“Stretching” Distributions of Qualified Plans and IRAs at Death

The economic principles that make deferring distributions from a qualified plan or IRA advantageous during the participant’s lifetime, apply equally well after the participant’s death. In planning for the distribution of qualified plans and IRAs after death, structuring the beneficiary designation and distribution options to maximize income tax deferral should be a primary objective. The difficulty is how to achieve estate tax minimization and deferral at the same time. One planning strategy that you may consider is a “stretch.”

“Stretch” Distributions and IRAs

The “stretch” is not a financial product, but a planning strategy that allows for the deferral of tax on the assets accumulated in the qualified plan or IRA. This is done by allowing the required minimum distributions to be stretched out over the owner's lifetime and possibly the beneficiaries' lifetimes, before all the assets are required to be distributed. Thus, a “Stretch” Distribution or a Stretch IRA is simply a qualified plan or IRA that is eligible to be distributed over a long period of time after death. For income tax deferral purposes, you want post-death distributions from a qualified plan or IRA to qualify for a Stretch Distribution or as a Stretch IRA. This is accomplished by making sure that the plan or account is payable at the participant’s death to a Designated Beneficiary.

One common strategy to stretch an IRA is for the IRA owner to name his spouse as the beneficiary. The surviving spouse then will name a child or children as beneficiaries. Upon the IRA owner's death, the IRA can either be `rolled over' in the spouse's name or it can be treated as inherited.

For example, let’s assume that we have a client named Howard who will turn 70 1/2 this year. Howard has an IRA valued at $1,000,000. Howard’s 67 year old wife is Wendy, and she is the named beneficiary of his IRA. Howard decides to only take the required minimum distributions (RMD) out of his IRA each year until his death. If Howard dies at age 75, he has taken out RMD income of $271,510 from his IRA before income tax. If we assume a 7% hypothetical rate of annual return on the assets in the IRA during Howard’s life, Wendy will receive the IRA valued $1,181,160.

Now assume at Howard’s death Wendy rolls Howard’s IRA into her own name and Wendy names her daughter Donna, age 42, as her beneficiary and continues a payout under the new uniform tables. If Wendy lives until age 82, Wendy will receive RMD income between the age of 73 and 82 in the amount of $678,500. The value of the IRA at Wendy’s death will be $1,418,020. Donna, age 53 at her mother’s death, can elect to continue the IRA as the beneficiary and can begin distributions over her single life expectancy (31 years). Still assuming a 7% hypothetical rate of return, Donna will receive before tax income of $5,054,920 during her life.

There are two strategies that will assist you in implementing a Stretch IRA. One is to make sure that there are sufficient other liquid assets available for the payment of debts, claims and other obligations in the decedent's estate. Qualifying for a stretch distribution is of little use if the account has to be liquidated to pay taxes. Second, consider advising your client to rollover from a qualified plan into an IRA prior to death. IRAs generally are more flexible in their distribution options, and can qualify for stretch distribution more easily. In making this recommendation, review with your client the advantages of qualified plan participation that will be given up on an IRA rollover. These may include investment management costs, when they are absorbed or subsidized in the qualified plan, eligibility for favorable income tax treatment, or eligibility for the application of certain grandfather provisions, such as estate tax exclusion under the IRC § 2039 grandfather provisions, or exemption from the current minimum distribution rules, under the "TEFRA 242(b)" (See, P.L. 97-248) grandfather provisions. The existence of loans against the plan, or life insurance in the plan, also may be issues, as neither can be rolled over to an IRA.

When naming individual beneficiaries of a qualified plan or IRA for stretch distribution purposes, there are a number of other issues to be considered:

-Is the possibility of minor beneficiaries adequately provided for, either under the beneficiary designation or the underlying plan documentation?

-Will the beneficiary designation be appropriate if there is an unusual order of deaths (i.e., child predeceases parent)?

-Is adequate provision made for the distribution of the account in the event of the death of the individual beneficiary before the complete distribution of his or her share of the account?

-Is the taxation of the account on the death of an individual beneficiary before the complete distribution of his or her share clear? The account should be subject to estate tax in the beneficiary's estate if the beneficiary has the right to withdraw the account at will, or to designate a successor beneficiary without restriction (either of which constitute a general power of appointment under IRC § 2041), or if the beneficiary's estate will receive any undistributed assets at the beneficiary's death.

-Do you want to use the qualified plan or IRA as a form of generation-skipping transfer? If so, are you certain that the beneficiary does not have any rights or powers (either under the participant's beneficiary designation or distribution election or under the plan documentation itself) that will cause the account to be included in the beneficiary's estate?

-Is the distribution of the qualified plan or IRA to individual beneficiaries consistent with other (non-tax) provisions of the participant's estate plan, including the allocation or apportionment of estate taxes?

-Are there adequate provisions governing investment management in the account after the participant's death?

The plan and trust documents for a qualified plan, and the trust or custodial account agreement for an IRA, contain all of the provisions governing the participant's interest under the plan. Although these documents have to comply with IRS requirements, they do not have to include all available options allowed by the IRS, and may specify their own rules regarding investments, distributions and defaults, to the extent not inconsistent with the Internal Revenue Code and ERISA. It is important to keep this in mind when planning for distributions from qualified plans and IRAs, as your

planning options may be restricted by the terms of these documents. You may not have the ability to address the issues outlined above in a manner other than as provided in the plan documents.

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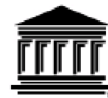

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