Stretch IRA

Stretch IRA strategies are a popular approach to transferring wealth. Investors are using stretch IRAs to extend their required minimum distributions (RMDs) over an increased period of time, including after the owner's death and even over multiple generations.

But are stretch IRAs right for everyone? In this article, we define the basic stretch IRA strategy as well as the potential benefits and drawbacks of this approach. We also discuss the tax treatment of this strategy and identify investors who may benefit from implementing a stretch IRA strategy.

What is a stretch IRA?

To be clear, the stretch IRA is a wealth transfer strategy rather than a particular type of IRA. Prior to the Pension Protection Act of 2006, only spouses were eligible for the special tax treatment associated with stretch IRAs. Today, the tax law provides other family members, including children and grandchildren, with similar benefits. The stretch IRA strategy provides for a substantial tax deferral for the majority of an individual's inherited IRA, creating a powerful and efficient wealth transfer vehicle.

Why stretch?

Earnings from an IRA grow tax deferred, which helps investors accumulate wealth. However, investors are required to eventually withdraw the funds and are taxed on them as ordinary income (with the exception of qualified distributions from a Roth IRA, which are tax free). For traditional IRAs, required minimum distributions must begin the year the investor turns 70 ½.

For those investors who do not need income from the IRA, the goal is to withdraw the minimum amount required to leverage the tax-deferred benefits of the IRA in order to continue to compound growth on the maximum amount of assets possible for as long as possible – which is why the stretch IRA strategy is so powerful. It enables the investor to extend the life of the IRA through a beneficiary designation so the beneficiaries can receive distributions from the IRA over a longer period. A designated beneficiary is the individual(s) chosen by the IRA owner to receive the IRA assets after the owner dies.

How does it work?

Assume you are the original IRA account owner and you name your spouse, child or even grandchild as your beneficiary. If your spouse is your primary beneficiary, he or she will receive those assets after you pass and can treat those IRA assets as if they are his or her own IRA and then name another beneficiary. There would be no income tax due at this time. Should a non-spouse beneficiary receive the assets, he or she would take minimum distributions based on life expectancy. Heirs will only pay income tax due on the distribution at the time they receive it. Therefore, receiving smaller distribution amounts each year will result in a lower tax liability, thus allow the remaining balance in the IRA to continue to grow on a tax-deferred basis.

For example:

Brian started with a $300,000 IRA and took RMDs for two years. When he passed away at age 71, his IRA passed to his wife, Melissa, age 66, who waited until she turned age 70½ and then took RMDs from Brian's inherited IRA for eight years. When Melissa passed away at 77, her son Jake, age 53, inherited the account and received distribution income for more than 23 years. When he died at age 75, his son Jon, age 41, received distribution income over the next nine years until the account was depleted. In total, the family received more than $2 million from Brian's original $300,000 IRA by using the stretch IRA strategy and spreading payouts over three generations and a 46-year time period.*

Potential candidates for the stretch

The stretch IRA strategy is most appropriate for individuals who:

- Are interested in leaving a legacy to their heirs
- Have significant IRA assets
- Do not need their IRA assets for their retirement living expenses

Elements of a successful stretch strategy

In order to achieve the maximum benefit from a stretch IRA strategy, it is important to:

1. Confirm your custodian provides for the stretch strategy, as many do not.

2. Assign the appropriate primary and secondary beneficiaries.

3. Limit the amount of withdrawals from the IRA account. If too much is withdrawn, this strategy loses its benefit. The beneficiaries should request to take withdrawals based on their remaining life expectancies at the death of the IRA owner to minimize distributions.

Considerations

As illustrated in the example above, the benefits to maximizing a stretch IRA strategy can be extremely powerful; however, as with any investment strategy, one must carefully consider the drawbacks as well as the benefits. There are several important considerations when choosing to use a stretch IRA strategy:

- There is a proposal in the Highway Investment, Job Creation and Economic Growth Act of 2012 that would require inherited IRAs to be distributed within five years of the original owner's death. While this act is far from being enacted, investors should consider its potential impacts. Specifically, this provision could increase the tax burden on beneficiaries, possibly making another form of wealth transfer more beneficial.
- Inflation and market risk may impact the value of the assets over time.
- If an RMD is missed, the IRS may assess a 50% penalty on the amount of the missed distribution.
- The benefits of the stretch strategy may be negatively impacted if the original investor or a beneficiary withdraws more than the required minimum distribution amount.

When implementing a stretch IRA strategy, it is also important to ensure beneficiary designations have been made, as only designated beneficiaries may qualify for the stretch IRA. This strategy is not available if the estate is named as a beneficiary.

Often, IRA owners will name their multiple children as beneficiaries. However, this may not be the most efficient way of passing along these assets. Instead, owners may wish to consider splitting the single IRA into multiple IRAs (one for each primary beneficiary) while they are alive, so each beneficiary will have the ability to stretch distributions over his or her own life expectancy. This method may also eliminate various issues that can arise with sharing assets, including a shared investment strategy. Alternatively, the IRA can be split into multiple IRAs after the owner's death. The deadline for dividing the IRA's assets is December 31st following the year of the owner's death. Splitting the IRA while the IRA owner is still alive, however, remains the preferred option as it provides for greater flexibility.

Investors may also wish to consider designating a younger beneficiary, thus decreasing the amount of the RMD and allowing more assets to grow tax-deferred in the account. Referring to the previous example, Brian may have considered designating his grandson, Jon, as the primary beneficiary of his IRA. Because Jon is the youngest beneficiary, his monthly calculated minimum distribution is significantly less than his grandmother Melissa's, and more assets remain in the account. Of course, this strategy would only work if neither Melissa nor Jake (Brian's son) needed the assets.

How First Point Financial can help

At First Point Financial, we are well versed in the intricacies of wealth transfer planning. Our holistic planning approach takes into consideration a wide range of strategies, including the stretch IRA. We work to understand each client's individual goals and specific objectives, and we incorporate those objectives into a customized plan that meets the client's individual needs. We then reevaluate and modify that plan on a regular basis, ensuring our recommendations are in line with current regulations, market trends and the economic environment. Our advisory teams have decades of experience helping clients navigate various challenges to arrive at their personal financial destinations.

For more information on the stretch IRA strategy or how First Point Financial can help you achieve your goals, please contact us at 913-647-9700 or visit our website, www.firstpointfinancial.com.

* The example above is for discussion purposes only. Actual results will vary. The example includes the following assumptions:

- 6% annual rate of return
- All investment earnings were reinvested and distributions we taken at year-end
- All family members withdrew the smallest amount the tax law provided
- The projected figures do not take inflation into consideration

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