Vold & Morris, LLC.

Memo

From: Vold & Morris, LLC.
Re: Stretch IRA

One of the most important decisions you can make is who to name as the beneficiary of your retirement plan. Each choice (spouse, children, or trust) has large tax implications for the person that will receive the benefits after you are gone.

When an IRA is distributed to a spouse, the proceeds are generally rolled over into the spouse's IRA. Distributions are not required from the spouse's IRA until the spouse reaches seventy and one-half years of age. The amount required to be distributed is recalculated each year based upon the spouse's life expectancy, which is calculated by using a very favorable table (Click for Table at Exhibit A.) For example, when the surviving spouse is age 70, her life expectancy, according to this table, is 27.4 years. The plan balance would be divided by 27.4 to determine how much must be withdrawn from the plan in the first year and taxed as ordinary income.

The required distribution from an IRA to a non-spouse beneficiary is not as favorable. The required distribution from an IRA to a non-spouse beneficiary is based on the life expectancy of the beneficiary. In most cases, our clients are instructed to make their living trusts the beneficiary of the IRA if there is no spouse, or the contingent beneficiary after the spouse if a spouse is living. A trust (or a probate estate) has a life expectancy of 0 years. This does not mean that the entire amount of the IRA is immediately taxed. That would be too harsh, even for the IRS (but the results are still not very good). The beneficiary must receive and pay income tax on the entire proceeds of the IRA within a 60-month period. This short required distribution period creates a huge income tax disadvantage to the children.

How can this tax problem be alleviated? If we add a substantial number of technical distribution requirements to the trust, it becomes a "Stretch IRA" trust and the required distribution takes place over the life expectancy of the oldest beneficiary of the trust (click for table at Exhibit B.) There is no recalculation after the figure is assessed. For example, if the deceased participant left children of 39, 41 and 43 years of age, the IRA custodian would be required to use the single life expectancy table to determine the expected life expectancy of the oldest beneficiary, 43 in this case. That table estimates the oldest child's life expectancy at 40.7 years. Thus, all the children in our example will be required to accept distribution of about 1/40th of the IRA proceeds and will be forced to pay income tax only on that small distribution. The next year about 1/39th of the IRA will be distributed. The following year about 1/38th of the IRA will be distributed. This process continues until the IRA proceeds are fully distributed and taxed. The required distribution process takes 40 years rather than 5 years and the required distributions in the early years are so small that the distributions will usually not even equal the earnings, which means that the IRA will actually grow in value.

There are exceptions to this simplified example, but it illustrates in general terms how IRA distributions and a Stretch IRA trust work. If the children in our example don't care about the income tax implications and want to take the money, they can. But they will have a choice, and the wise investors will invest pretax money as long as possible.