The stretch IRA: A simple yet powerful estate planning tool

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The IRA's value as a retirement planning tool is well known: IRA assets compound on a tax-deferred (or, in the case of a Roth IRA, tax-free) basis, which can help build a more substantial nest egg. But if you don't need an IRA to fund your retirement, you can use it as an estate planning tool to benefit your children or other beneficiaries on a tax-advantaged basis by turning it into a "stretch" IRA.

Stretching the benefits

Turning an IRA into a stretch IRA is simply a matter of designating a beneficiary who's significantly younger than you. This could be, for example, your spouse (if there's a substantial age difference between the two of you), a child or a grandchild.

If you name your spouse as beneficiary, he or she can elect to roll the funds over into his or her own IRA after you die, enabling the funds to continue growing tax-deferred or tax-free until your spouse chooses to begin withdrawing the funds in retirement or must take required minimum distributions (RMDs) starting after age 70½. (Note that RMDs don't apply to Roth IRAs while the participant is alive.)

If you name someone other than your spouse as beneficiary, he or she generally will have several options:

- Take a lump-sum distribution of the IRA's balance.
- Withdraw the funds by the end of the year of the fifth anniversary of your death (if you die *before* beginning to take RMDs).
- Withdraw the funds over your "remaining" life expectancy, calculated under the applicable IRS table as of the year of death (if you die *after* beginning to take RMDs).
- Hold the funds in an "inherited IRA," which allows the beneficiary to spread RMDs over his or her own life expectancy.

Usually the inherited IRA is the best choice because it maximizes the benefits of tax-deferred or tax-free growth.

Naming a trust as beneficiary

A disadvantage of naming your child or grandchild as beneficiary of your IRA is that there's nothing to prevent him or her from taking a lump-sum distribution, erasing any potential stretch IRA benefits.

To ensure that this doesn't happen, you can name a trust as beneficiary. For a trust to qualify for stretch treatment, it will need to meet certain requirements, such as distributing RMDs received from the IRA to the trust beneficiaries.

Proposed law

There is proposed legislation that would end the stretch IRA, subject to certain exceptions. Under the proposed law, beneficiaries of inherited IRAs would be required to withdraw and pay income taxes on the entire IRA within 5 years of the IRA owner's death. This action accelerates income taxes and will likely push the beneficiary into a higher tax bracket. Exceptions include the surviving spouse, charities and charitable remainder trusts, minors (however, the 5-year rule starts to run when the individual reaches the age of majority), disabled and chronically ill individuals, and beneficiaries born within 10 years of the deceased IRA owner. Also, $450,000 (indexed for inflation) of inherited retirement assets per deceased IRA owner would be excluded from the 5-year rule. Note that $450,000 is the maximum exclusion amount regardless of the number of beneficiaries.

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