Death and Taxes, the Sequel

Your death could be more taxing than you imagine.

Thanks to 2015's $5.43 million federal estate-tax exclusion, perhaps just one out of 600 deaths this year will trigger federal estate taxes. Yet many heirs still will face steep tax bills, partly because some states levy their own estate tax—but mostly because of the income taxes due on inherited retirement accounts.

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If you bequeath, say, a stock in a regular taxable account that has climbed in value, the cost of the investment for tax purposes automatically rises to its current value as of your death. This "step-up in cost basis" means that the potential capital-gains tax bill can disappear.

But if you die owning traditional retirement accounts, such as 401(k) plans and individual retirement accounts, the income taxes owed on withdrawals still have to be paid by your heirs.

Moreover, this tax problem could get a whole lot worse if Congress kills off the "stretch" IRA. Right now, after you die, your IRA's beneficiaries can draw down the account slowly over their lifetime.

But if the stretch IRA disappears, your heirs may be forced to empty inherited retirement accounts within five years of your death—and the extra income could push them into a much higher tax bracket.

This change almost became law in 2013. The White House proposed eliminating the stretch IRA again this year for all beneficiaries, except for spouses and in certain special situations, and many experts believe it is just a matter of time until the law gets changed.

"I think there's a better than 50% chance that the death of the stretch IRA will eventually pass," says Pittsburgh accountant and investment adviser James Lange, author of "Retire Secure."

All this is bad news for many Americans. For the typical household approaching retirement age, retirement accounts are the second-largest asset they own, after their home, according to calculations by Boston College's Center for Retirement Research. (This ignores any value assigned to Social Security and traditional employer pensions.)

How much do older Americans have in retirement accounts? According to the Federal Reserve's 2013 Survey of Consumer Finances, retirement accounts are owned by 48% of families headed by someone 65 to 74 years old, and the median value is $149,000.

A 2014 report by the Investment Company Institute, a fund-industry trade group, found that 19.2% of IRA investors age 75 and older have accounts worth $200,000 or more—and the number would be even larger if 401(k), 403(b) and other retirement accounts were included.

The federal estate tax is all but dead. But your problems may be just beginning.

What should these investors do? There are three key strategies that many folks ought to consider, and two others that could make sense for some families.

◆ First, you might shelve the standard advice for retirees, which is to tap your taxable accounts first, while leaving retirement accounts to continue growing tax-deferred. Instead, you might hang on to taxable-account investments, with a view to getting the step-up in cost basis upon your death.

"When you think about how much you need to live, you might pull more out of your IRA, rather than spending down your taxable-account assets," says Alisa Shin, a senior wealth planner at Vanguard Group. "But you want to do it strategically. We don't want to push you up to the 39.6% tax bracket [with large IRA withdrawals]. But if we can do it and stay within the 25% tax bracket, it could be worthwhile."

◆ Second, you might convert part of your traditional retirement accounts to a Roth IRA. You will have to pay income taxes on the conversion. But once the money is in a Roth, it will grow tax-free.

To figure out whether converting makes sense, you need to compare the tax you will pay on the conversion to the taxes that will likely be paid by your beneficiaries when they empty the account. For instance, if you can convert and pay taxes at 25%, that would be better than bequeathing a traditional IRA on which your children then pay 33% in taxes.

◆ Third, you might kill the problem with kindness. "Let's say people are planning to leave some amount to charity," Mr. Lange says. "If it's a significant sum, I'd leave IRA money to the charity," while bequeathing taxable-account money to your heirs.

What are the two other strategies? First, you might consider purchasing life insurance, so your heirs have money to pay your IRA's income-tax bill.

This makes particular sense if your assets also will be subject to estate taxes. Life-insurance proceeds should be income-tax-free, and they also can be estate-tax-free—if you arrange for somebody else to own the policy, such as your children or an irrevocable life-insurance trust.

Second, if the stretch IRA disappears, it may make sense to bequeath your IRA to a charitable remainder trust. As with the stretch IRA, the trust could allow your heirs to enjoy lifetime withdrawals from the IRA, though Mr. Lange notes that the trust isn't as financially advantageous as the stretch IRA and would involve higher fees.

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