Leaving a Legacy for your Family: Stretch IRA or the Tax Man

The other day I was listening to the Beatles channel on Sirius Radio and the song came on called, "The Tax Man" by Eric Clapton and George Harrison. And it goes like this:

"Let me tell you how it will be.
There's one for you, 19 for me.
Because I'm the tax man.
Yeah, I'm the tax man."

I'm sure there was a reason these rock stars were singing the blues about paying a huge amount of taxes.

Let's assume you're not a rock star. What is it you can do you to help your beneficiaries minimize taxes upon your demise?

Leave them a legacy through a Stretch IRA

The stretch IRA concept, which I have implemented for almost 20 years, is truly one of the most powerful money/investment techniques that I know, that doesn't cost anything.

Background of the Stretch

In the late 1990's, 401(k) rollovers had gotten huge and IRA's were pretty hard to have if you were going to put aside $2,000 a year, in order to have a huge IRA 15 - 20 years down the road. People had rolled over their 401(k)'s into IRAs, and a lot of them had $1 million. There was very little planning on how this sum of money was going to be passed down to beneficiaries.

It would be best to discuss your stretch strategy goals with your heirs early on. With a clear understanding of the process, beneficiaries can take the proper steps to receive the greatest benefit from the account. Over time, the stretch strategy could result in an important legacy for your heirs if they choose to take advantage of it—and it can be especially rewarding to know that your children or grandchildren can benefit from substantial savings over time as a result of your generosity.

In the 90's

I had a client whom I'll never forget. He was from Germany and he was as stubborn as a mule. His wife had predeceased him a couple years prior and he said, "John, I've lived in a mobile home my whole life. I've sacrificed mainly because my kids don't have anything - they have no retirement plan and they're going to have a bleak retirement. My goal is to make sure that this money passes on to them." I explained to him, "Well, upon your demise, there are a few ways you can do it. I explained some options to him and ultimately conveyed that we could set up a stretch IRA and not only set it up but counsel them on the correct actions to take."This client wasn't having any of the latter. He said, "No John, I want them to pay the taxes on it and that's it," and there was no more further discussion. Well, I'll never forget when his kids finally did inherit the money—back then they were from California—they lost almost 45% of it due to state and federal income taxes. It was one of the first times I had ever seen somebody lose that amount of money to taxes. It was sad, and it didn't have to happen that way.

Most of the time, when people pass away, they just want to get everything over with quickly and that's when they make big mistakes. You'll see some people do things they would actually never do. They'll sell the home at a discount just to get rid of it within a week or two. It's important to meet with someone who can say, "We understand that you're just trying to get this over, and you're in a lot of pain because you just lost a loved one. But let's just hold on and see if there's a beneficial way to inherit this money."

Fortunately, There Is

It's called an inherited IRA or stretch IRA. The mechanics are very simple. But just because the mechanics are simple doesn't mean that people do it. (It's just like losing weight, everyone knows how to diet) A stretch IRA is a method that avoids a large sizeable tax bill to the beneficiaries. If children or grandchildren are named this stretches the lifespan of the IRA. This extends tax-deferred growth for years beyond the life of the original account holder.

With a stretch IRA, the account holders name their IRA beneficiaries. Those younger relatives then take RMDs that are small enough to trigger minimal taxes. The rest of the inherited account can continue to grow tax-deferred and increase in value.

Let's say upon your death, let's say you have two beneficiaries and $1 million in an IRA, if an account has been titled properly, the beneficiaries have an option to either pay the tax or continue the IRA as an inherited/stretch IRA.

You may be thinking, "Why would anybody want to pay the tax?" Folks, it's back to the prior example. They don't know. They're trying to deal long distance with somebody. They're dealing with somebody, maybe the money is still in a 401(k), and they're just trying to get the stuff done and off their desk.

The cool news is a stretch IRA doesn't have to be for a relative. It can be for any beneficiary.

Mechanics of the Stretch

It's really fairly simple. With this strategy, you name your non spouse (obviously if your spouse is still alive, then you should probably name your spouse as beneficiary) as your IRA beneficiary. He or she rolls your IRA into an inherited IRA in his or her name and starts taking RMDs at age 70.5. Your child or beneficiary names a member of the younger generation (such as your grandchild) so when your child dies, the grandchild beneficiary starts taking the small RMD's and now they have their own stretch courtesy of you.

Family Dynamics

Let's say your name is John Smith and you have your two sons Joe Smith and Melvin Smith as beneficiaries. Now, one of your sons is a frugal guy, and realizes that he doesn't have enough money saved for retirement (There are very few people walking around today with pensions, so you either save it or you just try to exist on Social Security, which is tough). The other son, Melvin, now Melvin is a party guy and he's not thinking about 20 years down the road. He's thinking about right now, what he could do with that money, what kind of car he could buy, what kind of house he could have, his standard of living, and to heck with it, he may not even live that long. In many families, you'll have two siblings that are fairly opposite with their outlook towards money.

Furthermore, people who have trusts, name their one more responsible son or daughter as the trustee and executor. And they always tells that son/daughter "Please look after your sibling, financially after I am gone." The sibling who wants the money, Melvin, is going to be badgering the other one. The other one is going to say, "He wants this, but I know what my parents wanted me to do," and then they're just torn.

As you know, with any IRA, if you're IRA owner and you reach age 70-1/2, you have to do required minimum distributions, which are based on your life expectancy (RMDs are calculated each year and must begin no later than December 31 of the year following your death.) The stretch IRA will have to do required minimum distributions, but they're a lot less, because for example, at age 40, your life expectancy is probably 40 - so you're going to be taking about 2.3% which is very minimal.

Pay Less Taxes, Pay Later

I don't know who coined this phrase, but this phrase, "Pay less taxes, pay later," really hit the nail on the head. Whether it's a tax-deferred annuity, whether it's tax-free municipal bonds, or whether it's IRAs/401(k) s, everybody would rather have their money working for themselves. They would rather pay fewer taxes and pay it later. Most people understand that if you have a lot more money working for you, you're going to end up a lot better down the road.

Can you imagine the difference to your beneficiaries if they were to receive the full value of your IRA? For example, let's just use a $1 million IRA, and something happens and you pass away. If your beneficiaries cash it in because they're being given bad advice, they don't know what they're doing, or they just get impatient, they're going to lose 45%. That is a huge tax bill.

So the name of the game is, instead of losing that hypothetical $450,000 in the above example, you keep that money that was going to go to taxes working for your new beneficiaries, for their lifetime, and even possibly your grandchildren's lifetimes.

Take a second and go back and think: If you had an extra $450,000 working in some kind of investment, I don't care what the return was, for the last 40 or 50 years, how much more would you be worth? How better would your retirement have been?

Mind Blowing Legacy

So let's say your grandchild is in college and every month he receives a check from your inherited IRA that says, "Favorite grandson BDA deceased owner name IRA." The deceased owner is you- for the rest of the beneficiary's life they are getting a check courtesy of you.

So what is a BDA IRA account? It is an inherited IRA, which is also called a beneficiary distribution account IRA. It is important that the IRA custodian registers the account properly. This is the key. If this is not done properly, then this whole concept does not work.

Now, if the beneficiary is NOT a spouse, this is where it gets a little bit trickier. A non spouse beneficiary must move the funds into a BDA IRA in his or her name and take life expectancy payments accordingly. For example, let's say you have two kids, the two above-mentioned kids, one is a spender, and one is not. Regardless, what has to happen or should happen - the IRA should be split.

Spend this and start your own retirement

In a lot of cases, people will have, you know, let's say half their money in IRAs and half their money maybe in homes and brokerage accounts and what not. I have had a lot of success when I sit down and talk to talk to these beneficiaries, I say, "you know, if you are like a lot of people out there today, you probably do not have enough savings for retirement, you probably do not have a pension," and I review the above mentioned two courses of action. In many cases I will say to the beneficiary, "your parent had half their assets in IRAs and the other half in brokerage accounts. Let's do this; we can get the other half of the money that is non IRA to either invest, spend, or whatever you would like to do with it. But let's go ahead and set up this IRA as your own retirement plan."

When you have beneficiaries with different outlooks, there is a smart way to distribute assets at death and there is also a dumb way. If you have ever been involved in a settlement of an estate worth a significant value with more than one beneficiary, you know exactly what I am talking about. There is not a whole lot of logic between a couple beneficiaries, their spouses, children, and a big pile of money. It is important for this to be taken care of on the front end because I tell you, in most cases; it will not be taken care of in the tail end.

Certain things have to be implemented at certain times. The main problem, as we mentioned before is the first time somebody has died and that has left them money, they do not know what they are doing. It is real hard for them to get advice. So they will call up wherever the account is being held and they will talk to some 24-year-old representative. Do not let them make a mistake. If there is a way I could help you, if you have any questions there are multiple ways to reach out to me. Either shoot me an e-mail, a phone call, come to the office or even Skype with me. And if you are not a client, I would be glad to explain this whole process to you about the benefits. I have done this for decades.

Sincerely,

John Romano, CFP®

John Romano, CERTIFIED FINANCIAL PLANNER™, has over 30 years experience in the financial field. John is a Registered Representative with Securities America, Inc. (member of the FINRA and SIPC), and an Investment Advisor Representative with Securities America Advisors. He has prepared hundreds of reports for retirees to assist in their retirement income planning needs. He is dedicated to providing portfolio analysis, dividend and income information, and investment management services to retirees (and those preparing to retire) in The Villages, Florida, and throughout the United States.

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Most retirees are concerned today about outliving their income. Very few have a written income plan. This may be a good time to stress-test your retirement plan. Maybe I can help. Send me an email or schedule a phone time.
I will get back with you within one business day.

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