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Man vs. Machine: IRA Estate Planning – ChatGPT vs. Financial Expert

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Explore the challenges of traditional IRAs in estate planning, comparing ChatGPT's insights with expert critique on tax implications, beneficiary rules and effective estate planning strategies.

In our latest installment of Man vs. Machine, we asked ChatGPT the following question: **Why do traditional IRAs present unique problems in an estate planning context?** And then we asked Sarah Brenner, the director of retirement education at Ed Slott and Company, to critique the answer.

Here's ChatGPT's answer to the question:

Traditional IRAs present unique challenges in estate planning due to their tax-deferred nature and strict distribution rules. Here are the key issues:

1. Income Tax Burden for Beneficiaries

• Unlike Roth IRAs, traditional IRAs are funded with pre-tax dollars, meaning distributions are subject to ordinary income tax.
• When heirs inherit a traditional IRA, they must pay taxes on withdrawals, which could push them into a higher tax bracket.
• The SECURE Act (2019) eliminated the "stretch IRA" for most non-spouse beneficiaries, requiring full withdrawal (and taxation) within 10 years, accelerating tax liabilities.

2. Required Minimum Distributions (RMDs)

• IRA owners must take RMDs starting at age 73 (as of 2023), which can complicate tax planning.
• If an IRA owner dies after RMDs have begun, beneficiaries must continue taking them.
• This can create higher taxable income for heirs during their peak earning years.

3. Potential for Estate Tax Exposure

- While IRAs receive no step-up in basis at death (unlike taxable investment accounts), they are still included in the owner's estate for estate tax purposes.
- For high-net-worth individuals, this could trigger federal or state estate taxes, reducing the overall inheritance.

4. Creditor and Divorce Risks

- Inherited IRAs do not have the same creditor protections as retirement accounts while the original owner is alive.
- If a beneficiary goes through a divorce or lawsuit, the inherited IRA could be at risk.

5. Loss of Control Over Assets

- If a traditional IRA passes directly to heirs, the original owner loses control over how the assets are used.
- A trust can help dictate distributions, but using a trust as an IRA beneficiary comes with complex tax rules (e.g., see-through trust requirements).

Solutions & Strategies

- Roth Conversions: Converting some or all of a traditional IRA to a Roth IRA can reduce tax burdens for heirs.
- Trust Planning: A properly structured trust can provide control and protection for IRA assets.
- Charitable Giving: Leaving an IRA to a charity avoids income taxes and can be an effective estate planning tool.
- Strategic Beneficiary Designation: Naming lower-income beneficiaries or a surviving spouse can help reduce tax burdens.

The Critique

And here's the critique from Sarah Brenner, the director of retirement education at Ed Slott and Company:

ChatGPT got a lot right here!

Beneficiaries of traditional IRAs will have to pay taxes on inherited funds (unlike Roth IRA beneficiaries) and the SECURE Act has done away with the stretch IRA, which allowed those beneficiaries to at least stretch out the taxable distributions over life expectancy. Now most nonspouse IRA beneficiaries are subject to a 10-year payout rule.

Also, it is correct that traditional IRA owners must take RMDs during their lifetime, which can cause tax issues since those RMDs are included as taxable income. ChatGPT did not give the details but RMDs can increase so-called “stealth taxes” such as IRMAA surcharges and taxation of Social Security benefits since RMDs are included in adjusted gross income.

It is also true that naming a trust as an IRA beneficiary can address the problems of loss of control and issues with creditors and divorce.

Converting to a Roth IRA is suggested as a strategy here which is a good move. Converting to a Roth IRA does solve the problem of lifetime RMDs since you are not required to take RMDs during your lifetime from your Roth IRA. However, ChatGPT does not make it clear that while Roth IRA distributions to beneficiaries are not taxable, most non-spouse Roth IRA beneficiaries are still subject to the 10-year payout rule like traditional IRA beneficiaries (even though Roth IRA beneficiaries do not have to take RMDs during the 10-year payout period as traditional IRA beneficiaries may). There is no escaping the SECURE Act’s 10-year rule with a Roth IRA, even though the tax consequences are more favorable than with a traditional IRA.

Also, ChatGPT does not make it clear that a Roth IRA , like a traditional IRA, is potentially subject to the federal estate tax. Roth IRAs are better than traditional IRAs for income tax purposes but converting to a Roth IRA does not help with avoiding the federal estate tax. Currently, the federal estate tax is only a concern for very large estates but this is good to keep in mind for those situations.