

Contributions of Military Death Gratuities to Roth IRAs and Coverdell Education Savings Accounts

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This article discusses how to take advantage of significant tax savings by contributing proceeds from military death benefits to tax preferred accounts—a unique opportunity for survivors of servicemembers who qualify for military death benefits.

The Heroes Earnings Assistance and Relief Tax (HEART) Act was enacted in 2008 to provide various tax relief opportunities for servicemembers and their families.¹ Among other forms of tax relief,² the Act creates a provision that allows beneficiaries of military death benefits to contribute those proceeds to tax preferred accounts. There are two types of payments³ that survivors of servicemembers may be eligible for upon the death of a servicemember: (1) payment of a death gratuity,⁴ or (2) proceeds from a policy for Servicemembers Group Life Insurance (SGLI).⁵ Both of these payments are specifically excluded from gross income under the tax code.⁶

Congress wanted to allow survivors, who may not need the benefit proceeds at the time of the servicemember's death, to invest those benefits for future expenses, such as retirement or education.⁷ This change created a significant tax benefit for survivors of servicemembers who are not in immediate need of the payments. The Act allows recipients of such payments to contribute the proceeds to Roth Individual Retirement Accounts (IRAs) or Coverdell Education Savings Accounts.

Roth IRAs

In many respects, Roth IRAs are similar to traditional IRAs; however, there are several significant differences. Contributions toward a traditional IRA are tax deductible, but withdrawals at retirement age are taxed as ordinary income. Contributions to Roth IRAs, on the other hand, are

not tax deductible at the time of contribution, and are thus made using after-tax dollars.⁸ In addition, qualified distributions from Roth IRAs are not includable in gross income.⁹ There is also no mandatory distribution as there is for traditional IRAs,¹⁰ so the beneficiary of the Roth IRA may defer distributions to take further advantage of tax-free growth.¹¹

Beneficiaries of death gratuity and SGLI benefits can make use of the Roth IRA to generate significant retirement savings. The Act treats contributions from military death gratuity or SGLI as a “qualified rollover,” and are therefore not subject to tax prior to contribution.¹² This means that because the funds are from a death gratuity or SGLI insurance proceeds, the funds are not taxed prior to contribution, and because it is part of a Roth IRA, neither are the proceeds at the time of distribution. This results in an entirely tax-free transaction, with tax-free growth for the life of the beneficiary.

In addition to allowing a contribution of tax exempt monies, the Act provides an exception to the annual contribution limit, which is currently \$5,500.¹³ Normally, contributions made in excess of the annual limit are subject to an excise tax.¹⁴ Under the Act, however, a beneficiary could place the entire death gratuity and SGLI policy proceeds in the Roth IRA account at the same time and without penalty. A beneficiary could make a one-time deposit of up to \$500,000 (the sum of the current death gratuity and a maximum coverage SGLI policy) tax-free, watch it grow over time, and withdraw the funds at retirement tax-free.

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¹ Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, Public Law 110-245, 122 Stat. 1624 (2008).

² The HEART Act also created an election to include combat pay as earned income for the purposes of the Earned Income Credit, and changed the treatment of differential pay to be treated as wages. *Id.*

³ Survivors of servicemembers may also be entitled to other benefits; however, the HEART Act only addresses death gratuity and Servicemembers Group Life Insurance (SGLI) payments.

⁴ 10 U.S.C. § 1477 (1998).

⁵ 38 U.S.C. § 1967 (2010).

⁶ 26 U.S.C. § 101 (2011); 26 U.S.C. § 104 (2010).

⁷ J.C.S.-1-09 NO 12 (I.R.S.), 2009.

⁸ 26 U.S.C. § 408A(c)(1).

⁹ *Id.* § 408A(d)(1). Payments that are made once the individual has attained fifty-nine-and-a-half years of age are considered qualified distributions. A distribution may also be a qualified distribution if it is made to an individual's beneficiary or estate after his death, or if distribution is attributable to the individual's disability. *Id.*

¹⁰ Traditional Individual Retirement Accounts (IRAs) require the holder to take distributions at age fifty-nine-and-a-half, reducing the principal; this makes the traditional IRA less effective as an instrument for wealth transfer at death.

¹¹ *Id.* § 408A(c)(5).

¹² *Id.* § 408A(e)(2).

¹³ *Id.* § 408A(c)(2). Contribution limits to Roth IRAs are also subject to the taxpayer's adjusted gross income. *Id.*

¹⁴ *Id.* § 408A(e)(2)(B).

The following chart shows the drastic tax advantage of contributing even a portion of these military death benefits to a Roth IRA.*

Rollover Contribution at Age 25	Balance at Age 60	Savings Compared to a Contribution to an Ordinary Taxable Savings Account
\$500,000	\$5,338,291	\$2,997,393
\$400,000	\$4,270,633	\$2,397,914
\$300,000	\$3,202,974	\$1,798,436
\$200,000	\$2,135,316	\$1,198,957
\$100,000	\$1,067,658	\$599,479

* Calculations assume no additional contributions; an annual growth rate of 7%; and a 25% marginal tax rate.

What makes this strategy ideal for tax planning is that the Act also includes a provision for relief for early withdrawals. Early withdrawals from Roth IRAs generally require inclusion as income, and are potentially subject to a 10% penalty.¹⁵ Under the Act, if a beneficiary needs access to the money, he can make withdrawals without penalty.¹⁶

Therefore, any amount of time that the contribution spends in the Roth IRA will grow without imposition of tax, and the Act treats distributions attributable to death gratuity or SGLI payments from the Roth IRA that would not otherwise be a “qualified distribution”¹⁷ as an investment in the contract.¹⁸

Coverdell Education Accounts

Coverdell Education Accounts are similar tax preferred accounts.¹⁹ Contributions to Coverdell Accounts are normally included as taxable income for the year in which the contribution is made. Distributions from Coverdell Accounts for qualified expenses are not subject to income tax upon distribution.²⁰

Contributions made from death gratuity or SGLI payments to Coverdell Education Accounts are treated in a similar manner to contributions made to Roth IRAs. Such

contributions are treated as rollover contributions.²¹ The annual limit for contributions does not apply to such contributions,²² and distributions attributable to death gratuity or SGLI payments that would be includable in gross income under section 72 of the Internal Revenue Code²³ are treated as an investment in the contract.²⁴ The primary difference is that only distributions that are used for qualified educational expenses are not subject to income tax. Distributions that are not used for qualified educational expenses may be subject to adverse tax consequences.²⁵ Care must be taken to balance the contribution with the anticipated need, since distributions used for anything other than qualified educational expenses may be subject to tax.

The total contribution is limited to the total death gratuity or SGLI payments in cases of contributions to both Roth IRAs and Coverdell Educational Accounts. Contributions may be allocated to each, but the total combined contribution cannot exceed the total SGLI and death gratuity payment.²⁶ As mentioned, care must be taken in planning, as Coverdell accounts may only be used for qualified expenses; contributions should be limited to expected costs, and any remaining contribution should be made to the Roth IRA.

It is rare for the IRS to allow taxpayers to take advantage of a provision that has such a whipsaw effect on revenue. The ability to contribute tax-free proceeds from a death gratuity or from an SGLI policy to a tax-preferred account whose distributions are also tax-free is a significant

¹⁵ *Id.* § 72(t). A 10% additional tax is imposed on distributions from qualified retirement plans that are not qualified distributions as defined in *id.* § 408A(d).

¹⁶ *Id.* § 408A(e)(2)(C). Non-qualified distributions of any amount attributable to the qualified rollover are considered an investment in the contract, or recovery of basis, and not subject to early withdrawal penalties. *Id.*

¹⁷ *Id.* § 72.

¹⁸ *Id.* § 408A(e)(2)(C).

¹⁹ *Id.* § 530(a).

²⁰ *Id.* § 530(d)(2).

²¹ *Id.* § 530(d)(9)(A).

²² *Id.* § 530(d)(9)(B).

²³ *Id.* § 72.

²⁴ *Id.* § 530(d)(9)(C).

²⁵ *Id.* § 530(d)(9)(C); I.R.S. Notice 2010-15, 2010-06 I.R.B.; 26 U.S.C. § 530(d)(2). Distributions in excess of expenses are includable in gross income and may be subject to an additional 10% tax. *Id.*

²⁶ *Id.* § 408A(e)(2)(A)(i),(ii); *Id.* § 530(d)(9)(A)(i),(ii).

opportunity for tax savings. Congress intended to afford this opportunity to servicemembers and their survivors, and it is

incumbent on judge advocates to educate Soldiers and their Families about this unique opportunity.