

Understanding the Stretch IRA Strategy

Preserving Assets for Your Heirs

DIGGING DEEPER

If you don't need the assets in your individual retirement account (IRA) to meet your retirement living expenses, you may want to consider preserving as much of the account as possible for future generations.

Through a “stretch” strategy, your beneficiaries have the opportunity to benefit from many years of continued tax-deferred growth potential in what is called an Inherited IRA. Over time, a modest IRA inheritance could become a significant supplementary source of income for your beneficiaries. (See A Gift for Generations on page 11.) Notes Christine Fahlund, CFP®, a senior financial planner with T. Rowe Price, “If the IRA is a Roth, the benefits of stretching are even greater for your heirs because distributions from Roth IRAs generally are income tax free, while those from Traditional IRAs typically are taxed as ordinary income.”

The RMD Factor

The beneficiary of either a Traditional or Roth IRA may liquidate the entire account as a lump sum or begin taking required minimum distributions (RMDs) each year from the Inherited IRA beginning in the year following the owner's death. In the latter case, the annual RMD amount usually is based on the beneficiary's actuarial life expectancy. The younger the beneficiary, the smaller the initial RMD will be as a percentage of each prior year-end Inherited IRA balance.

RMD amounts for beneficiaries are calculated as follows: In the calendar year following the year in which the owner dies, the first beneficiary should consult the applicable IRS Life Expectancy table (available at irs.gov) and identify the factor that corresponds with the age he or she will turn that year. The beneficiary then takes the balance of the Inherited IRA as of December 31 of the prior calendar year and divides the dollar amount by the factor from the IRS table. The result is the minimum amount that beneficiary is required to withdraw from the Inherited IRA by December 31 of that year. (He or she always can withdraw more.) For subsequent years, the beneficiary should repeat the RMD calculation using the original life expectancy factor minus one each year. (There is no need to go to the table for a new factor.) Any beneficiaries of



the Inherited IRA after the first should continue to use the RMD calculation factor determined by the first IRA beneficiary for their own annual RMDs—again subtracting one from that factor for each year thereafter.

Spousal Beneficiaries

Surviving spouses older than age 59½ typically choose to roll over the assets in the deceased's IRA into an IRA in their own name. This gives them full control of the assets and allows them to delay withdrawals until their own RMDs must begin when they attain age 70½. Spousal beneficiaries of Traditional IRAs are subject to the RMD rules, while spousal beneficiaries of a Roth IRA can treat the account as their own and avoid RMDs. In either situation the surviving spouse can name his or her own beneficiaries for the assets in the new account.

ILLUSTRATION BY RANDY LYHUS

Maintaining assets in an Inherited IRA may be more appropriate for spouses in some instances. Two examples include:

- If the surviving spouse is younger than age 59½ and needs to take distributions to meet current living expenses, the withdrawals taken from an Inherited IRA will not be subject to the 10% federal early withdrawal tax penalty.
- A surviving spouse who is significantly older than the original account owner and doesn't need income can delay taking distributions from an Inherited IRA until December 31 of the year the deceased would have turned age 70½.

Under these circumstances, the surviving spouse could designate beneficiaries for the Inherited IRA, and those individuals could continue to keep the assets invested tax-deferred (or tax-free for Roth IRAs) after the spouse's death.

Non-spousal Beneficiaries

As with spousal beneficiaries, non-spousal beneficiaries can take distributions from an Inherited IRA before age 59½ without incurring the 10% federal early-withdrawal tax penalty. They also can designate their own beneficiaries for the Inherited IRA.

In the case of a nonindividual beneficiary—an estate or a charity, for example—the rules are complicated. Take special care if you leave an IRA account to both individuals and organizations. “The transfers at your death must be handled carefully,” says Fahlund. “Otherwise individuals may be precluded from stretching out their portion of the assets.” Furthermore, IRS rules can be particularly complex when trusts are involved as beneficiaries. Consult a tax advisor to determine appropriate actions for your particular situation.

Leaving a Legacy for Your Heirs

Your heirs may be unfamiliar with rules governing Inherited IRAs, so it is best to discuss your stretch strategy goals with them early on. With a clear understanding of the process, beneficiaries can take the proper steps to receive the greatest benefit from the account. Explains Fahlund, “Over time, the stretch strategy could result in a significant legacy for your heirs if they choose to take advantage of it—and it can be especially rewarding to know that your children or grandchildren can benefit from sizeable savings over time as a result of your generosity.” 🐘

A Gift for Generations

The potential benefits of additional years of tax-deferred compounding in an Inherited IRA are significant. Below is an example of stretching a \$100,000 Traditional IRA out across three generations. RMDs only are taken from the account, generating over \$300,000 for the first beneficiary over a 30-year period and an additional \$245,000 for the beneficiary's heir over a seven-year period before being fully depleted.

Jack, age 70, has a balance of \$100,000 in his Traditional IRA on Dec. 31 of 2010. He dies in 2011, having already taken his RMD for that year. Jack's daughter, Jamie, inherits the IRA at age 45 and chooses to maintain it as an Inherited IRA. She takes her first RMD in 2012. When she passes away at age 75, her son, Jordon, inherits the IRA in 2041 at age 49. He begins his RMDs in 2042, depleting the account fully in 2048.

Name and relationship	Age and year of first RMD		Cumulative RMDs withdrawn	# of RMDs (years)	Balance remaining in the Inherited IRA
Jack	70	2010	\$3,650	1	\$104,059
Jamie* (Jack's daughter/beneficiary)	46	2012	\$311,031	30	\$218,262
Jordon** (Jamie's son/beneficiary)	50	2042	\$245,292	7	\$0

*Jamie is a first, non-spousal beneficiary and must begin taking RMDs (using her own life expectancy factor and subtracting by one for each subsequent year), at age 46 in 2012, the year following her father's death.

**Jordon is a non-spousal heir of the first beneficiary and must begin taking RMDs (continuing to use his mother's—the first beneficiary of the Inherited IRA—RMD calculation factors) at age 50 in 2042, the year following his mother's death.

Chart is for illustrative purposes only and does not represent the performance of any particular investment. The dollar amounts shown do not represent current value purchasing power due to the effect of annual and cumulative inflation. RMD calculations and related discussion regarding RMD rules are based on current tax laws, including special rules for Inherited IRAs, and are subject to change. Illustration assumes an 8% annual pretax rate of return and 3% inflation.