadership
Director*

So you've planned well enough to be able to leave some money to your children or grandchildren. But have you thought about the tax consequences of your gift?

Tax-efficient withdrawal strategies can be helpful for people looking to spend down their assets in retirement while paying fewer taxes. It may also be beneficial to address strategies for a tax-efficient way to leave assets to your heirs—specifically income taxes (rather than estate taxes, which affect very few people). Here are two factors to consider:

1. Your heirs' tax rates.

The decision to draw from Roth or tax-deferred savings depends largely on future

tax rates—yours and your heirs'. If your heirs' tax rates are likely to be lower than yours, you may want to use assets from your Roth account for spending and leave your loved ones the tax-deferred assets. That's different from the conventional approach, where you wait until taxable and tax-deferred accounts are depleted before spending Roth assets.

2. Taxable assets with gains, which can be passed down to your heirs tax-free.

Under current tax law, the cost basis for inherited investments in taxable accounts is the value at the owner's death. This is known as a "step-up in basis," and it effectively makes gains during the original owner's lifetime tax-free for

heirs. This benefit is why you may want to hold some taxable assets as long as possible, contrary to the conventional wisdom that suggests spending taxable assets first. This can be an especially beneficial strategy with highly appreciated investments in your later years.

The right approach to drawing down your retirement portfolio may involve different tactics at different stages of retirement based on your marginal tax rate. Required minimum distributions (RMDs)—annual withdrawals that people generally are required to take from tax-deferred retirement accounts, such as individual retirement accounts (IRAs)—limit your flexibility and can affect what tactics are best in different years. RMDs must be taken once you reach age 73.*

*The SECURE 2.0 Act of 2022 changed the RMD age to 73 for individuals who turn age 72 on or after January 1, 2023. The new law also provides that the RMD age will change again to 75 in 2033.

For example, for the years—if any—that you are in the 10% or 12% tax bracket, capital gains you realize are generally not taxed. Therefore, you might take advantage of this period to sell investments in taxable accounts. In other years, you may want to preserve taxable assets by prioritizing either tax-deferred or Roth distributions.

How would these strategies work? Let's consider two married couples retiring at age 65 whose heirs are expected to have different tax rates after they inherit the money:

- Both couples have \$2.5 million across their investment accounts: 50% taxable, 40% tax-deferred, and 10% Roth;
- Both couples spend \$140,000 (after taxes) each year;
- Both couples collect \$50,000 in Social Security benefits annually; and
- One couple's heirs will have a 10% marginal tax rate, while the other couple's heirs will have a 28% tax rate.

The first column of the table below illustrates the conventional wisdom approach—withdrawing from taxable accounts first, followed by tax-deferred accounts and, finally, Roth assets. The other columns show the best strategies we found for the two couples.

As you'll see in the table, the biggest difference between the couples' strategies is that the first one depletes the Roth account fairly quickly, whereas the second aims to deplete the tax-deferred account. In both scenarios, the couples can preserve some taxable assets for the step-up in basis.

A few final tips and reminders:

- While Roth conversions were not part of the best strategies we found for these examples, they could make sense in other situations.
- As a result of the SECURE Act of 2019, most retirement account beneficiaries will need to draw down

the account fully within 10 calendar years of the original owner's death. That could increase their tax rates during the 10-year period. That higher tax rate should be considered in your withdrawal strategy and may make Roth conversions or tax-deferred distributions in retirement more beneficial.

- Taking large tax-deferred distributions to fund spending needs (like the second couple above) can help your highly taxed heirs but incurs a significant tax burden for you.
- We recommend using a tax professional or financial planner and starting the planning process at least 10 years before you're subject to RMDs.

When planning your estate and retirement income strategy, it may not be easy to predict your kids' future financial situation, let alone their tax bracket. Even so, it can be worth taking some time to weigh the possible income tax consequences for the estate recipients versus taxes you will pay during your lifetime.

	Conventional wisdom (both couples)	Strategy for couple #1 (heirs with a lower tax rate)	Strategy for couple #2 (heirs with a higher tax rate)
Account withdrawals	Taxable account (years 1–28), tax-deferred (starting with RMDs in year 9, running out in year 34), followed by Roth (years 34 on).	Before RMDs (years 1–8), draw primarily from the taxable account plus just enough from other accounts so that capital gains aren't taxed. Thereafter, supplement RMDs with Roth funds until depleted (year 21), then use taxable funds. In most years, avoid taking more than RMDs from the tax-deferred account.	Before RMDs, follow a similar approach to the other couple but without Roth distributions. Then rely largely on the tax-deferred account, aiming to deplete it by year 30 (which entails some Roth distributions). After that, use the taxable account, with most capital gains tax-free.
Federal taxes paid by each couple over the course of 30 years	\$438,000	\$343,000 (22% reduction)	\$409,000 (7% reduction)
After-tax value of the portfolio to heirs	\$995,000 (lower-taxed heirs) or \$917,000 (higher-taxed heirs)	\$1,095,000 (10% increase)	\$1,014,000 (11% increase)

The chart is for illustrative purposes only and is not indicative of any specific investment. Additional assumptions: Amounts are in today's dollars and rounded; investment returns (before taxes) of 3% above inflation; taxable account generates only qualified dividends and long-term capital gains; cost basis is 25% of the taxable account value at the start of retirement; couple retires at age 65; federal taxes are based on rates effective January 1, 2023, including the fact that some rates are scheduled to revert to pre-2018 levels after 2025; and state taxes are not considered. The results (taxes paid and value of the portfolio to heirs) reflect amounts at age 95, but the description of the strategy includes the possibility that the couples live longer.

Important Information

This material has been prepared for general and educational purposes only. This material does not provide recommendations concerning investments, investment strategies, or account types. It is not individualized to the needs of any specific investor and is not intended to suggest that any particular investment action is appropriate for you, nor is it intended to serve as the primary basis for investment decision-making. Any tax-related discussion contained in this material, including any attachments/links, is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any tax penalties or (ii) promoting, marketing, or recommending to any other party any transaction or matter addressed herein. Please consult your independent legal counsel and/or tax professional regarding any legal or tax issues raised in this material.

All investments involve risk, including possible loss of principal.

© 2024 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. All other trademarks are the property of their respective owners.

T. Rowe Price Investment Services, Inc.