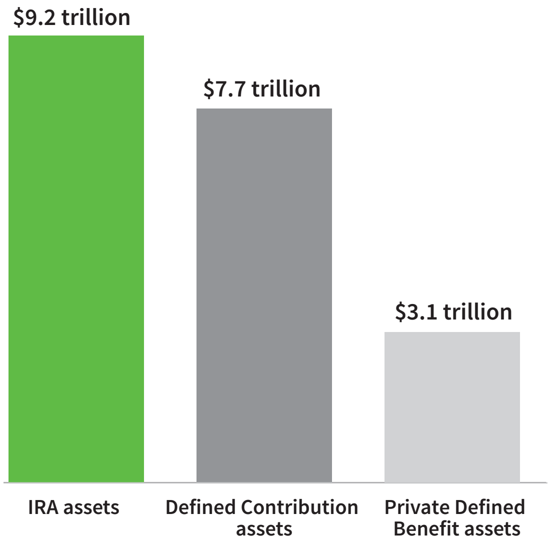
Stretch an IRA over generations

Individual retirement accounts (IRAs) have become a mainstream investment vehicle since their introduction by the Employee Retirement Income Security Act in 1974. IRAs were designed to help individuals without access to a workplace retirement savings plan, providing them with a tax-favored way to accumulate money for the future. In fact, since many investors use IRAs to roll over assets from 401(k) plans when changing employment or retiring, IRAs are now the dominant vehicle for retirement savings.

U.S. retirement market



Source: ICI, December 2017.

As a result, investors may have a growing amount of assets in IRAs. But for those who do not need to tap into their IRA funds in retirement, an IRA can also be used to pass on assets to heirs. One of the features of an IRA is the potential to "stretch" withdrawals across multiple generations, which can help extend the life of your savings.

What is the "stretch IRA" approach?

A stretch IRA is a strategy to extend the life of an IRA for successor beneficiaries. This concept allows the IRA to continue to grow tax deferred even after the death of the account owner.

How it works: Maximizing the life of your IRA

While account owners are always free to withdraw as much as they want (subject to tax and potential penalty) from an IRA, federal tax law requires that owners of a Traditional IRA take required minimum distributions (RMDs) when they reach age 70½. The same requirement applies to SEPs, SARSEPs, and SIMPLE IRAs. Participants in qualified employer-based retirement plans, such as 401(k) plans, are subject to similar rules as well.

For most IRA owners, the rules require RMDs to be based on remaining life expectancy and paid out over a period of years determined by using the IRS Uniform Lifetime Table. Annual RMDs are generally calculated by dividing the balance of the IRA account as of December 31 of the previous year by the IRS life expectancy factor.

If an IRA owner has designated a spouse as sole beneficiary and the spouse is more than 10 years younger than the account owner, RMDs can be calculated based on the actual joint life expectancy of the owner and spouse.

After an IRA owner dies, federal tax law requires beneficiaries to withdraw a specific minimum amount each year. To maximize the life of the IRA and defer taxes on those assets for as long as possible, account owners may want to withdraw as little as possible for as long as the rules permit.

Create a stretch strategy

As with any savings, it is advisable to make an IRA last as long as possible by stretching out distributions over a long time period. There are several key elements to establishing a stretch strategy:

- Make sure you have designated primary and secondary beneficiaries for your IRAs.
- Limit your withdrawals to RMDs to maximize the amount left to beneficiaries.
- When the IRA owner dies, beneficiaries may request to take RMDs based on their remaining life expectancy (see "Single life expectancy" chart above). Assuming the beneficiary is younger than the deceased account owner, this often results in smaller amounts for the RMDs.
- Use the longest life expectancy factors available. If an IRA has only one beneficiary, then that beneficiary is generally required to calculate RMDs based on his or her own life expectancy. When more than one beneficiary has been named, it is required that the heir with the shortest life expectancy be used to calculate RMDs, which results in higher RMD amounts. Later in this piece, we will discuss account segregation strategies that allow multiple beneficiaries to use their own life expectancy in order to avoid taking higher RMDs.
- Name someone to receive RMDs in case the beneficiary does not outlive life expectancy. Federal tax code permits RMDs to be withdrawn over a beneficiary's life expectancy, even if the beneficiary dies before his or her life expectancy elapses. To ensure that the entire life expectancy period can be used, beneficiaries should name someone to receive RMDs. If not, the beneficiary's estate would generally become entitled to the IRA upon the account owner's death. At that point, the estate may choose to withdraw the IRA in its entirety rather than continue to receive RMDs over any remaining life expectancy period.

Can a Roth IRA be stretched?

Even though RMDs are not required for Roth IRA owners, beneficiaries must begin taking distributions upon the death of the account owner. But these distributions are generally not taxable for the beneficiaries.

However, while Roth withdrawals are not considered taxable income, restricting distributions to the minimum amount based on the beneficiary's remaining life expectancy may allow more assets to remain within the Roth to potentially grow tax free.

Single life expectancy

Age	Life expectancy	Age	Life expectancy	Age	Life expectancy	Age	Life expectancy
20	63.0	31	52.4	42	41.7	53	31.4
21	62.1	32	51.4	43	40.7	54	30.5
22	61.1	33	50.4	44	39.8	55	29.6
23	60.1	34	49.4	45	38.8	56	28.7
24	59.1	35	48.5	46	37.9	57	27.9
25	58.2	36	47.5	47	37.0	58	27.0
26	57.2	37	46.5	48	36.0	59	26.1
27	56.2	38	45.6	49	35.1	60	25.2
28	55.3	39	44.6	50	34.2		
29	54.3	40	43.6	51	33.3		
30	53.3	41	42.7	52	32.3		

Source: IRS Publication 590, Individual Retirement Arrangements (IRAs).

Establishing a stretch IRA

In order to limit RMD amounts and avoid potential IRS penalties, IRA beneficiaries need to act relatively quickly upon inheriting an account. While a spouse who is the sole primary beneficiary of an account has the ability to treat an inherited account as his or her own or defer taking mandatory distributions until the year the deceased owner would have reached age 70½, non-spouse beneficiaries must generally start taking distributions the year after the owner's death. Failure to do so may result in IRS penalties equal to 50% of the RMD amount, or (in cases where the owner died prior to reaching age 70½) the loss of the ability to stretch altogether.

Beneficiaries may avoid having to take higher RMD amounts by taking these actions:

- For IRAs with multiple primary beneficiaries, each beneficiary should establish a separate account and begin taking minimum distributions no later than December 31 of the year following the year of the IRA owner's death. Doing so will allow each beneficiary to use his or her own life expectancy for the calculation of required distributions. If separate accounts are not established by this deadline, distributions must be calculated using the oldest beneficiary's life expectancy — thus resulting in greater potential distribution amounts.

- Alternatively, beneficiaries (or non-living beneficiaries such as trusts) can either withdraw their entire portion of the IRA or, within 9 months of the IRA owner's death, formally give up their right to a share of the funds. If either of these actions is taken before September 30 of the year following the year of the IRA owner's death, those beneficiaries' shorter life expectancies will not be considered when calculating the RMD amount. This strategy is also useful in cases where it makes sense for assets to pass to the contingent, or secondary, beneficiary.

As always, you should consult your financial representative to determine what may be best for your individual needs.

Pitfalls to avoid when naming beneficiaries

A key to the stretch strategy of maximizing the life of your IRA is to leave assets to younger beneficiaries with a higher life expectancy. Higher life expectancies will result in lower amounts for RMDs following the death of the account owner.

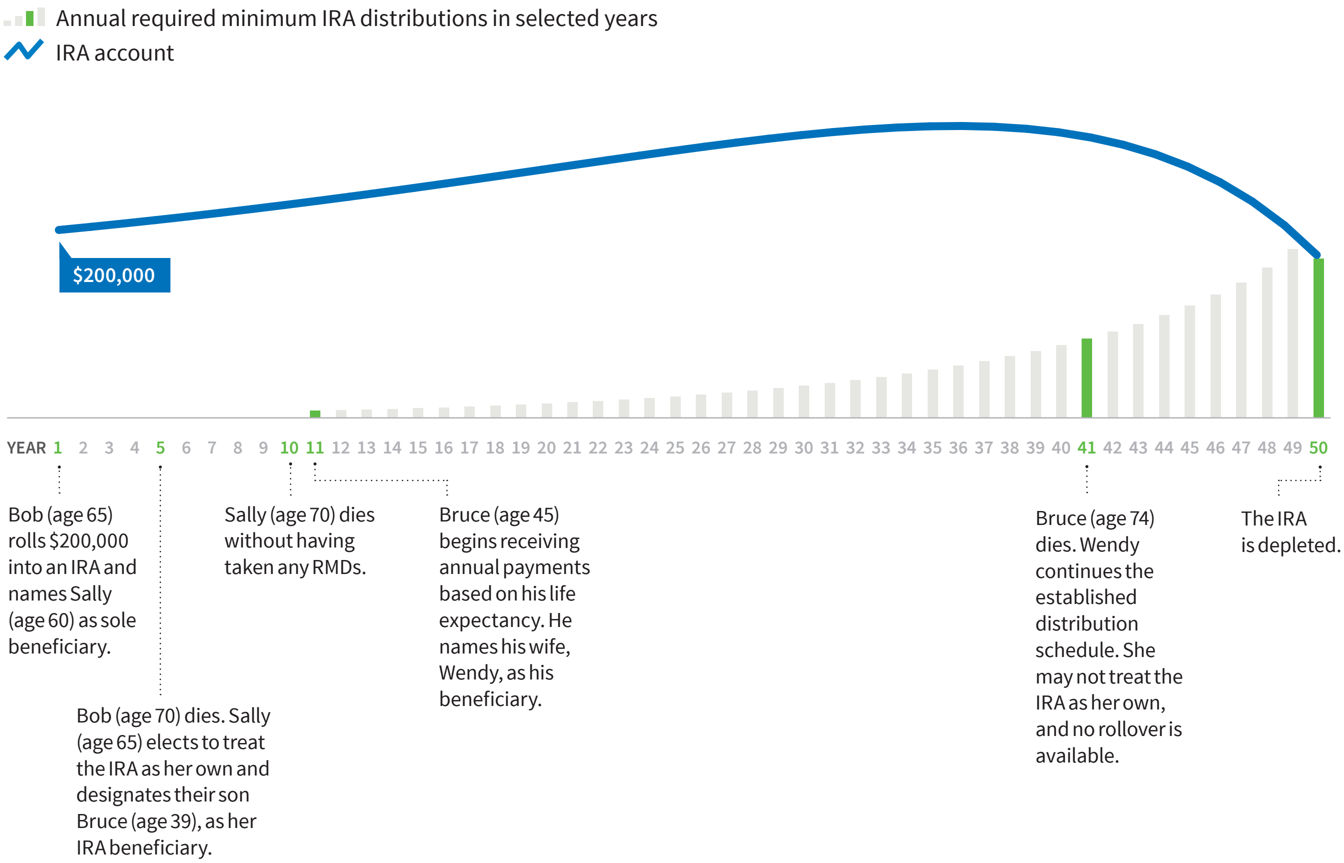
What happens if there is no beneficiary or the beneficiary is an estate?

If there is no beneficiary designated or the beneficiary, such as an estate or trust, does not have a life expectancy, options for stretching out the distributions may be limited. For instance, if the owner has not begun taking minimum distributions, all IRA funds must be distributed within 5 years of the death of the owner. Even if the owner has begun distributions, without a named beneficiary, the distributions can only be stretched out as long as the owner's lifespan.

If the beneficiary is a trust, there may be an opportunity to stretch distributions. When established, the trust may clearly identify beneficiaries by using a "look through" provision. In this case, the trust beneficiaries would have the ability to utilize the stretch IRA strategy. If the beneficiaries identified are people, then life expectancies can be used to calculate distributions.

Stretch IRA example: So how does all this work in the real world?

The possibilities are as varied as IRA owners and beneficiaries themselves. But let's look at an example involving an IRA owner, Bob, and his wife, Sally, who both want to provide for their son, Bruce, and his family. **Stretched for more than 50 years, Bob's $200,000 IRA eventually pays over $3 million in income.**



Income is based upon an initial investment of $200,000 and cumulative annual distributions for 39 years. This hypothetical illustration assumes an 8% annualized return (8.30% effective return) and that distributions are kept to the required minimum. It does not represent the performance of any Putnam fund or investment or take into account the effect of any fees or taxes. Investors should consider various factors that can affect their decision, such as possible changes to tax laws and the impact of inflation and other risks, including periods of market volatility when investment return and principal value may fluctuate with market conditions.

The stretch IRA feature is designed for investors who will not need the money in the account for their own retirement needs.

For more information on stretch provisions or detailed questions on IRAs, please call the Putnam IRA hotline at 1-888-661-7684.

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Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

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