

SPECIAL REPORT

www.disinherit-irs.com

STRETCH-OUT TRUSTS

By Salvatore J. LaMendola, Esq.

The Stretch-Out

The best way to understand the benefit of a stretch-out *trust* is to understand the benefit of a *stretch-out*. And the best way to understand the benefit of a *stretch-out* is to see how one works.

Assume that Robert inherits a \$300,000 IRA from his mother Roberta when Robert is age 44. Beginning with the year following the year of Roberta's death, and each year thereafter, Robert must take a "required minimum distribution" ("RMD") from the inherited IRA.¹ If Robert limits his withdrawals to just the RMD for the year and if the IRA earns 6% per year, Robert will receive more than \$1,200,000 in total, pre-tax distributions, as follows:

Table I: The Stretch-Out²

<u>Distribution Year</u>	<u>Robert's Age</u>	<u>Value of IRA</u>	<u>Life Expectancy (in years)</u>	<u>Required Minimum Distribution (RMD)</u>	<u>Cumulative Distributed</u>
1	45	\$ 300,000	38.8	\$ 7,732	\$ 7,732
5	49	\$ 341,823	34.8	\$ 9,823	\$ 43,728
10	54	\$ 395,219	29.8	\$ 13,262	\$ 102,741
15	59	\$ 444,832	24.8	\$ 17,937	\$ 182,501
20	64	\$ 481,497	19.8	\$ 24,318	\$ 290,528
25	69	\$ 489,864	14.8	\$ 33,099	\$ 437,322
30	74	\$ 444,747	9.8	\$ 45,382	\$ 637,957
35	79	\$ 304,433	4.8	\$ 63,424	\$ 915,873
39	83	\$ 77,646	1.0	\$ 77,646	\$ 1,216,210

The Stretch-Out Advantage

Table I, however, does not tell the whole story, for it does not consider how well Robert would have done had he not "stretched-out". Table II below does that job. It assumes that Robert withdraws the entire IRA shortly after inheriting it, pays taxes on the same, and reinvests what's left in a taxable account for the same 39 years.

¹The same is true if Robert inherits a Roth IRA or other Roth retirement plan, except that no income tax on the RMDs would be due.

²For brevity, only every fifth year is shown. In reality, Robert would receive an RMD in each and every year of the stretch-out.

TABLE II: The Stretch-Out Advantage³

<u>Income Rate of Return</u>	<u>Capital Gain Rate of Return</u>	<u>Total Return</u>	<u>Stretch-Out Investment Account Balance</u>	<u>Cash-Out Investment Account Balance</u>	<u>Stretch-Out Advantage</u>
2%	2%	4%	\$ 866,802	\$ 708,927	\$ 157,875
2%	3%	5%	\$ 1,251,269	\$ 1,017,625	\$ 233,643
2%	4%	6%	\$ 1,800,123	\$ 1,455,903	\$ 344,220
2%	5%	7%	\$ 2,581,078	\$ 2,076,164	\$ 504,914
2%	6%	8%	\$ 3,688,702	\$ 2,951,216	\$ 737,486

Now Available to More Heirs Than Ever

Prior to 2010, if Roberta were still in an employer-provided retirement plan like a 401(k) or 403(b), it was uncertain (at best) whether Robert could stretch-out. But starting on January 1, 2010, all 401(k)s, 403(b)s, and other employer-provided plans must allow all non-spouse beneficiaries to stretch-out - the same as their IRA counterparts have been doing for years.⁴ As a result, the stretch-out advantage is now available to more heirs than ever.

Stretch-Out Trusts

Despite all the good news, the stretch-out advantage is not assured. This is because an inherited IRA is subject to cash-out risk, creditor risk, and "stranger" risk (the risk that some unintended party eventually inherits). Stretch-out trusts reduce or eliminate all three risks, as follows.

Cash-Out Risk

Stretch-out trusts eliminate cash-out risk by forbidding the same. Instead, for the duration of the trust, the trustee is directed to take the RMD only; twice the RMD; the RMD or 5%, whichever is greater; the RMD plus extra as needed for support; or whatever other format is desired. Thus, with a stretch-out trust, Roberta can ensure the stretch-out advantage for Robert, at least until he reaches age 65, 70 or some older (or younger) age, as she decides.

³This is why Forbes Magazine called the stretch-out "one of the greatest loopholes in modern tax law." Ashlea Ebeling, *The Stretch IRA*, Forbes Magazine, October 3, 2003.

Assumptions: Same rates of return for IRA and taxable investment account. 28% income tax rate (except for 35% income tax rate on cash-out due to "bracket creep"); 15% capital gains tax rate (25% of capital gains realized annually); All income and capital gains taxes paid from the investment account; All after-tax earnings in the investment account also reinvested; All RMDs taken at the end of the year and reinvested in a similar investment account at the start of the following year.

⁴To stretch-out an employer-provided plan, the non-spouse beneficiary must complete a direct rollover of the plan to an inherited IRA by the end of the year following the year of the plan owner's death. The non-spouse beneficiary must also take the first RMD by that deadline.

Creditor Risk

Stretch-out trusts reduce or eliminate creditor risk by maintaining ownership of the inherited IRA in the name of the trustee, not the beneficiary (where creditors could otherwise reach it). Thus, with a stretch-out trust, Roberta can ensure that Robert will not lose the stretch-out advantage if he is sued.⁵

Stranger Risk

Stretch-out trusts eliminate stranger risk by eliminating the ability to include them. Instead, only the beneficiaries you name can enjoy the stretch-out advantage. Thus, with a stretch-out trust, Roberta can ensure that if Robert dies young, the next beneficiaries of the inherited IRA will be chosen by her, not him.

The Next Step

By stretching-out, heirs inherit more. But without stretch-out trusts, the stretch-out advantage could be lost to cash-outs, creditors, or strangers. To prevent the same, stretch-out trusts should be made part of the estate plan.

Salvatore J. LaMendola, Esq., is an estate planning attorney with the law firm of Giarmarco, Mullins & Horton, P.C. in Troy, Michigan. Contact him at (248) 457-7204 or sjl@disinherit-irs.com.

This brochure is designed to provide accurate (at the time of printing) and authoritative information with regard to the subject matter covered. It must not be used as the basis for legal or tax advice. In specific cases, the parties involved must always seek out and rely on the counsel of their own attorneys. Thus, responsibility for modifying and guiding any party's action with respect to legal and tax matters is placed where it belongs—with his or her own legal counsel.

TO THE EXTENT THIS BROCHURE CONTAINS TAX MATTERS, IT IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED BY A TAXPAYER FOR THE PURPOSES OF AVOIDING PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER UNDER LAW, ACCORDING TO CIRCULAR 230.

GMH GIARMARCO, MULLINS & HORTON, P.C.
TAX AND BUSINESS PRACTICE GROUP

⁵If the trustee is given the authority to hold back RMDs when received (called an "accumulation" trust) the RMDs can be protected as well. If not (called a "conduit trust"), creditors can reach the annual RMD, but the balance of the IRA will still be protected.