

Planning Ideas—Maximizing the Benefits of a Stretch IRA

With the Stretch IRA, an IRA owner designates a younger-generation family member as the IRA beneficiary. The beneficiary can then elect to receive the required minimum distributions (RMD) based on his or her longer life expectancy, thereby extending the opportunity for tax deferral. Overall, there should be enhanced benefits for the IRA beneficiary and, potentially, for downstream heirs.

That's the textbook plan. But, of course, in real life things are usually more complicated. What if the IRA owner wishes to benefit multiple beneficiaries? What if the IRA owner fears that one or more of the IRA beneficiaries will deplete the IRA by taking distributions in excess of RMDs?

Example

Jake Walters is age 73. He has significant business and investment assets from which he derives more than enough income to meet his needs. In addition to his businesses and investments, Jake has \$3 million in an IRA, which represents amounts rolled over from profit sharing and 401(k) plans along with earnings thereon. He currently receives RMDs from his IRA and his goal is to leave as much of the IRA as possible for the benefit of his three grandchildren, Morris (age 35), Ethan (age 22), and Kendall (age 20).

Let's consider the alternatives.

Alternative #1

The most straightforward approach for prolonging tax-deferral and maximizing benefits for the grandchildren is to simply name them as multiple beneficiaries of the IRA. Assuming separate accounts are created for each beneficiary by the end of the year following Jake's death, the beneficiaries can elect to receive RMDs over their longer life expectancies.

This approach works well, so long as the IRA custodian allows for the establishment of separate accounts and the grandchildren follow Jake's wishes to withdraw no more than RMDs. However, it is important to keep in mind that as outright beneficiaries of his IRA, there is nothing, other than good judgment, preventing the grandchildren from taking larger annual distributions or even taking their IRA shares in a lump sum and squandering it.

If Jake wants to assure that his IRA is distributed according to his wishes, he needs to take a further step.

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Alternative #2

This alternative involves establishing a trust for the benefit of the grandchildren and naming the trust as the IRA beneficiary. So long as the trust qualifies as designated beneficiary, the trust can choose to receive no more than RMDs from the IRA, thus preventing the possibility that the IRA funds will be misused. To qualify as a designated beneficiary the trust must meet the following requirements:

- It must be valid under state law;
 - The trust must be irrevocable or will, by its terms, become irrevocable on the death of the plan participant;
 - The beneficiaries of the trust who are beneficiaries of the trust's interest in the plan participant's benefit must be identifiable from the trust instrument; and
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- The trust administrator must provide the plan administrator with a copy of the trust document or a list of all of the beneficiaries of the trust. Treas. Reg. Section 1.401(a)(9)-4, Q&A-5(b).

One challenge with this approach, however, is that Treasury Regulations require the RMD amount to be calculated with reference to the oldest beneficiary's life expectancy. Although Morris is considerably younger than Jake, he is also quite a bit older than Ethan and Kendall. RMDs based on Morris's life expectancy will be larger than those that would have been payable using Ethan and Kendall's life expectancies. Using Morris's life expectancy to determine Ethan and Kendall's distributions will result in potentially less benefit to them over the long term and frustrate Jake's intentions.

Alternative #3

A third approach is for Jake to create a trust for the benefit of his grandchildren with a separate sub-trust for each grandchild. Each separate sub-trust should be named an equal beneficiary of the IRA. Using this approach, the life expectancy of each individual sub-trust beneficiary can be used to determine the RMD payable to that sub-trust.

This results in potentially greater long-term benefits for Kendall and Ethan as compared to Alternative #2 and is better aligned with Jake's intentions.

One consideration with this approach relates to the timing of payments from the trustee to the beneficiaries of the sub-trusts. Using a *conduit-trust* approach, the RMDs received by the trustee are funneled immediately through the sub-trust into the hands of the beneficiaries. Using a more flexible *accumulation-trust* approach, the RMDs may be accumulated in the trust and distributed as directed by the trust instrument or in the trustee's discretion.

Different types of sub-trusts, accumulation or conduit, can be used for different beneficiaries. For example, if Ethan is a big spender, Jake may want to create an accumulation sub-trust for him. For Kendall, who is a better steward of family wealth, a conduit sub-trust is likely to be more appropriate.

Transfer Tax and IRD Considerations

Transfer and income taxes should be considered any time Stretch-IRA planning is used. Keep in mind that while there is a repeal of federal estate and generation-skipping transfer taxes in effect for decedents dying in 2010, the repeal only lasts for one year. Furthermore, some planners have expressed concern that Congress, facing a large deficit, could retroactively repeal the repeal.

One alternative for handling the triple-tax threat associated with Stretch-IRAs is to purchase life insurance insuring Jake's life using his RMD lifetime distributions. Provided the life insurance is owned in a manner so that it avoids inclusion in Jake's estate, for example in an Irrevocable Life Insurance Trust, the income and estate tax-free proceeds can be used to offset the tax hit to the IRA.

If Jake from the example above dies in a year in which the estate and GST taxes are in effect, the value of the IRA passing to the grandchildren will be included in Jake's estate. Also, the transfer to the grandchildren would be subject to GST taxes, requiring allocation of Jake's GST exemption.

Furthermore, keep in mind that while significant tax deferral benefits are available from a Stretch IRA, the amounts received by the grandchildren, trust and/or sub-trusts are considered Income in Respect of Decedent (IRD). Consequently, such amounts are subject to income tax. A deduction for estate taxes attributable to the IRA is allowed to the beneficiary as an income tax deduction.

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Bottom Line

Stretch-IRA planning can make a lot of sense. The key is to maximize tax-deferral while addressing the client's other goals and objectives. The use of sub-trusts with accumulation features should be considered.

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