



## “Stretch” IRAs and Life Insurance

Many clients have been relatively successful and have more than sufficient assets to meet their post retirement income needs. Often a large part of their wealth will be concentrated in IRA accounts.

**FACTS:** Paul Andrews (age 70) is such a person. Payments from his pension fund, his deceased wife’s credit shelter trust, and social security will provide him with more than adequate income for his lifetime. He doesn’t envision the need to take income from his IRA to cover his living expenses.

A widower without any direct heirs, Paul has always financially assisted his divorced niece, Kathryn (age 37), and her daughter, Ann (age 11). He would like to provide them with financial protection after his death.

**SOLUTION:** A “stretch” IRA taking just the minimum required distributions (MRDs) might be the most efficient tool for Paul to use. The “stretch” IRA is not a financial product, but a strategy that allows for the extended deferral of tax on assets accumulated in a qualified plan or an IRA. (Since qualified retirement plans are not required to offer minimum required distributions, it may be necessary to transfer assets from a qualified retirement plan to an IRA in order to utilize this strategy.)

In a typical stretch IRA plan, the owner postpones any distributions until the required beginning date (generally age 70½) and then only withdraws the minimum required distribution. By taking MRDs over his/her life, a larger IRA balance is left for the beneficiary. And, by naming a younger person as a designated beneficiary, the payout is spread over the beneficiary’s longer life expectancy. This will allow the power of accumulation and income tax deferral to further compound growth inside the IRA. It is important to remember, that if financial circumstances should change, the IRA owner can always take out more than the MRD.

### Benefits of the stretch IRA:

- More money is kept in a tax-deferred account for continued compound growth

- Potential to leave a larger legacy to the heirs

### Available to:

- Pre-retirees who have assets in employer-sponsored retirement plans
- Retirees wanting to leave a legacy
- High-net-worth individuals with discretionary income

The key to making the “stretch” distribution concept work is maximizing the sum left to the beneficiary. If IRA assets are used to pay transfer taxes in a taxable estate, valuable dollars that would otherwise result from long-term income tax deferral and growth are lost forever. Where there is significant estate tax liability, the solution can be to have life insurance owned inside an irrevocable life insurance trust (ILIT). Or, for smaller estates, the intended beneficiary can own the policy.

At the IRA owner’s death, income tax free death benefits (under IRC 101(a)) can be loaned to the estate to pay taxes, and the IRA balance can pass intact to the designated beneficiary. The combination of the stretch IRA and the life insurance proceeds can potentially maximize the amounts passing to the heirs. And, where the IRA owner does not need the MRDs for his or her support, the after-tax distributions can be gifted to the ILIT or beneficiary/owner to pay life insurance premiums.

**PRODUCT CHOICE:** Paul and his advisors decided that a PruLife® Universal Protector policy with Kathryn as owner/ beneficiary was the appropriate solution. The face amount of \$225,000 will cover estate taxes and other expenses and the annual premium of \$6,906 is well under Paul’s annual gift tax exclusion. In this situation, the premium will also provide a lifetime death benefit guarantee.

### Let’s take a closer look at Paul’s situation.

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By naming one or more designated beneficiaries, IRA owners have an opportunity to determine who receives the money and the number of years that distributions can be “stretched” in order to maximize tax deferral and growth. Not naming a beneficiary limits the deferral or stretch period to the remaining years of the life expectancy of the IRA owner at his/her death; or to a lump sum payout where required – a fatal error for maximizing amounts transferred to the heirs.

Let’s look at some alternatives for Paul. His choices can maximize funds passing to Kathryn and her daughter, helping to ensure their future financial security. The assumptions:

Paul’s estate, 2006:	Total value of assets: \$2,000,000 with an IRA balance of \$1,800,000
Paul’s death, 2008:	Age 72, Minimum required distributions have been taken to date of death
Estate Tax liability, 2008:	\$225,000
Growth rate:	5% (before tax)
Heirs’ Tax bracket:	28%
Life Insurance:	\$225,000 face amount, full pay premium of \$6,906, Lifetime Death Benefit Guarantee <sup>1</sup> (Assumes issue age 70, Preferred Plus class)

### **Scenario 1: No Designated Beneficiary, Life Insurance is Available to Pay Taxes**

During his life, Paul computes his MRD withdrawals using the Uniform Life Table. At his death, assuming that no designated beneficiary was named, future MRD withdrawals to the heirs are computed using the Life Expectancy Table for Paul at his age of death (72). The effect is to reduce the permitted number of years of tax deferral and growth from 24 years to 13 years. Assuming the \$1.8 million IRA goes to his estate and is paid out over 13 years, his heirs would net about **\$2,000,000** after taxes. A better approach would be to name Kathryn as his designated beneficiary.

### **Scenario 2: Kathryn is Named Designated Beneficiary, Life Insurance is Available to Pay Taxes**

Again, assume Paul dies at age 72. However, because Kathryn is the named designated beneficiary, she is able to continue distributions based upon her life expectancy of approximately 44 years. While she is free to withdraw any amount, including the entire balance at anytime, she understands that if she takes MRDs over the 44 years, tax deferral and growth will make it possible for her to receive almost **\$5,000,000** (after taxes). That’s almost \$3 million more than in scenario 1.

But wait – naming a **much** younger beneficiary can further maximize the amounts passing to the heirs.

### **Scenario 3: Disclaimer/Multiple Beneficiaries, Life Insurance is Available to Pay Taxes**

Here, we will assume that Paul named Kathryn as the beneficiary of his IRA and Ann, his grandniece, as the contingent beneficiary. At Paul’s death, Kathryn, if financially secure, could disclaim all or some of the rights to the IRA. Let’s assume she properly disclaimed half of the IRA, so that \$900,000 passes to Ann, the contingent beneficiary, at her age 13.<sup>2</sup> Ann would have a life expectancy of over 70 years during which she could take the MRDs on her \$900,000 IRA. Using the investment and tax assumptions above, Ann would net about **\$6,000,000**. Adding the totals: Kathryn would net about **\$2,500,000** (from the \$900,000 IRA assets she didn’t disclaim) and her daughter would net about **\$6,000,000** for a total IRA distribution of approximately **\$8,500,000**.

The story is in the numbers. A stretch IRA with life insurance funding is a powerful planning tool.

<sup>1</sup> All guarantees are based on the claims-paying ability of the issuer.

<sup>2</sup> If properly executed the disclaimer should have no tax effect on Kathryn. In addition, no generation skipping tax would result, as the disclaimer amount is less than Paul’s 2008 GST applicable exclusion amount of \$2 million.