



**The Stretch IRA Trust:
*Don't Let the IRS and Creditors be the
Beneficiary of your IRA or 401K***

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There is a coming disaster awaiting those beneficiaries who will be inheriting the \$3 trillion plus dollars currently sitting in IRA and 401k accounts. The problem is twofold. First, the “triple-tax” awaits those who inherit IRAs and 401ks and can eat up to 70% or more of an inherited IRA. Second, even if you minimize the triple-tax through a “Stretch,” a problem awaits in that IRAs are an extremely attractive asset for beneficiaries’ creditors, ex-spouses, and lawsuit plaintiffs.

The purpose of this article will be to (1) explain the triple-tax and its effects, (2) how to “Stretch” an IRA to produce millions of dollars of distributions to your family while minimizing the triple-tax, (3) explain why stretching will generally not work, and (4) explain how a Stretch IRA Trust can force the “Stretch-out” to occur.

At the end of this article, you will be equipped with the knowledge necessary to defuse the coming IRA time bomb and create an explosion of benefits for your loved ones. You will also be armed with an action plan of steps needed to ensure the stretch occurs. For the purposes of this article, please note that I use the term IRA to generically refer to any qualified retirement plan, such as a 401k, 403b, etc.

Part I: Triple-Tax

An IRA is subject to three taxes upon your death. These taxes are (1) the federal estate tax, (2) the federal income tax, and (3) state income taxes. This section will explain how these taxes act as a deadly combination that will decimate your IRA or 401k.

Federal Estate Taxes

The federal estate tax is a tax due upon the death of an individual or the surviving spouse (in the case of a married couple). Each individual is allotted an estate-tax credit equal to the applicable amount in the year of death. Married couples get one credit per spouse; however, at least one credit is often lost due to poor planning and lack of a properly drafted revocable living trust.

For every dollar's worth of assets you have above the applicable credit amount, you will lose a portion of your estate to an estate tax, at rates determined by the Internal Revenue Code. The exclusion amounts and the highest estate tax rates are changing over the next few years.

The estate tax credit amount is increasing, until 2010, when there is no estate tax.

Year	Exemption Amount	Highest Tax Rate
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	Unlimited	n/a
2011	\$1,000,000	55%

However, this reprieve is only temporary and will end in 2011, when the credit decreases to \$1,000,000. Any amount owned above this threshold will be subject to taxes as high as 55%.

Example #1

Bob, age 65, has \$1,000,000 in real estate property, \$500,000 in liquid business, and a \$500,000 IRA. If he were to die between 2007 through 2010, there would be no estate tax due, because his assets fall under the credit exemption amount. But say Bob dies in 2011, at age 69. According to present law, suddenly Bob's house meets the credit exemption amount. This means that the entire IRA is subject to an estate tax as high as 55%. Assuming growth of 8%, the IRA There will also be estate taxes due on the business, but let us ignore those for the purposes of this article and focus solely on the IRA estate taxes.

Federal Income Taxes

In addition to any estate taxes due, your IRA will be subject to federal income tax. This tax is currently at rates as high as 35%. In addition, any amounts distributed to pay estate tax are subject to federal income tax. So in the example above, if Bob's heirs pay the IRA estate tax bill of \$420,913 by taking a distribution from the IRA, then there will be a deemed distribution of \$420,913, subject to a tax of 35% equating to \$147,319. That means \$147,319 in addition to the \$420,913 estate tax.

State Income Taxes

Finally, Bob has state income taxes due in addition to the federal estate and income taxes. The California rate is as high as 9.3%. When that \$420,913 is used to pay the estate tax bill, California gets \$39,145, in addition to all other taxes paid.

Triple-Tax Recap

As you now see, the triple-tax can really crush an IRA. In our example, Bob's decedents had to pay (1) \$420,913 in federal estate taxes, (2) \$147,319 in federal income taxes, and (3) \$39,145 in state income taxes. That's \$396,825 in potential taxes, totaling 79% of the IRA. The result is even worse if Bob's beneficiaries withdraw the entire IRA, as will be discussed below. Now, with some crafty accounting and deductions, an experienced CPA can reduce the income taxes, somewhat, by deducting the state income taxes paid from the federal. However, the end result is still combined taxes of over 70%. This is the worst result possible, and we need a plan to avoid it.

Part II: "Stretching" an IRA

Do not get discouraged at this point. You can not only beat the triple-tax, but you can turn your IRA into the best possible asset for your loved ones to inherit. There are two steps to beating the triple-tax.

Step One: Estate Tax Paid with Other Assets

First, we must make sure that any estate taxes are paid with non-IRA assets. In Bob's case, he had two other assets—real estate and a business. If possible, any estate taxes should be paid with these assets. However, often these assets are not liquid enough to produce the cash necessary to pay estate taxes. If this is the case, Bob should have a life insurance policy, owned by an Irrevocable Life Insurance Trust, with a payout large enough to cover potential estate taxes. If Bob can avoid having his beneficiaries be forced to use IRA assets to pay estate taxes, then no distribution is required (if the "Stretch" requirements are met), and thus no income taxes are due as a result of the payment of estate taxes. By providing liquid funds to pay estate taxes and coordinating the entire estate plan (including the Revocable Living Trust) with the IRA plan, Bob can avoid incurring unnecessary income taxes. In addition, the Life Insurance Trust will cover all estate taxes and ensure that Bob's loved ones get the full benefit of his estate without being reduced by estate taxes. Then Bob's children will have the ability to "Stretch" the IRA and thereby minimize the income tax portion of the time bomb.

Step Two: Stretch the IRA

"Stretching" an IRA is when the beneficiaries of an inherited IRA take only the required

minimum distribution, as determined by such beneficiary's age, rather than the original IRA owner's age. Stretching is a very new concept and has only been around a few years. In fact, the concept is so new that a majority of estate planners are not sufficiently trained to handle IRA planning.

Let us step back and explain this by looking at how to handle distributions from your IRA. You may take distributions without early withdrawal penalties at any time after age 59 ½. However, most people use other assets, seeking to avoid the ordinary income tax treatment of their IRA assets. When you reach age 70 ½, however, you will be required to begin taking required minimum distributions (RMDs), unless you have a Roth IRA, in which case, no RMDs are required during your lifetime. These distributions are taxed at ordinary income tax rates (subject to some allowances) when they are withdrawn (unless your IRA is a Roth IRA), and everything remaining in the IRA is not subject to tax. As such, taking only the RMD will allow you to accumulate much more wealth within your IRA, all growing tax-free. You calculate your RMD by dividing your account balance as of December 31 of the previous year by your distribution factor, found in the Uniform Life Tables published by the IRS.

Example #2

Bob turns 74 and his IRA was \$500,000 on December 31 of the year before; therefore, he must withdraw \$21,008.40. The amount necessary to withdraw will increase steadily during his remaining years. If Bob lives until age 80 and takes only the RMD every year, he will receive \$210,912.06 in total distributions from his IRA.

An interesting thing happens if you only withdraw the RMD. Because the tax code wants to make sure you do not outlive your IRA, they make the RMDs small enough so that your IRA will last well into your 100s. This means that, in reality, your IRA account balance will be greater when you die than when you begin taking required minimum distributions. This fact makes planning for your IRA even more important.

Example #3

If Bob dies at 80, his IRA will be worth \$765,298.16, assuming 12% growth. In fact, Bob's IRA will not start declining in value until he is 97 years old, when it will be worth \$1,427,830.71. In fact, Bob would have to live until age 115 for his IRA to fall under the original \$500,000 value. Given that the average American does not live past 85, you can see that, most likely, an IRA will be larger at death than when RMDs are first taken out. This is all due to the wonders of tax-free compounding. Please feel free to test these results on the Stretch IRA calculator found at:

<http://www.principaltrust.com/tools/calculators/stretchira.htm>.

When a beneficiary inherits an IRA, these wonders of tax-free compounding compound (no pun intended) to produce even more incredible results. A beneficiary inheriting an IRA can take distributions according to their age on what is called the “Single Life Table” produced by the IRS. The distribution factors for younger beneficiaries are much lower than that of the original IRA holder, and as such, the RMDs are lower, and more can be allowed to accumulate tax-free within the IRA itself. The results are astounding, but show why Albert Einstein called compound interest the 8th World Wonder. Say Bob’s son, Jack, inherits his father’s IRA when Bob dies at age 80, when Jack is age 50. If Jack lives until age 80 as well, he will receive \$7,299,862.71 dollars of distributions over his lifetime. In addition, when Jack dies, there will still be \$3,146,894.13 in the IRA. Now, Jack’s children cannot “Stretch” the IRA but instead will receive the remainder over the next 4 years (there will be a little growth, meaning \$3,495,571.10 in total distributions to Jack’s children). All in all, the total family wealth created by this is \$10,895,441.81 in distributions after Bob’s death. Now, these distributions will be taxed; however, the fact that only the RMD is taxed and the rest allowed to grow tax-free creates this amazing amount of wealth.

Recap of the Stretch

Take a look at the alternatives. Bob can have 70% or more of his IRA lost immediately to federal estate, federal income, and state income taxes. In our example, if he died at 80, there would be \$765,298.16 left in the account. The federal estate and federal and state income taxes will total around \$607,378.88. That’s 77.5% of the inherited IRA! Jack would receive just \$171,620 in distributions (assuming he just took out what was left and Stretched the remainder. Alternatively, Bob can plan for the Stretch, have Jack receive \$7,299,862 of distributions over his lifetime, and has almost \$3,500,000 left over for his grandchildren.

The contrast is obvious, and the course of action is clear. Your IRA can either be your children’s worst tax nightmare, or the greatest source for generational wealth. In order provide the most benefit possible from your IRA, you **MUST** take the steps necessary to make the Stretch happen. However, as we will see, the Stretch is neither automatic nor is it likely to happen without planning on your part.

Part III: WARNING: Stretching is Neither Automatic Nor Likely

Please note that the awesome power of the Stretch is not automatic, and most people who inherit IRAs will never experience its power. The problem is that the Stretch will only occur if your beneficiary withdraws no more each year than the RMD. If the beneficiary withdraws more than the RMD, the tax deferral is lost, and they will owe a large tax bill on the amounts withdrawn. When the Stretch-out is lost, we call this a “Blow-Out.”

Reasons for Blow-Outs

Even if you avoid the problem outlined above of being forced to use IRA assets to pay estate tax, it is still very likely that your beneficiary will withdraw the IRA within one year after your death and be forced to pay estate taxes. Why would they do this? Why would they throw away millions of dollars of wealth and suffer a Blow-Out? This is something you really need to worry about.

The reasons are numerous, but I will try to list the most common reasons here:

1. Not understanding the rules and choices. Most beneficiaries, when they learn they have inherited an IRA, will not know about the Stretch and will just ask for the check from the administrator. Once this happens, the cat is out of the bag, and there is no way that the Blow-Out can be corrected.

2. Asking the advice of the custodian. Often when beneficiaries contact an IRA custodian and ask what their next step should be, the custodian just sends them the check, thereby blowing the Stretch.

3. Corporate plans require distribution within 1 year. While less frequent, some corporate plans (i.e., 401ks and 403b plans) require distributions to be made within one year of the deceased participant's death. This causes the beneficiary to withdraw the amounts in the account, thereby blowing the Stretch.

4. Beneficiary does a rollover. Non-spouse beneficiaries are not allowed to "roll over" an inherited IRA. This will be deemed a distribution and thus a Blow-Out. However, often beneficiaries are not aware of this, fail to seek advice, and ruin their chances of a Stretch.

5. Beneficiary wants to spend it. The average inheritance, when received by a beneficiary, is completely consumed within one year. IRAs are not immune to this problem. But IRAs are even worse than regular assets. If your beneficiary spends a normal inheritance, the money is gone, and that's that. With an IRA, not only would the money be gone, but there will be a huge tax bill to pay.

As you can see, for the above reasons, it is quite unlikely that the Stretch will occur. But what if your beneficiary is both wise and prudent? What if they (1) learn the Stretch rules and (2) have the discipline necessary to take only the RMD, and no more, every year. There still are a plethora of problems that can cause a Blow-Out.

Creditors, Predators, and Divorce

One of the worst problems facing inherited IRAs is the lack of creditor protection. If you leave your IRA outright to a beneficiary, then there is a good chance they will eventually lose some or all of the inherited IRA to one of the following:

Creditors. If your beneficiary is in debt and cannot pay, then their creditors can go after their inheritance if distributed outright to your beneficiary. This has become even easier with the Bankruptcy Act of 2005.

Divorce. In a perverse twist, tax laws actually make an IRA an excellent asset for a divorcing spouse to try to take, because the distribution will be taxed to your beneficiary, while their ex-spouse gets the proceeds tax-free. If your child is married, then this is a huge problem, considering 50% of all marriages end in divorce. You can be sure that if your beneficiary gets divorced, their ex-spouse's attorney will fight furiously to make sure their client gets the IRA.

Lawsuits (a.k.a., "Litigation Lottery"). A new lawsuit is filed every 90 seconds in California. I imagine that in a few years the most common source of workplace repetitive stress syndrome will come from court clerks furiously stamping the latest lawsuit. An inherited IRA does not receive the same level of creditor protection as it does in your hands. As such, your beneficiary could lose their IRA to any number of lawsuits, whether legitimate or frivolous.

You must think by now that the situation is hopeless. You see the power of the stretch but are sure that your loved ones will never enjoy the benefits due to the roadblocks in the way. Well, they can, if you help them. The choice is yours. How can you ensure that your beneficiaries enjoy the Stretch-out? Let's find out.

A Living Trust Won't Work

You may think that you will successfully avoid the Blow-Out by simply leaving your IRA to your Living Trust. While Living Trusts are great for avoiding probate and can have other benefits (if properly drafted), they are generally not good recipients of IRAs for the following reasons:

Usually Limited Creditor Protection. If properly drafted, a Living Trust can provide the most asset protection possible to your family. However, 90% of all Living Trusts do not contain the language necessary to ensure this asset protection. As such, your Living Trust would probably not protect your beneficiaries from creditors, divorce, and lawsuits.

Mandatory Distributions. Most Living Trusts contain a provision that states that all assets must be distributed to the beneficiaries immediately or upon the beneficiary reaching a certain age. If this is the case, such distribution makes the IRA proceeds immediately taxable.

Oldest Beneficiary is Spouse. When an IRA is payable to a trust, without special planning, the life expectancy used in taking RMDs is the oldest beneficiary. For married couples, this is usually the surviving spouse. As such, the children will not be able to take

RMDs according to their life expectancy, but instead according to that of the surviving spouse, resulting in accelerated distributions and a Blow-Out.

Non-Designated Beneficiaries. For a Stretch to occur, all beneficiaries must be individuals. If your trust leaves anything to a charity or other non-individual beneficiary, the Stretch cannot occur, and you will incur a Blow-Out.

No Stretch Language. A Standard Revocable Living Trust does not contain the language necessary to allow the trustee to take only the RMD according to a beneficiary's age. As such, the trustee will probably not be allowed to Stretch an IRA with most trusts.

As you can see, for a variety of reasons, a Revocable Living Trust is not the answer and will in fact make absolutely sure that the Stretch does not happen. The only way to ensure that the Stretch will occur and that your beneficiaries avoid losing their inherited IRA to the IRS and/or creditors is by using a Stand-Alone Stretch IRA Trust.

Part IV: The Stand-Alone Stretch IRA Trust

If you wish to both ensure that your beneficiaries are able to take the Stretch-out and provide them with asset protection to avoid losing their inherited IRA then a Stand-Alone Stretch IRA Trust is the only logical solution.

The Basics

The Stand-Alone Stretch IRA Trust is a Revocable Trust that you establish for the express purpose of being the beneficiary your IRA upon the death of you and your spouse. This trust is completely separate from your main Revocable Living Trust, which is meant to own non-IRA type assets.

Unlike your Revocable Living Trust, the Stand-Alone IRA Trust is specially designed to be the beneficiary of your IRA upon your death. It contains special language that allows the trustee to withdraw the RMD according to your beneficiary's age, thus preserving the Stretch. However, the main advantage is that your beneficiary will never be able to take out more than the RMD, unless the trustee deems such distribution necessary. This will force the Stretch and ensure your family receives as much as possible from your IRA.

The choice of trustee is important with a Stretch IRA trust. Obviously, having your beneficiary serve as trustee defeats the purpose. A beneficiary serving as trustee could just choose to withdraw more than the RMD for themselves, thereby causing a Blow-Out. Instead, I recommend that clients choose a corporate trustee to serve as the fiduciary of their Stretch IRA Trust. A corporate trustee is an entity, such as a bank or other financial institution, which will serve as an independent fiduciary acting in the interests of your beneficiary. This serves the purpose of forcing your beneficiaries to take only the RMD

every year, thus ensuring they will receive the most benefit possible from your IRA.

Another benefit of an independent corporate trustee is asset protection. A Stretch IRA Trust, combined with an independent trustee will ensure that your beneficiary will receive the full benefit of their trust, despite creditors, divorce, lawsuits, or other attempts by a third party to take your IRA.

This asset protection is strengthened by the fact that your trustee is not required to distribute the RMDs every year to your beneficiary but may instead choose to accumulate such RMDs within the trust, should the beneficiary run into creditor problems. This “accumulation” will give the beneficiary the ability to settle with their query on favorable terms, instead of being forced by a court to hand over the IRA to their creditor.

Each Beneficiary May Take RMDs According to Their Age

Normally, when a trust is the beneficiary of an IRA, the RMDs will be made according to the age of the oldest beneficiary. In the case of a normal Living Trust, that beneficiary is the surviving spouse, who is significantly older than the children. Having RMDs taken at the spouse’s age defeats the purpose of the Stretch and causes a Blow-Out. Instead, the beneficiaries of your Stand-Alone IRA Trust should be your children, grandchildren, or other significantly younger beneficiaries. As will be explained below, your spouse will still be able to benefit from your IRA, but they will not be a beneficiary of the Stand-Alone IRA Trust.

Another recent development is an IRS ruling stating that with proper planning, your Stretch IRA Trust can use the life expectancy of each beneficiary for their portion of the IRA. This is done by including language in the trust separating the inherited IRA into Separate Share Trusts for each beneficiary. This means every beneficiary’s share is separate, and distributions to one beneficiary do not affect another beneficiary.

In order for this Separate Share treatment to occur, you must properly list each beneficiary’s separate share trust on your IRA custodian’s Beneficiary Designation Form. This language is critical and should only be drafted by an attorney who is an expert in this area.

But What About Your Spouse?

You may have been thinking that this idea is great, but what about my spouse? The answer is that your spouse can still enjoy your IRA after your death. In fact, your spouse will be able to “Stretch” your IRA according to his or her age by “rolling-over” your IRA after your death. Once that rollover is done, your spouse will just list your trust as the designated beneficiary, allowing the Stretch to occur after his or her death. Due to the tax-free compounding of your IRA when inherited by your spouse, your IRA will likely

be larger after your spouse's death than when he or she first inherits it.

Example# 4

Let's go back to our example with Bob, only this time we will broaden the facts a little. Bob, currently 74, is married to Sue, who is 68. Bob's IRA is now worth \$500,000. Bob decides to set up a Stretch IRA Trust, with Jack as beneficiary. Bob fills out his Beneficiary Designation Form, naming Sue as the primary beneficiary and Jack's separate Share Trust as a contingent.

As stated before, Bob then dies at age 80, when the IRA is worth \$765,298.16. Sue immediately rolls-over the IRA and begins taking distributions according to her age. She names Bob's Stretch IRA Trust as her beneficiary. She lives until age 80, taking out \$287,576.00 in RMDs. At her death, the IRA is worth \$1,236,006.24. The trustee of the trust then begins taking distributions according to Jack's age. These RMDs will total \$10,284,151.95, assuming Jack dies at age 85.

Now assume that sometime after his father and mother's death, Jack is the subject of a lawsuit and owes \$2 million. Without the Stretch IRA Trust, he could lose his inherited IRA to satisfy the judgment. With the Stretch IRA Trust, however, the IRA is safe, and he will have strong leverage to settle the judgment on favorable terms.

CONCLUSION

As you can see, your IRA can be the best asset your children inherit, or the worst. You can have over 70% lost to taxes and the rest subject to creditors, divorce, and lawsuits, or you can do preemptive planning to protect your family and help them enjoy millions of dollars from your IRA.

Stretching an IRA will both minimize your loved ones' tax burdens while at the same time providing potentially millions of dollars of wealth to several generations. However, as we have seen, the Stretch will generally not happen on its own. Mistakes or frivolous spending can cause a Blow-Out and cause huge tax consequences. In addition, creditors, ex-spouses, and lawsuits can further decimate an inherited IRA.

The beauty of the Stretch IRA Trust is that it puts the Stretch on autopilot, forcing it to occur, while at the same time preventing the wrong parties from taking the IRA from your beneficiaries. Really, the decision to do a Stretch IRA Trust is a "no-brainer." The set up fees are small compared to the benefit your loved ones will receive.

A Stretch IRA Trust will ensure that your IRA serves as an enduring legacy, rather than a problem asset. The good news is that the choice is up to you. If you take the step of

having a Stretch IRA Trust drafted, then you will have ensured the protection of your family for years to come.



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