“Stretching” an IRA into a lasting legacy

If you own a traditional IRA, it may be one of your more important estate assets. Your IRA will pass to whomever you have named as its beneficiary. When it’s a substantial sum, there is the opportunity for continued tax deferral, as well as a source of income for many years and, perhaps, for more than one generation, through a technique known as IRA “stretching.”

The first step in the process is to limit what you take from your IRA to the required minimum every year; withdrawals are required after you reach 70½. After your death the stretch options depend upon whom you have chosen as your beneficiary and what your beneficiary decides to do.

When your spouse is your beneficiary

Your spouse has several choices when he or she inherits your IRA. If he or she withdraws everything in your IRA, or a portion of it, regular income tax is paid on the amount withdrawn. Taking everything ends any further “stretch.”

Other choices will extend the life of the IRA and could provide the potential for a substantial legacy for your children or grandchildren.

• *Transferring the assets to the spouse’s own IRA (or a new one).* If otherwise eligible, your spouse can make contributions to this IRA, boosting the balance even higher for future beneficiaries. He or she needn’t make annual withdrawals until after age 70½, and the withdrawals will be based on his or her life expectancy. (This rule was suspended for 2009 only.)

• *Remaining a beneficiary.* Your spouse’s name is added to yours as the owner of the account. Although contributions are not permitted, there’s an advantage when your spouse is younger than age 59½. Should he or she need IRA funds before then, there’s no 10% early withdrawal penalty. The distribution rules are more complicated, however. If you die before reaching age 70½, your spouse must start distributions when you would have turned age 70½, and they must be based upon his or her life expectancy. If you had started making the required distributions before your death, your spouse can continue to receive them, over your life expectancy or your spouse’s, whichever results in larger distributions.

• *Disclaiming (refusing) the IRA.* If your spouse has sufficient assets of his or her own, he or she may disclaim your IRA within nine months of your death. The IRA then will pass to an alternate beneficiary whom you have named, without paying gift tax and, perhaps, with the opportunity to stretch the IRA over the lifetime of a younger beneficiary, such as a child or grandchild. Consult your advisors to discuss this option further.

Other beneficiaries, multiple beneficiaries

If anyone other than your spouse is the beneficiary of your IRA, he or she cannot treat the IRA as his or her own. And if your beneficiary wants to withdraw all the money from the IRA, it must be done by December 31 of the fifth year after your death. (Recent legislation allows you not to count 2009 if it within the five year period.)

If your beneficiary doesn't withdraw the funds from your IRA soon after your death, distributions must begin no later than December 31 of the year after your death. The best scenario is when a beneficiary is young, and you had not yet begun receiving required distributions at the time of your death, because a beneficiary is entitled to stretch out distributions over his or her lifetime. There's a very good chance that the required distributions will be less than the investment return of the account, so the IRA can keep growing. If you already had begun receiving required distributions from your IRA, your beneficiary can keep receiving them, calculated over your life expectancy or the beneficiary's, whichever yields the larger annual distribution. In this case, having a young beneficiary offers no added benefit, because withdrawals will be based upon what was your shorter life expectancy.

If you plan to leave your IRA to more than one person—for instance, to more than one of your children—the annual distributions must be calculated over the life expectancy of the oldest beneficiary. This result yields the largest distributions and the fastest exhaustion of the IRA's assets. You can avoid this situation by dividing the assets in your IRA into separate IRAs for each beneficiary. Distributions from each IRA will be based upon the life expectancy of the beneficiary of that IRA. This arrangement must be completed by December 31 of the year after your death.

A trust as your beneficiary

Naming a trust as the beneficiary of your IRA may provide an extra layer of protection and a degree of control over the assets in your IRA.

An IRA trust works like this: The trust's beneficiary is considered the beneficiary of your IRA, and the required distributions must be calculated over his or her life expectancy; if more than one beneficiary, over the life expectancy of the oldest beneficiary. When the IRA beneficiary dies, assets pass as you have directed in the trust agreement.

There are significant benefits to naming a trust as your IRA beneficiary:

• The trustee is given the authority to pay only the required distributions to an IRA beneficiary, maximizing the IRA's life.

• You, not your IRA beneficiary, control to whom your IRA passes at your beneficiary's death.

• Because your IRA is in a trust, its assets are less likely to be lost to a beneficiary's poor investment management skills, divorce or creditors' claims.

An IRA trust must be set up following a specific set of requirements established by the IRS in order to achieve the desired benefits and to avoid negative income tax consequences. Consult one of our trust professionals for more information.

The Roth IRA alternative

Amounts that you contribute to a Roth IRA aren't tax deductible. However, presuming that the requirements are met, distributions will be completely tax free. In addition, minimum distributions are not required for the account owner (though they are required for a surviving beneficiary).

A traditional IRA owner may find those propositions appealing. But, currently, converting a traditional IRA to a Roth IRA is possible only in a year that your adjusted gross income doesn't exceed $100,000. You must be willing to pay ordinary income tax on the amount that is transferred from your traditional IRA to your Roth IRA. (On the plus side, by paying the tax, you have removed that amount from your estate and the threat of death taxes.)

The good news is that, if your beneficiaries inherit your Roth IRA, they won't pay tax on the distributions, and they escape the 10% penalty as well. The distribution rules, however, remain the same.

An invitation

Are you interested in exploring how to make your IRA a legacy for your loved ones? We would be glad to discuss your options with you and help you to integrate a bequest of your

IRA with the rest of your trust and estate planning.