



Charitable IRA vs. Stretch-Out IRA

by

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There are two significant planning strategies used to enhance the inherited values of retirement funds such as an IRA.

Stretch-Out IRA: This strategy typically involves naming children as income beneficiaries in order to continue the tax deferral of the IRA throughout the life of the next generation. While this does not avoid the estate tax on the death of the IRA owner, it does continue the deferral of the income tax until funds are withdrawn.

With substantial IRAs, the typical approach is to purchase life insurance in a *Wealth Replacement Family Trust* to cover the estate tax so the heirs are *not* forced to withdraw taxable funds from the IRA to cover the estate taxes that are due. This leaves the tax deferred values intact, but minimum distribution rules will force heirs to make ongoing taxable withdrawals.

Charitable IRA: With this approach, the tax deferred IRA is left to charity *at death* (where its tax status is irrelevant). A *Wealth Replacement Family Trust* is set up to hold a life insurance policy in an amount equal to the IRA thereby providing the heirs with *income and estate tax free capital* -- not tax deferred funds.

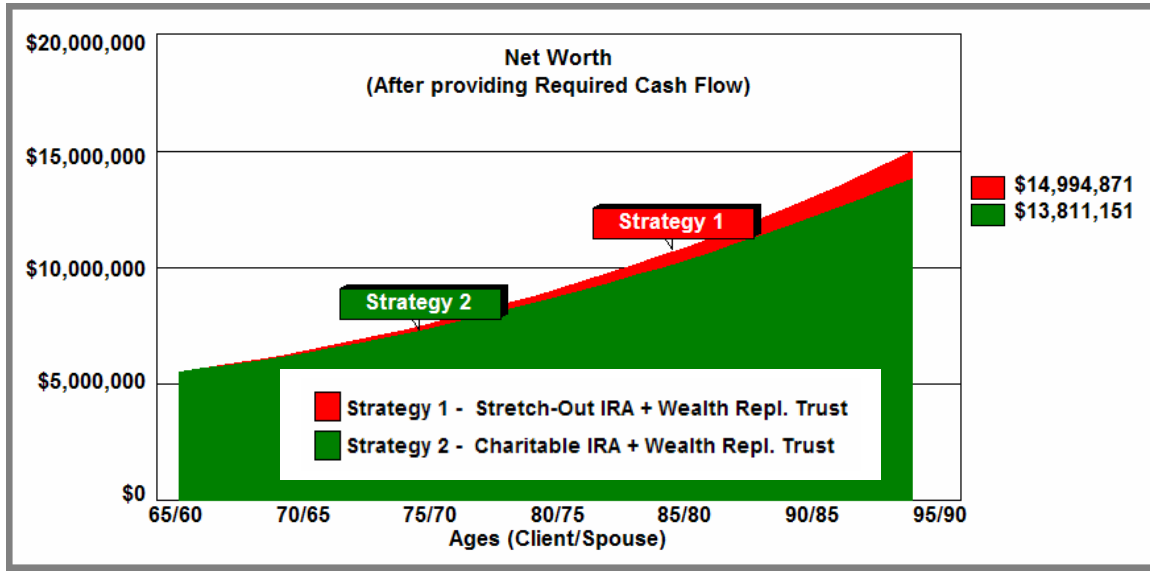
Unlike a Stretch-Out IRA, a Charitable IRA does not saddle the heirs with ongoing IRS compliance and record-keeping or minimum distribution requirements and, unlike the Stretch-Out IRA, the Charitable IRA delivers significant dollars to charity.

Case Study

Harold and Martha Fontaine, ages 65 and 60, have an estate close to \$5.5 million -- including \$1,000,000 in an IRA. Their retirement plan calls for \$150,000 a year in *after tax* income (indexed at 3% as an inflation offset). After providing this level of retirement cash flow, the analysis indicates that their estate is projected to grow to \$16 million over the next 30 years -- including their IRA.

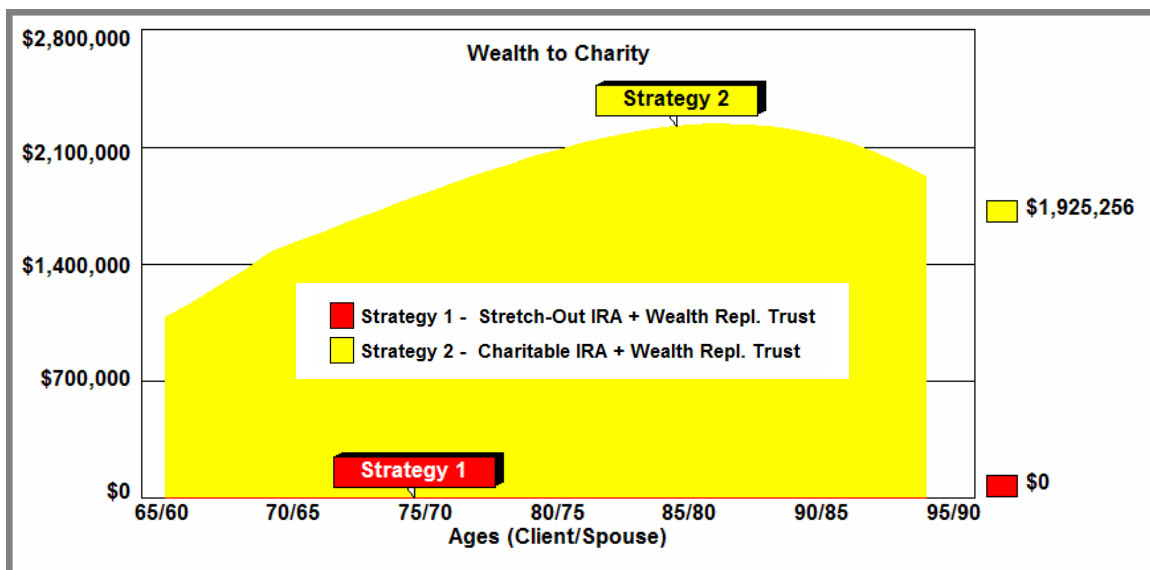
Let's compare the effect of implementing a Charitable IRA versus a Stretch-Out IRA using an analysis from InsMark's Wealthy and Wise[®].

Establishing the Face Amount of the Life Insurance: There are several ways to do this; however, for the Stretch-Out IRA, we used a face amount of \$950,000 (annual premium: \$10,500) to match the high point of federal estate taxes of \$947,928 that is projected to occur at Harold's age 90. For the Charitable IRA, we used a face amount of \$2,250,000 (annual premium: \$25,000) to match the high point of IRA values of \$2,235,623 that is projected to occur at Harold's age 86. The graphic below from Wealthy and Wise shows the effect of both strategies on Net Worth.



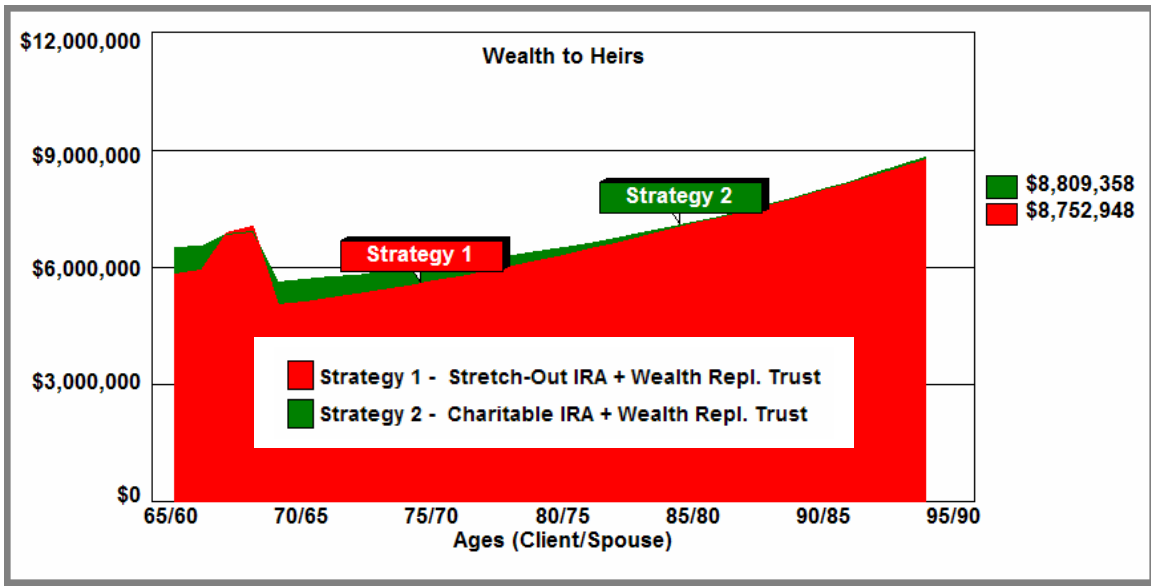
Strategy 2 depletes Net Worth more than **Strategy 1** because of the increased gift to the Wealth Replacement Trust (due to the higher premium of with the Charitable plan).

The graphic below shows the effect on the Fontaines' favorite charitable cause:



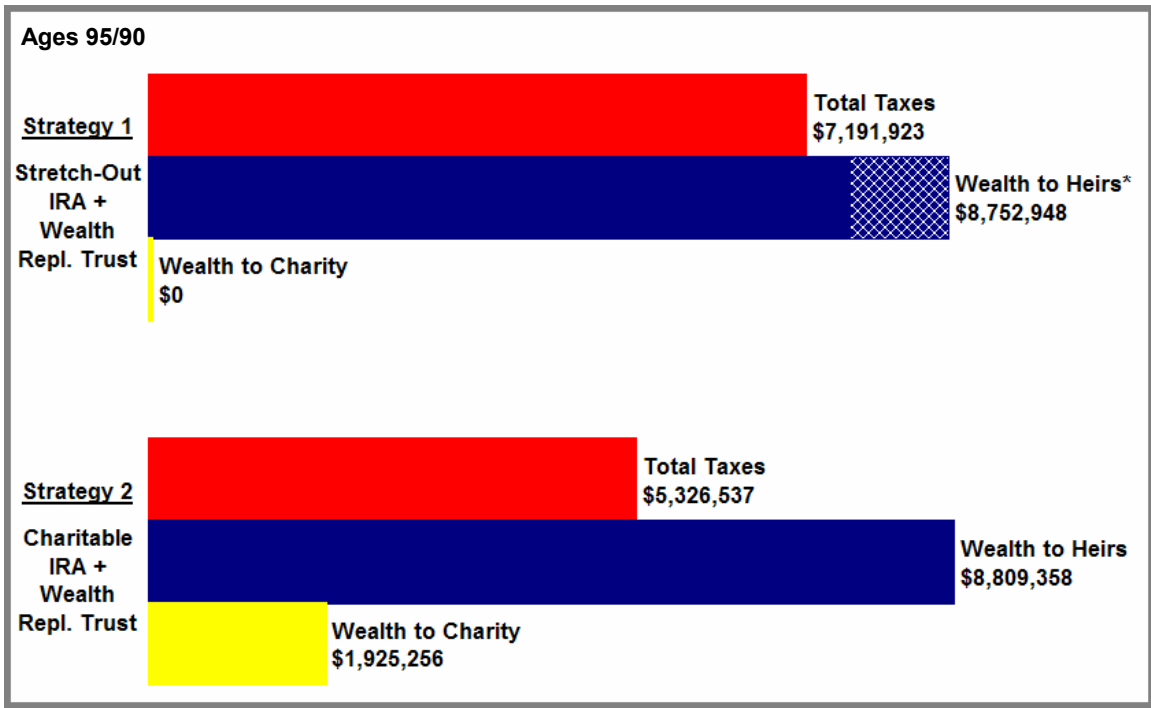
Strategy 1 (the Stretch-Out plan) delivers nothing to charity. **Strategy 2** illustrates a long-range gift of almost \$2,000,000.

Let's now examine the impact on the heirs.



Strategy 2 (the Charitable plan) delivers a few more dollars to the heirs; however, the difference is statistically insignificant.

Below is another way to look at the results.



Strategy 2 (the Charitable plan) delivers *higher quality* dollars since all of the inheritance in **Strategy 2** represents capital with a 100% cost basis. This is not the case with **Strategy 1** as almost \$1,100,000 of the long-range value of the inherited IRA (represented by checkered section of the top blue bar) is fully taxable to the heirs as ordinary income when withdrawn.

What is the source of funds for the gifts required for either plan?

We illustrated an annual transfer from assets to fund the gifts; thus the reduction in Net Worth caused by the higher life insurance premium associated with the Charitable IRA.

Can a Charitable IRA or Stretch-Out IRA be revoked at a later date?

One of the fundamental keys to any financial concept is flexibility, and either plan can be modified or revoked at any time prior to death. You can even swap one for the other -- and back again.

What if the Fontaines live longer than the 30 years shown?

Notice the trend lines in the first three graphs. You can infer the continuance of those trend lines.

Does either plan restrict Harold and Martha's access to the IRA funds during their lifetimes?

With either plan, all IRA assets are freely available during both their lifetimes.

Regarding the Charitable IRA, must the Fontaines obtain permission from the charitable beneficiary in order to access funds from the IRA during their lifetimes?

No -- the IRA remains totally in their personal control.

With the Charitable IRA, can different charities benefit?

Yes. An easy way to do this is to make the beneficiary of the IRA a "donor-advised" account at a public operating charity. Many Community Foundations offer this option.

Conclusion: From the taxpayer's perspective, this comparative analysis provides the data to make an informed decision regarding either plan. From the heirs' perspective, the analysis provides vital information regarding the quality of inherited funds. From the advisers' (attorney, CPA) perspective, a Charitable IRA is legally as justified as a Stretch-Out IRA -- with the former requiring far less inter-generational paperwork. From the charity's perspective, dollars developed from the Charitable IRA are donated on a "I can't afford not to" basis -- thus generating far more potential for deferred gifts than almost any other concept.

Illustration Data: For this analysis, we used Version 8.1 of Wealthy and Wise. Space prevents us from including all the reports generated; however, those who are licensed for Wealthy and Wise can download a Workbook containing the reports along with the menu prompts at <http://www.insmark.com/WorkbookDownload/ConceptLibrary.html>. Look for the file named "Charitable IRA(CL)!WW"; double click it to import it into your System.

Note this selection found under the Pension tab that illustrates Stretch-Out IRA:

Set the heirs' income tax bracket to 0% for transfer taxation of pension assets in order to illustrate the effect of a "stretch-out" pension strategy.

Note this selection found under the Pension tab that illustrates Charitable IRA:

Include Charitable Bequests at age:
 100.00 % of pension asset value

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