Leaving Inheritance To Children Easier Said Than Done

by Stephanie Powers (Contact Author | Biography)

Deciding whether to leave an inheritance for your children impacts the amount you save, the retirement plans you choose and how you take qualified retirement plan distributions. However, beyond your desire to leave some wealth to your children (or not), there are some essential personal financial issues to consider. Read on to learn more.

Consider Your Own Income Needs

Some retirees mistakenly give their retirement savings away without considering their own income needs. Before you make gifts to others, it's important to assess how much to spend on yourself. Retirement calculators such as those available at Dinkytown.net can help you determine how much you need to save and how much you can withdraw each year once you retire.

Be sure to take into account the impact of inflation and taxes and maintain a diversified portfolio of growth and income investments that can help your portfolio keep pace with inflation. (To review the different retirement plans and determine which type may be best for you, consult *Which Retirement Plan Is Best?* and *Not All Retirement Accounts Should Be Tax-Deferred*.)

Plan for Rising Healthcare Costs

The biggest risks to your retirement income and your children's inheritance are unexpected illness and high healthcare costs. Government programs are often of little assistance when it comes to paying for nursing homes and other forms of long-term medical care. Medicare covers nursing-home stays for a very limited period of time, and Medicaid requires that you spend almost all of your own money before it pays for long-term care. You cannot simply transfer assets to family members to qualify for Medicaid, as the program restricts benefits if asset transfers were made several years prior to a nursing-home stay. (For more on the dangers failing health poses to your nest egg, read *Failing Health Could Drain Your Retirement Savings*. For more information on Medicare and Medicaid, visit Medicare.gov.)

Some people protect their assets from the costs of catastrophic illness with a long-term care insurance policy, which can be purchased either individually, through an insurance agent, or through a group plan with an employer. However, these policies are very expensive and have a number of coverage limitations, so you should consider them carefully. (Look for more information on long-term care insurance in *A New Approach To Long-Term Care Insurance* and *The Evolution Of LTC-Insurance Plans*.)

Don't Outlive Your Income

What if you outlive your retirement fund? When you are over 90 years old, your children and grandchildren may celebrate every birthday gratefully. But if you have spent your nest egg they may also be paying some or all of your bills. With longer life expectancies, it's important to try to manage retirement-plan withdrawals to avoid depleting assets during your lifetime. (Read up on how to make money last through retirement with *Systematic Withdrawal Of Retirement Income*.)

As a solution, you could buy an immediate annuity with some of your retirement money to ensure that you receive a guaranteed amount for at least as long as you live. Certain pension and retirement plans may allow you to stretch payments over single or joint life expectancies rather than receive the proceeds as a lump sum.

Consider the Tax Implications
If you expect to inherit assets from your parents, you may be in a better position financially than someone who does not expect to receive an inheritance. Keep in mind that certain inherited assets, such as stocks and mutual funds, are eligible for favorable tax treatment called a step-up in basis. If you are leaving assets to others, this tax treatment could mean significant savings for heirs.

Set Up a Trust
In certain situations, it may make sense to set up a trust to control distributions from the estate to the surviving spouse and children. If you or your spouse have children from previous relationships and you don't have a prenuptial agreement, trusts can ensure that specific assets are passed to designated children. (You can also reach such an agreement after marriage. Read *Create A Pain-Free Postnuptial Agreement* to learn more.)

Children who are well off may prefer that you keep every penny of your nest egg rather than distribute it during your lifetime. Discuss the transfer of your estate with them.

Choose Investments Wisely
Those with very large estates may expect children to pass inherited assets to grandchildren. A portfolio designed to last multiple generations grows, preserves capital and generates income with investments like growth and income equities and a portfolio of laddered bonds. Inheritors who wish an estate to last several generations should withdraw income only and avoid dipping into principal. (Learn more about growth and income mutual funds in *Digging Deeper Into Mutual Fund Names*.)

Estimate the amount of inheritance you will leave to your children by considering inflation as well as years of compounded investment growth.

How to Leave Your Legacy
Below are some possible ways to share your wealth with others:

Gift Assets
Gifting assets is one way to allow loved ones to make use of your money while you are still alive. Gifts qualifying for the annual exclusion from gift tax - often called "annual exclusion gifts" - are completely tax free and do not require filing a gift tax return.

A separate annual exclusion applies to each person to whom you make a gift. As of 2008, the annual exclusion is $12,000. While gift recipients will not receive a step-up in cost basis, any capital gains will be taxed at their applicable rate, which may be lower than yours.

Some people gift to children or grandchildren using custodial accounts set up under the Uniform Transfers to Minors Act (UTMA) or Uniform Gifts to Minors Act (UGMA). However, depending on a recipient's earned income and status as a student, the earnings in the account may be taxed at the donor's rather than the child's tax rate. Others simply open a joint account with the minor child or buy savings bonds in a child's name. (More information on UTMA/UGMA accounts can be found in *Investing In Your Child's Education*. Read more on savings bonds in *The Lowdown On Savings Bonds*.)

Bequests made to charities are not subject to any limitations and are deductible from ordinary income. (Read more in *Gifting Your Retirement Assets To Charity*.)

Create a Trust
Trusts protect your children's interests, and the assets in them avoid probate (which maintains privacy). You can appoint a trust company or knowledgeable person as trustee to manage assets and control distributions from the trust. (Read *Can You Trust Your Trustee?* for tips on choosing who will manage your trust.)

An irrevocable trust is considered a gift, so you can't control it or take it back. With a revocable living trust, however, you own and control the assets while you are alive, then they pass to beneficiaries as part of your estate.

Defer Income
Retirement accounts such as deductible IRAs and 401(k) plans defer taxes on capital gains, interest or dividends from investments until the money is withdrawn, when it is taxed as ordinary income. If you anticipate being in a higher tax bracket at retirement than you are now, a non-deductible Roth IRA allows earnings to accumulate tax-free, and there are no taxes on withdrawals. (Read *Roth Feature Boosts Earnings For 401(k) And 403(b) Plans* for more information.)

Consider Life Insurance or Tax-Deferred Variable Annuities
With life insurance, your beneficiaries receive the proceeds tax-free, without having to go through probate or worrying about stock market fluctuations. Fixed or variable annuities allow you to participate in the stock market through mutual funds or fixed-income investments and also have a life insurance component. However, these policies often carry hidden charges and fees so it's important to shop around and study them carefully. (Read about various types of annuities in *Watch Your Back In The Annuity Game* and about life insurance in *Life Insurance Distribution And Benefits*.)

Final Details
Make sure you take care of the legal details to ensure your estate plan will work the way you want it to.

Beneficiaries

- Review the beneficiaries on all accounts. (Read *Don't Forget The Beneficiary Form* for more information.)
- Changing beneficiaries may require your spouse's consent.
- List secondary beneficiaries in case your primary beneficiary dies before you.
- Your retirement accounts pass to beneficiaries without going through probate court, but if you leave a retirement account to your estate, it may have to go through probate before the assets can be distributed.

Probate

- Know the probate laws in your state. (Read *Skipping Out On Probate Costs* for more information.)
- Investment accounts without a joint owner or documented beneficiary may have to go through probate to change ownership, a potentially long and costly process.

Wills

- Draw up a will. (Read *Why You Should Draft A Will* for more information.)
- Dying without a will (called "dying intestate") means that state law determines how your investments are divided among relatives.
- If you have no living relatives and no will, your assets escheat back to your state of residence.

Conclusion
The above suggestions may not be right for everyone, so it's important to consult an attorney or tax advisor to determine which make the most sense for you. Evaluating distribution options for your nest egg will help ensure your wishes are followed while maximizing flexibility for your heirs.

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