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## **Estate Planning 101: Fitting Your Assets into Your Estate Plan**

*Retirement is a big step that makes you rethink almost every aspect of your life. An important item to include in your reassessment is your estate plan.*

If you already have an estate plan, you may want to look at it again. Your life has probably changed (family, assets, priorities), and you may need to change your estate plan to keep up with it. The tax system may also have changed. To get you thinking constructively, let's take a brief look at how some of the assets you own may fit into your estate during your retirement.

### **Pretax Retirement Savings and IRAs**

Pretax retirement savings hold a unique position in an estate plan. You can't make withdrawals during your lifetime without paying income tax. And because you hold these accounts in your own name, they're included in your taxable estate and are subject to estate taxes when you die. And if you leave them to your heirs, they then have to pay income taxes when they make withdrawals after your death.

In effect, these retirement savings are subject to two forms of taxation. Mind you, that's not all bad — it's just the payment the IRS extracts for all those years of tax-deferred growth. The important thing is to plan for both the income and the estate tax consequences.

So what do you do? There are two schools of thought: (1) If you need the money for your retirement, spend this money down first to avoid estate taxes when you die; or (2) If you want to leave the money to your heirs, avoid spending it, maximize the tax-deferred growth, and have your heirs defer taking the money for as long as they possibly can.

These two approaches aren't as contradictory as you might think. Which works better for you depends on multiple assumptions — the size of your income tax bracket versus your heirs', what you expect your estate tax bill to be, and what return you expect to receive on your investments. Figuring out the right approach can be tricky — and should involve your tax advisor.

### **“Stretch”**

One specific strategy relating to retirement accounts and IRAs is often called the “stretch” concept. If you know that you want to leave a particular qualified retirement plan balance to a nonspouse heir, then you probably want to “stretch” the tax-deferred

growth of that account — and postpone taking taxable distributions from it — as long as possible.

You probably know that the IRS requires you to begin taking minimum distributions on your retirement accounts after you reach age 70½. The stretch concept takes advantage of IRS rules that allow beneficiaries younger than you to reduce the size of the minimum distributions. Essentially, during your lifetime, if your spouse is more than ten years younger, you can use a joint life expectancy table to effect smaller required distributions. Similarly, if you leave retirement accumulations in the form of IRA funds to younger, non-spousal beneficiaries (such as your children, for example), distributions from the inherited IRAs can generally be taken over the younger beneficiaries' individual life expectancies — allowing them to “stretch out” the tax-deferred status of the funds.

Please recognize that the general concept of stretch IRAs that we've just discussed is complex, is based on current law and should be discussed with your tax advisor. The stretch concept does not typically apply to Roth IRAs (because the age 70½ minimum distribution requirements don't apply to them).<sup>1</sup> If tax laws change, an investor's ability to maintain estimated distributions may be affected. And, lengthy distribution periods may expose investors to significant market risks. Additionally, designating a beneficiary two or more generations younger than the IRA owner may result in additional taxes when the distribution is made. Stretch IRAs should only be considered by investors who will not need the money in the account for their own retirement.

### **After-tax Deferred Annuities**

Deferred annuities that are not a part of an employer-sponsored retirement plan are subject to a different set of rules. Distributions from these after-tax annuities can consist of two components: taxable income and nontaxable return of investment. These annuities are also subject to estate tax. And your heirs will have to pay income tax (with no stretch provisions) on any gain in the annuity.

The tax-deferred nature of these annuities can be very powerful, especially as you're not typically required to take distributions from them until you reach age 90. While your inclination may be to postpone taking distributions for as long as possible, you might consider tapping these annuities for retirement income to avoid estate taxes later.

### **Mutual Funds, Stocks and Bonds**

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<sup>1</sup> Although Roth IRA owners are not subject to required minimum distributions (RMDs), beneficiaries are subject to the RMD requirements applicable to traditional IRAs when they inherit Roth IRA funds. Although the funds may be tax-free, the beneficiaries may still elect to receive the funds over their respective life expectancies.

You can spend down these investments or transfer them to your heirs without paying income taxes. But you do have to worry about capital gains taxes, which can affect your estate plan.

If you sell low-basis stock during your lifetime, you must pay a capital gains tax on any gain realized. If you give the stock to your daughter during your lifetime and she sells the stock, then she takes your original basis in the stock and has the same taxable capital gain that you would have had.

But if you keep the stock and leave it to your daughter when you die, the basis of the stock is generally “stepped up” to its fair market value on the date of your death. (This is the quid pro quo for having the stock subject to estate tax in your estate.) Your daughter receives the stock with a higher basis and will have a smaller taxable gain if she sells it.

### **Real Estate**

Real estate is subject to the same basis rules as the assets just described, but it can present additional planning challenges, such as what to do with real estate that you want to keep in the family. It can be tough to balance an emotional attachment to property with a substantial estate tax bill. Don’t overlook the possibility of making a gift of the real estate during your lifetime. There are a number of advanced planning tools (one is called a “qualified personal residence trust” or QPRT) that you can use to leverage the value of your gift.

### **Life Insurance**

People at retirement age often already own several life insurance policies — typically a couple of term policies and maybe even a permanent policy. But these policies purchased earlier in life may not meet retirement needs, like extra retirement income for a surviving spouse or partner, bequests to heirs, charitable legacies and estate tax planning. Now may be a good time to sit down with an insurance professional to match policy provisions and ownership with your planning goals.

### **Art, Collectibles, Jewelry**

Personal property is also subject to estate taxation. If you own personal property of great value, don’t fall into the common trap of thinking that you can just give it to your kids, skip paying gift tax, and avoid mentioning the artwork on your estate tax return. That approach is fraudulent and could be disastrous in an estate tax audit. An IRS auditor can discover this sort of fraud by looking at such things as old insurance bills, loans to museums, and collection catalogues.

Personal assets can also raise issues of family conflict when multiple heirs want a particular item. If that’s your case, you may want to decide who gets the item and

communicate openly about how and why you made the decision. Open discussion is often the best way to address the emotional conflicts that can lead to fights over property.

## **Future Changes**

Your needs will continue to change, so you should expect to review your estate plan again in the future. And, there's a good chance that we could see another overhaul of the gift and estate tax system.

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