By James Lange

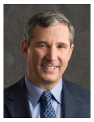
Preparing for the Death of the Stretch IRA

What savvy financial professionals can do to protect their clients' retirement savings

The term "stretching" an individual retirement account refers to the practice of partially sustaining the tax-deferred status of an IRA when, after the death of the owner, the account is left to a non-spouse beneficiary (typically a child or grandchild or perhaps more than one). Stretching an IRA, or a qualified retirement plan, such as an Internal Revenue Code Section 401(k) or Section 403(b) (hereafter all referred to as IRAs), can provide significant financial advantages for the owner's heirs. These advantages can amount to hundreds of thousands of dollars for the first generation and sometimes millions of dollars for the second generation, if the stretch is sustained.

In 2012, Congress introduced a formal proposal to eliminate the stretch IRA.[1] President Obama wanted the elimination, and the Republican house voted for it, but the Senate defeated the bill by a narrow margin: 51-49. The stretch IRA survived, if only temporarily. The provision has been included in the President's proposed budget every year since then, and many experts believe that it's a question of "when" rather than "if" the stretch IRA will be eliminated. It could be as early as this year, but it's more likely to occur in 2017, after the election. When the stretch is killed, any non-spouse beneficiary will be required to pay all of the income tax on inherited IRAs within five years of the original IRA owner's death. The good news is that, since the legislation is already written, financial professionals know what to expect once it's passed.

How drastic are the consequences of the change? "Stretch Advantages," this page, compares the value of a $1 million inherited IRA liquidated through two distribution methods. In one scenario, the beneficiary stretches the inherited IRA and takes only the required minimum distributions (RMDs) from the inherited IRA as permitted under the current law. In the second scenario, the beneficiary is required to withdraw the entire IRA within five years of the owner's death, as will be the case when (and if) the proposed legislation is passed.

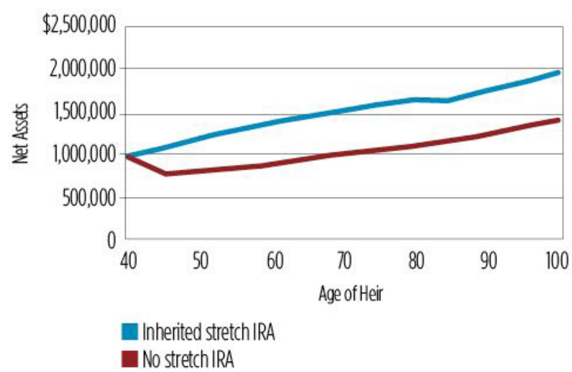


James Lange is president of Lange Financial Group LLC in Pittsburgh

"Stretch Advantages" assumes that: (1) the income taxes are paid out of the IRA withdrawal, (2) the remainder of the withdrawal is reinvested in an after-tax account, and (3) both the IRA and the after-tax account earn a 6 percent rate of return. As you can see, the accelerated federal tax payments on the distributions, as well as the loss of the tax-deferred status on the growth, results in a significant attrition of the account. So, what new strategies should you propose to your clients to minimize the impact of this change?

Stretch Advantages

Distributions cause significant attrition of the account



— James Lange

Choose the Best Beneficiary

The first and perhaps most obvious recommendation is that your client should name his spouse as the primary beneficiary of the IRA. In the December 2014 issue of Trusts & Estates, I wrote an article quantifying the advantages of naming a spouse versus a non-spouse as the beneficiary of an IRA under the proposed legislation.[2] The RMD rules for spousal beneficiaries aren't expected to change, so a spousal beneficiary who limits withdrawals to the RMD could stretch the IRA much longer than a non-spouse beneficiary.

But, what about when there's no spouse or when plans include

contingent beneficiaries? What happens after both the husband and wife pass and what's left of the IRA goes to the children? What options can you present to your clients that will at least partially compensate for the loss of the stretch?

Consider naming a charitable remainder unitrust (CRUT) or charitable remainder annuity trust (CRAT) as the beneficiary of your client's IRA instead of a child or other non-spousal heir. (In Part 2 of this article, which will appear in next month's issue, I'll address using life insurance and Roth IRA conversions.)

Charitable Remainder Trusts

A CRAT can be an effective estate-planning tool for an IRA owner who wants a spendthrift beneficiary to receive only a fixed amount every year from the charitable trust. The beneficiary is locked in to a lifetime of fixed payments that have no growth possibility or inflation protection, and, at his death, the remainder is distributed to charity. A CRUT, by comparison, pays out a fixed percentage each year to the beneficiary during his lifetime, with the remainder being distributed to charity. For an IRA owner who wants the individual beneficiary to benefit from the growth of the trust, a CRUT is usually a better option because, if the assets in the trust grow, the individual beneficiary will receive a percentage of a higher amount. The discussion that follows demonstrates a CRUT as the beneficiary, but a CRAT could be used in its place.

When your client establishes a CRUT for the benefit of his non-spouse heir and names it as the beneficiary of his IRA, the beneficiary receives income for a specified period of time—whether for a number of years or even for as long as a lifetime. At the end of that period, the remainder is given to a designated charity. Prior to the attack on the stretch IRA, I never recommended any type of charitable trust unless the client was charitably inclined. Now, with the potential legislative changes, the tax benefits of naming a charitable trust as the beneficiary of an IRA are so significant that I'm asking many of my own clients to consider the CRUT even if they haven't indicated a preference for charitable giving. When stretching an IRA by a non-spouse beneficiary is no longer an option, naming a CRUT as the beneficiary of an IRA will, in many cases, be more favorable to the child than naming the child as the beneficiary directly. It still won't be as good as what the stretch can provide under the current law, but it will be better than some other alternatives.

Let's take a look at what happens if your client establishes a CRUT and names the trust as the beneficiary of his IRA. Under the current CRUT rules, which aren't expected to change as a result of this legislation, no income is recognized at the time that the IRA is distributed to the CRUT as a lump sum. Income is only recognized by the lifetime beneficiaries (usually the children) when they receive mandated withdrawals from the CRUT. Care has to be taken to make sure that the distributions made to the beneficiary aren't so large that they violate the principal rule of the CRUT. This rule specifies that the amount paid to the income beneficiaries is calculated assuming that 10 percent of the present value of the IRA must eventually go to a qualified IRC Section 501(c)(3) charity. The estate receives a tax deduction for the present value of the amount going to charity at the time of the death of the IRA owner. If there's estate tax or inheritance tax due, you should make sure that there are sufficient funds available outside of the CRUT to pay it.

The advantage of naming a CRUT as the beneficiary of the IRA is that, unlike the child, the CRUT won't be subjected to the accelerated income taxes that accompany the loss of the stretch for a non-spouse beneficiary. The child will enjoy a lifetime of income on the entire amount of the inherited IRA. The principal won't be reduced by the massive income taxes that the child would have had to pay within five years, had he been the designated beneficiary.

But, there are disadvantages to naming the CRUT as the beneficiary of the IRA. The first, and perhaps the most difficult to overcome from your client's perspective, is that the child can't access the trust principal. But, your client must consider other disadvantages as well. If your client names a CRUT as the beneficiary and the child dies prematurely, the charity, not the child's estate, will receive the remainder of the IRA. Whereas, if your client had named the child as the beneficiary of the IRA and the child dies prematurely, the child's estate will get the money that remains. Even with the accelerated tax situation, the child's heirs would be better off without the CRUT if the child dies at a young age.

On the other hand, what happens if the beneficiary is a CRUT, and the child survives a long time? Will the income on the additional amount that was not lost to taxes compensate for the fact that the child won't have the principal? When does the "breakeven" between naming a child and a CRUT as the beneficiary occur? Is it possible that a CRUT can be used to partially replace the benefits of the stretch IRA?

"Breakeven Point," next page, compares what happens if your client names a child as the beneficiary of his IRA with what happens if the child is the income beneficiary of a CRUT

that's named as the beneficiary of the IRA.

The blue line on the graph assumes that the child is required to withdraw the proceeds of the IRA within five years, which will be his only option if the proposed legislation is passed. To minimize the impact of the income taxes that are due, he withdraws the IRA at a relatively equal rate each year. He reinvests the proceeds of the withdrawals in a non-qualified account that earns a rate of return of 6 percent. The brown line assumes that a CRUT is named as the beneficiary of the IRA and that the child is the income beneficiary of the CRUT. The CRUT pays the maximum possible to the child every year, for the remainder of his life. The child reinvests the distributions into a non-qualified account that earns a rate of return of 6 percent. If the child dies at age 85, the remainder beneficiary (or charity) will receive $164,336. By naming the CRUT as the beneficiary of the IRA, the advantage to the child is $301,740—even though 10 percent of his inheritance was eventually paid to the charity!

Here are some other points to consider. In June 2014, the U.S. Supreme Court ruled that IRAs inherited by individuals other than spouses aren't an exempt asset in bankruptcy filings,[3] though that's not the last word on this issue. But, inherited IRAs that are paid to CRUTs are, under current federal law, clearly protected from the creditors of the beneficiaries. This protection includes general creditors as well as former spouses. And, if your client lives in a jurisdiction that has an inheritance tax, the charitable deduction created by transferring the IRA to the CRUT will reduce that tax.

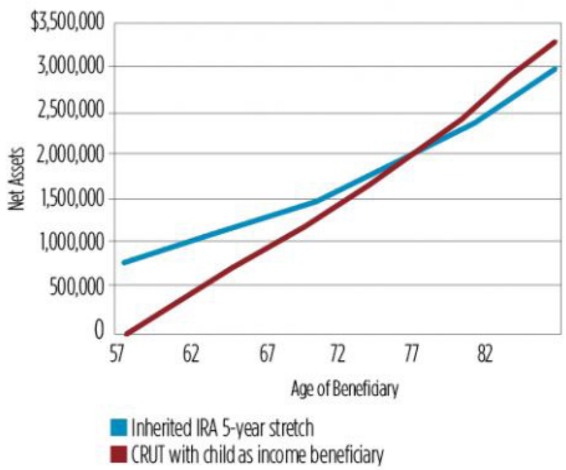
The expense and aggravation involved in setting up a CRUT can be considered a drawback. That cost and aggravation, however, is insignificant when compared to the ongoing additional administration and tax preparation for the CRUT. The tax complications after the death of the IRA owner will be considerable over the years. My rule of thumb, though I haven't done a precise analysis, is that if there's a balance of less than $250,000 per child, the combined administrative expenses and aggravation to the client will be too high to recommend the strategy. That is, if the client's IRA is worth $150,000 and the beneficiary is his child, don't bother with the CRUT.

After taking into account the objections stemming from the fact that CRUT beneficiaries won't have unlimited access to the money (as they would if they inherited the IRA directly) and the perception that the beneficiaries won't receive all of their inheritance because 10 percent must be left to the named charity, I believe that CRUTs are still viable options for those individuals with significantly large IRAs. But, unless your client expresses true charitable intentions, you should only consider CRUTs after the proposed change becomes law. Under the current law, naming a CRUT as the beneficiary of an IRA is less favorable than naming the children as beneficiaries. You should discuss the potential need to change strategies with your client now, so that he understands that he may need to make a significant change to his estate plan when the new law passes. Then, when stretching the IRA is no longer an option, you and your clients will be prepared.

In my next article, I'll present two other solutions, life insurance planning and Roth IRA conversions. Frankly, those solutions will have a bigger impact on the children's inheritance than the CRUT described in this article. Furthermore, these two solutions can be implemented immediately, in contrast to the CRUT solution, which should only be employed after the laws are changed.

Breakeven Point

Naming the charitable remainder unitrust as the beneficiary of the IRA gives the child a $301,740 advantage



— James Lange

—Special thanks to Carol Palmer and Shirl Trefelner of the Lange Financial Group, LLC for their help with this article.

Endnotes:

1. Section 310, Highway Investment, Job Creation and Economic Growth Act of 2012.

2. James Lange, "Optimizing IRAs and Retirement Plan Distributions," Trusts & Estates (December 2014), at p. 16.

3. Clark et ux v. Rameker, Trustee, et al. (Slip Op. No. 13-299 June 12, 2014).