Money Matters

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Question of the Month: Can Families Inherit a Traditional IRA?

By Aaron Skloff

Q: Can my family inherit my Traditional Individual Retirement Account (IRA)? If so, are there any advantages to avoiding withdrawals from my IRA?

A: Yes and Yes. The Problem. If you do not properly designate your family as the beneficiaries, your IRA could be destroyed by taxes. Like most good things, avoiding withdrawals from your IRA must come to an end at some point. The IRS mandates Required Minimum Distributions (RMDs) each year once you turn 70 ½ years old. This forces you to take withdrawals from your IRA. Forget to take them and you could pay stiff 50% penalties on the amount that should have been withdrawn.

The Solution. Naming your family as the designated beneficiaries with your IRA custodian allows your family to inherit your IRA and simultaneously take advantage of a Stretch IRA. A Stretch IRA is not a different type of IRA, but simply a strategy of “stretching” the tax sheltering benefits of an IRA beyond your own life. If you withdrawal only RMDs you will leave the largest amount possible from your IRA to your family.

Let’s look at an example of a $300,000 IRA that grows and stretches into $2,139,189 over three generations, based on a 7% annual rate of return. Harvey (age 70) names his wife Myrna as his sole beneficiary and over two years takes RMDs of $22,649 until passing away at age 71. Myrna (age 66) treats Harvey’s IRA as her own, names her son Marc as her sole beneficiary and over eight years takes RMDs of $156,123, until passing away at age 77. Myrna is able to treat Harvey’s IRA as her own because she is his spouse. Once it becomes her own IRA she is able to delay RMDs until she turns 70 ½ years old.

Marc (age 53) maintains the account as an Inherited IRA, names his son Logan as his sole beneficiary and takes RMDs of $933,576 (based on his own life expectancy of 32 years) over the course of 23 years, until passing away at age 75. Marc is only able to treat Myrna’s IRA as an Inherited IRA (unless he disclaims ownership within nine months of Myrna’s death) versus treating it as his own (an exception reserved solely for spouses).

Logan (age 41) takes RMDs of $1,026,841 (based on Marc’s remaining life expectancy until assets are divested) over the course of nine years. Logan takes RMDs for nine years because his father Marc had taken RMDs for only 23 of his 32-year life expectancy (32-23 = 9). In total, RMDs total $2,139,189 over three generations.

Albert Einstein and the Stretch IRA. Albert Einstein once said, “Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn’t...pays it.” Compounding allows an investor to earn interest on interest. At a 7% compound interest rate your investment will double its value in approximately 10 years.

Since Einstein’s statement, the introduction of the IRA allows you to realize compound interest in a tax shelter that can stretch over multiple generations. Importantly, earning 7% interest in an IRA is equivalent to earning approximately 11% interest in a taxable account and paying taxes at a 35% federal income tax rate.

Avoiding IRA Withdrawals. All too often investors look at their IRA as a piggy bank, breaking it open whenever unexpected expenses arise. Besides a 10% penalty for withdrawals (under most circumstances) before the age of 59 ½ and income taxes, withdrawals from your IRA are difficult to replace due to IRS mandated annual contribution limits. Even if you skip an annual contribution one year you can never make a contribution greater than the current year’s limit. For example, if you are 60 years old and withdraw $15,000 from you IRA in 2010, you can only contribute $6,000 to your IRA – even if you skipped your $6,000 contribution in 2009.

Action Step: Delay withdrawals from your IRA until required by the IRS, designate appropriate beneficiaries and instruct the beneficiaries to withdrawal at the pace required by the IRS and your family can reap the befits of your IRA over multiple generations. Establish an IRA as early as you can and let the compounding and tax sheltering begin.

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