What Is a "Stretch" IRA?

Finding a method to leave a lasting legacy to your loved ones without increasing their tax burdens can be difficult and complicated. A “stretch” IRA may be a useful approach that can benefit your heirs for generations to come.

A stretch IRA is not a special type of IRA but rather a term frequently used to describe this IRA strategy, also known as a “multigenerational” IRA, that can be used to extend the tax-deferred savings on inherited IRA assets for one or more generations to benefit future beneficiaries.

Here’s how it works. You let the funds accumulate in the IRA for as long as possible. You name as beneficiary someone younger, perhaps a son or daughter. When you have to start taking required minimum distributions (RMDs) from your traditional IRA after turning age 70½, you take only the minimum annual amount required by the IRS each year. (If you fail to take a minimum distribution, you could be subject to a 50% income tax penalty on the amount that should have been withdrawn.)

When your beneficiary inherits your IRA, he or she might also have the ability to take required minimum distributions (RMDs) based on his or her life expectancy. (RMDs are calculated each year and must begin no later than December 31 of the year following your death.) In this way, your beneficiary would have the potential to stretch the distributions over his or her own lifetime, which enables the funds to continue compounding tax deferred for a longer period and avoids a large initial tax bill. Your beneficiary can also name a beneficiary, who can potentially stretch the distributions even longer.

There is a limit to how long you can “stretch” an IRA. The IRS doesn’t want to postpone taxes indefinitely. The distribution period cannot extend beyond the first-generation beneficiary’s life expectancy. For example, if you designated your son to be the sole beneficiary of your IRA and he was 40 when you died (and you hadn’t yet reached the age for taking RMDs), he could take RMDs based on his 37.6-year life expectancy, starting the year after you died. If he died 20 years later, his designated beneficiary could continue taking minimum distributions based on what would have been your son’s remaining life expectancy (20.8 years).

Of course, nonspouse beneficiaries of IRAs face some hurdles. There are different sets of rules to determine the RMDs that a nonspouse beneficiary must receive. They depend on whether the original account owner died before, on, or after reaching the required beginning date for RMDs. Not only are these rules complex, but they can have far-reaching implications. Spousal beneficiaries of IRAs have more options than nonspouse beneficiaries.

If you have a desire to extend your financial legacy over future generations and don’t need the IRA assets for income during your lifetime, then this strategy may be appropriate for you. Because many tax and distribution rules must be followed, make sure to seek legal or tax counsel before making any final decisions.

Note: Make sure the provisions in your IRA allow beneficiaries to take distributions over their lifetimes and to name second-generation beneficiaries. Distributions from traditional IRAs are taxed as ordinary income. Distributions prior to age 59½ are subject to a 10% federal income tax penalty (this rule does not apply to IRA beneficiaries, who must begin taking minimum distributions no later than December 31 of the year following the original owner’s death). Beneficiaries also have the flexibility to take out more than the minimum distribution at any time.