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The "Stretch" Option for Inherited IRAs

"Stretch" IRAs

What is a "stretch" IRA?

The term "stretch IRA" has become a popular way to refer to an IRA (either traditional or Roth) that has provisions that make it easier to "stretch out" the time that funds can stay in the IRA after the death of the owner. A stretch IRA is not a special type of IRA under the Internal Revenue Code. It's just a traditional IRA or Roth IRA that has language (in the custodial or trust document that governs the IRA) giving a beneficiary (and backup contingent beneficiaries) the option to take distributions from an inherited IRA over the beneficiary's life expectancy. This language also generally allows successor beneficiaries to be named, facilitating the continued tax-deferred growth of the IRA over (possibly) more than one generation. There's nothing really dramatic about this "stretch" language; any IRA provider can include it. The fact is, though, many don't. Absent the "stretch" language, IRA funds might have to be distributed on a more aggressive basis upon the death of the IRA owner or the original beneficiary.

> **Tip:** Although the "stretch" moniker has caught on, financial institutions offer IRAs with similar provisions under a variety of names including legacy IRAs, multigenerational IRAs, extended IRAs, and super IRAs. In fact, any IRA, even without an impressive adjective in its name, can contain the language necessary to "stretch out" IRA funds as described here. And even when different financial institutions use the same terminology, they can mean slightly different things, so you need to look closely at the details.

Why is "stretching out" IRA distributions important?

Earnings in an IRA grow tax deferred. Over time, this tax-deferred growth can help individuals accumulate significant funds within their IRAs. For individuals fortunate enough to have adequate funds to support themselves in retirement without the need to tap into their IRAs, continuing this tax-deferred growth for as long as possible may be a priority. These individuals may want their heirs to benefit--to the greatest extent possible--from this tax-deferred growth as well.

> **Example(s):** John, age 60, has $500,000 in an IRA. John has non-IRA funds that are more than adequate to provide for a comfortable retirement, and doesn't want to take any funds from his IRA unless he is required to do so. John names his spouse Jenny (who is 10 years younger) as beneficiary. Together they agree that, should John die, Jenny will not take any distributions from the IRA unless required, leaving the IRA to their grandchildren. John dies 10 years later at age 69. His IRA is worth $895,424 at that time (it has grown 6 percent per year). Jenny rolls over the funds to a new IRA in her name, and does not take a distribution until she is required to at age 70½. By then, the IRA has grown to $1,603,568 (again, growing at 6 percent per year).

> **Caution:** The above example is for illustrative purposes only and does not represent the performance of any specific investment.

> **Caution:** Distributions from a traditional IRA are subject to federal income tax. If nondeductible contributions have been made to a traditional IRA, a portion of any distribution will not be subject to federal income tax. Qualified distributions from Roth IRAs are free from federal income tax.

You can only stretch so far

How long funds can stay in a tax-deferred IRA is limited by the required minimum distribution rules.

> **Caution:** The rules regarding required minimum distributions are complicated. The explanation that follows is a summary of the provisions most relevant to the concept of stretch IRAs.

Required distributions during the IRA owner's lifetime

Lifetime required minimum distributions, often referred to as RMDs or minimum required distributions, are amounts that the federal government requires you to withdraw annually from a traditional IRA after you reach age 70½. You can always withdraw more than the annual minimum amount from your IRA, but if you withdraw less than the required minimum in any year, you will be subject to a federal penalty equal to 50 percent of the amount not distributed as required. These RMDs are calculated to distribute your entire interest in the IRA over your life expectancy. The purpose of the RMD rules is to ensure that people use their retirement accounts to fund their retirement and not simply as a vehicle of wealth transfer and accumulation. This is true for all traditional IRAs, whether or not they have "stretch" provisions.

In fact, though, lifetime required minimum distributions can be spread over a significant period of time. Depending upon the performance of the investments within the IRA, it is possible for an IRA to continue to grow in overall value for a number of years despite required distributions.

> **Example(s):** John has $500,000 in a traditional IRA when he reaches age 70½ (Year 1). John determines his required minimum distribution for Year 1 is $18,248. If John's IRA investments grow at 6 percent per year, by the time John takes his first required minimum distribution (assuming he does so by the end of Year 1), his IRA will be worth $530,000. In fact, if John's investments within the IRA were continue to grow at an annual rate of 6 percent, each year his IRA would increase by an amount that is greater than John's required minimum distribution for the year--until Year 13, when John is 82 years old and the IRA is worth $597,425 (and by that time, John has taken a total of over $300,000 from the IRA in required distributions).
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> **Caution:** The above example is for illustrative purposes only and does not represent the performance of any specific investment.
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> **Tip:** There are no lifetime required minimum distributions for Roth IRA owners.

Required distributions after the IRA owner dies

All IRAs, including Roth IRAs, are subject to required minimum distribution rules after the death of the IRA owner. How and when the distributions must occur after a death depends on a number of factors including who the owner names as beneficiary and backup beneficiaries, and whether the owner dies before or after he or she begins taking lifetime required minimum distributions.

If the IRA owner has named someone other than his or her spouse as beneficiary of the IRA, the beneficiary may have several options upon the death of the owner . One of these options will generally be to take annual distributions over a fixed period of time based on the beneficiary's life expectancy at the time of the IRA owner's death (in some cases the period of time can be based on the remaining life expectancy of the IRA owner, if this results in a longer period of time). Young beneficiaries with long life expectancies can spread distributions over a substantial period of time, keeping the maximum amount allowable in the tax-deferred IRA.

> **Caution:** While you might appreciate the value of tax-deferred growth, your beneficiary might prefer instant gratification. There's little to prevent your beneficiary from simply taking a lump-sum distribution when he or she inherits the IRA, rather than "stretching out" distributions over his or her life expectancy. It is possible, though, to name a trust as the beneficiary of the IRA to establish some control over how distributions will be taken after your death.

If the IRA owner has named his or her spouse as beneficiary, then the spouse has additional options upon the death of the owner. A surviving spouse will commonly opt to roll over inherited IRA funds into his or her own IRA. Or, if your surviving spouse is your sole beneficiary (with an unlimited right to withdraw the IRA assets), he or she may opt to simply leave the funds in an inherited IRA and treat that IRA as his or her own. With either of these options, the surviving spouse names his or her own beneficiary. At some point, the spouse is required to begin taking lifetime required minimum distributions. When the spouse dies, the beneficiary has the option to take distributions based on his or her life expectancy, as described above.

Key "stretching" provisions

Because financial institutions use different terminology, it's important to focus on the actual language in the IRA documents. As discussed below, to maximize the time over which distributions can be taken after your death, you should be sure the agreement provides for post-death distributions based on the life expectancy of your beneficiary, and determine whether your beneficiary is able to name his or her own beneficiary.

Beneficiary allowed to take distributions over his or her own life expectancy

If you die with funds in an IRA, the required minimum distribution rules allow your beneficiary to take distributions from the inherited IRA over a period of time based on the beneficiary's life expectancy. However, even though the distribution rules allow your beneficiary to "stretch out" distributions, your IRA provider may not. The IRA documents might provide that beneficiaries must take a lump-sum distribution, or require that the funds must be distributed within 5 years. You'll want to check with your IRA provider to make sure that your IRA allows your beneficiary the option of taking distributions over his or her life expectancy.

> **Tip:** Even if an IRA doesn't allow a beneficiary to take post-death distributions over his or her life expectancy, the beneficiary can still effectively accomplish this by directly transferring the IRA to another financial institution when the IRA owner dies. To do this, your beneficiary would set up an IRA at a new financial institution in the name of the deceased IRA owner, "for the benefit of" the beneficiary, clearly stating that the account is an IRA. For example, "John Owner IRA, deceased January 1, 2012, F/B/O John Beneficiary." The first financial institution would then directly transfer the IRA funds to the new financial institution in a plan-to-plan transfer. Distributions would then be based on the new IRA document language.

Beneficiary allowed to name his or her own beneficiary

Here's where things get slightly confusing. Let's say that a beneficiary inherits an IRA, and--wanting to keep as much in the inherited IRA as possible--elects to take distributions over his or her life expectancy. What happens if the beneficiary dies a few years later, with funds still in the inherited IRA?

> **Example(s):** Benny, age 35, inherits an IRA worth $500,000. Benny elects to take distributions over his life expectancy, which according to the appropriate life-expectancy table is 48.5 years. Benny takes an initial required minimum distribution in the amount of $10,309.28 ($500,000 / 48.5). The IRA grows at an annual rate of 6 percent, so even after taking his first required distribution, the IRA has grown to $519,691. And even after Benny takes his second required distribution of $10,940.86 ($519,691 / 47.5), the account has grown to $539,931.60. Benny dies before taking his third required minimum distribution, leaving a significant balance in the inherited IRA.

> **Caution:** The above example is for illustrative purposes only and does not represent the performance of any specific investment.

This is where the IRA language becomes crucial. If, as is commonly the case, the IRA language doesn't address what happens when the beneficiary dies, then the IRA benefits are paid to the beneficiary's estate. This would also be true if the IRA language specifically requires payment to the beneficiary's estate (also not uncommon). However, IRA providers are increasingly allowing an original beneficiary to name a successor beneficiary. In these cases, if the original beneficiary dies, the successor beneficiary "steps into the shoes" of the original beneficiary and can continue to take required minimum distributions over the original beneficiary's remaining distribution schedule.

> **Caution:** This is a common point of misunderstanding. The successor beneficiary's age and life expectancy are not relevant--the distribution period is fixed at the point that the original beneficiary began taking the annual distributions.

> **Example(s):** To continue the last example, if Benny had named a successor beneficiary (because the IRA language so allowed) the successor beneficiary would be able to continue taking required minimum distributions based on Benny's original distribution schedule. After Benny's death, the successor beneficiary could take required minimum distributions calculated by dividing the IRA balance at the end of the prior year by Benny's remaining life expectancy (reducing the life expectancy by one year each year).

Caution: IRA providers often allow IRA owners to name a contingent beneficiary. Look at such language carefully, however. Generally, such IRA language provides that a contingent beneficiary is entitled to the IRA only if the original beneficiary predeceases the IRA owner. This would not allow the contingent beneficiary to "step into the shoes" of the original beneficiary after your original beneficiary's death if your original beneficiary survives you.

Some IRA illustrations may stretch the underlying assumptions used

There's no question that it is possible to "stretch" IRA funds over a considerable period of time, sometimes over generations. This long period of time combined with the tax-deferred compounded growth of an IRA can lend itself to some incredibly powerful sales presentations. However, the thought of turning a $200,000 IRA into a $2,000,000 inheritance for your grandchildren can be so appealing that you might not take the time to understand the underlying assumptions that are being used. These assumptions may be completely valid, but may not always apply to your situation. In a few cases, though, the assumptions themselves may be a stretch. Some things to consider:

First, almost all stretch illustrations assume that you will not make withdrawals from the IRA until age 70½, and that after 70½ you will only withdraw the minimum required amount each year. This isn't really misleading because these IRAs are intended for individuals who don't need to tap their IRAs for retirement, and want to keep the maximum amount in the tax-deferred IRA environment. If you will need to withdraw more than the minimum amounts from your IRA or need to start withdrawals before age 70½, just understand that the more you withdraw from the IRA and the earlier you withdraw it, the greater the impact on the overall growth.

Second, to demonstrate the ability of IRA funds to pass from generation to generation, illustrations often assume that the original beneficiaries die before they reach their full life expectancy. This doesn't really impact the total period of time over which funds are distributed (since successor beneficiaries "step into the shoes" of the original beneficiaries), but it does tend to show the funds ultimately in the hands of the successor beneficiaries, which may or may not happen. Successor beneficiaries only get the IRA funds if the original beneficiaries die before they reach their full life expectancy.

Caution: A FINRA Investor Alert cautions that, in addition to the two assumptions above, stretch IRA illustrations also typically assume that: (1) tax laws do not change (remember, these projections typically show the IRA growing over a very long period of time); (2) there is no inflation reflected (which would erode the purchasing power of your investment); and (3) the underlying investments within the IRA will grow at a constant and predictable rate.

Caution: You should also make sure that you understand and account for any estate tax issues relating to your IRA. This is particularly important in the case of IRAs with significant balances. Be sure to get estate planning advice on the naming of primary and backup beneficiaries to get the full benefit of a stretch IRA.

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