By **Bruce D. Steiner**

Charitable Remainder Trusts Replicate the Stretch for IRAs

There are some tradeoffs to consider

The Setting Every Community Up for Retirement Enhancement Act of 2019 (the SECURE Act) was enacted as part of the Further Consolidated Appropriations Act, 2020.[1] Under the SECURE Act, qualified plan and individual retirement account benefits generally have to be distributed within 10 years of the IRA owner's death.

There are several exceptions:

- A spouse may take distributions over his life expectancy. The balance must be distributed within 10 years after the spouse's death. As under prior law, a spouse may roll the benefits over into his own IRA.
- A minor child may stretch distributions over life expectancy until reaching majority, at which time the balance must be distributed within 10 years. For this purpose, a minor child is deemed not to reach majority until completing a specified course of education, but not beyond age 26.
- A disabled or chronically ill person may stretch distributions over his life expectancy. The balance must be distributed within 10 years after the beneficiary's death.
- A trust for the benefit of a disabled or chronically ill individual may stretch distributions over the beneficiary's life expectancy. The balance must be distributed within 10 years after the beneficiary's death.

Use of CRT

An IRA owner may replicate the stretch by naming a charitable remainder trust (CRT) as the beneficiary of his IRA. A CRT is a trust that distributes a percentage of the trust assets to one or more individual beneficiaries for life or for a term of up to 20 years. At that point, the trust ends, and the balance of the assets goes to charity.[2]

The percentage of trust assets distributed must be at least 5% but not more than 50%.[3] The payments may be fixed based on the value of the trust at the inception (a charitable remainder annuity trust (CRAT))[4] or may vary based on the value of the trust each year (a charitable remainder unitrust (CRUT)).[5]

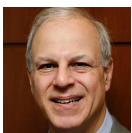
The actuarial value of the charity's remainder interest must be worth at least 10% of the value of the trust as of the inception.

A CRT is tax-exempt.[6] Distributions from a CRT are taxable in four tiers. They're ordinary income to the extent of the trust's current and accumulated ordinary income. After the ordinary income is used up, the payments are taxable as capital gains to the extent of the trust's current and accumulated capital gains. After the capital gains are used up, the payments come out of other income (that is, tax-exempt income) to the extent of the trust's current and accumulated other income. After the other income is used up, the payments are principal.[7]

Within each tier, the highest tax rate items are distributed first. Thus, for example, taxable interest is distributed before qualified dividends and short-term capital gains before long-term capital gains.[8] Because a CRT is tax-exempt, it may take the retirement benefits in a lump sum tax-free.

Because the payments from a CRUT are adjusted each year based on the value of the trust, a CRUT provides inflation protection. In addition, because the payments from a CRUT are adjusted annually based on the current value of the trust, a CRUT will never be exhausted.

By contrast, because the payments from a CRAT are based on the initial value of the trust, a CRAT doesn't



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provide inflation protection. In addition, a CRAT may be exhausted if there's a severe drop in the value of the trust assets.

Because the CRT is intended to last for a long period of time so as to replicate the stretch, an IRA owner will more likely select a CRUT to obtain inflation protection and avoid the risk of the trust being exhausted.

At one time, a CRUT could last for the lives of as many beneficiaries living at the inception of the trust as desired. A client could have created a CRT with unitrust payments going to his issue until the death of the last survivor of the client's issue who was living at the inception of the trust. The value of the charity's remainder interest would have been minuscule.

However, in 1997, Congress required that the actuarial value of the charitable remainder interest in a CRUT be at least 10% of the initial value of the trust, effective for unitrusts created after June 18, 1997. This limits the duration of a CRUT.

At the 2.2% Internal Revenue Code Section 7520 interest rate in effect in February 2020, it's not possible to create a CRUT for the life of a beneficiary under age 27. However, an IRA owner could create a 20-year CRT with the highest permissible payout (11.114% payable annually) for a beneficiary regardless of age.

The most common use of a CRT has been to sell a highly appreciated asset to diversify without current capital gains tax. The effect is to spread the capital gains over a number of years, replicating the installment method. However, unlike an appreciated asset, which the owner could continue to hold until death to obtain a basis step-up, there's no basis step-up at death for an IRA.

CRTs were common for retirement benefits before the Internal Revenue Service overhauled the proposed regulations in 2001. Until then, IRA owners had to choose between the term certain method and the recalculation method (or a hybrid method). If an IRA owner elected recalculation and didn't have a spouse beneficiary, the entire balance had to be distributed by the end of the year following the IRA owner's death. A CRT was a common workaround to replicate the stretch. Now that the stretch is generally limited to 10 years, CRTs will return as workarounds.

CRT vs. 10-Year Stretch

To compare a CRT to a 10-year stretch, planners have to make assumptions as to the investment return within the CRT, the beneficiary's after-tax return on the distributions from the CRT and how long the beneficiary is likely to live.

The minimum 5% payout rate may provide more wealth to the beneficiary if the CRT is expected to last for a long time. On the other hand, the maximum payout rate that will satisfy the 10% rule may provide more wealth to the beneficiary if the CRT isn't expected to last for a long time. For younger beneficiaries, the highest payout rate that will satisfy the 10% minimum value for the charitable remainder interest may not be much higher than 5%, so it may not make much difference whether the payout rate is 5% or the highest permissible payout rate.

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Because there's no way to know what the IRC Section 7520 rate will be when the IRA owner dies, the IRA owner could provide that the payout rate will be the highest permissible rate at the time of his death (that is, the rate that results in the actuarial value of the charity's remainder interest being 10%). Alternatively, the IRA owner could provide for the minimum 5% payout rate.

In the initial years, all of the distributions will be ordinary income due to the IRA proceeds. For example,

if the payout rate is 5%, the distributions will be entirely ordinary income for the first 20 years.

After all of the IRA proceeds have been distributed, the character of the payments will depend on how the trust invests the proceeds of the IRA. If the trustees want to minimize the beneficiary's taxes, they could invest primarily in stock index funds. However, trustees have to invest in a prudent manner, taking into account all of the relevant facts and circumstances.

Instead of using a CRT, the IRA owner could leave the IRA to or in trust for the beneficiaries. The trustees or beneficiaries could wait until the end of the 10th year following the IRA owner's death and then withdraw the entire IRA, so that the IRA could grow for an additional 10 years. Or, the trustees or beneficiaries could take some distributions from the IRA before the end of the 10-year period so as to take advantage of the graduated income tax brackets of both the trust and the beneficiaries. Of course, distributions will throw the amounts distributed into the beneficiaries' estates and expose them to the beneficiaries' creditors and spouses. In either case, after 10 years, the entire IRA will have been distributed, and the trust or beneficiaries will be taxed on the subsequent investment income.

Even if the family would be slightly better off without a CRT, some IRA owners will still be amenable to leaving their retirement benefits to a CRT because it will enable them to leave a substantial amount to charity at very little cost.

Depending on a beneficiary's age, the benefit of the stretch through the CRT may offset or outweigh the loss of the remainder interest. As a result, the beneficiary is likely to be equally well off or better off receiving unitrust payments for life rather than receiving the IRA outright, limited to a 10-year stretch.

In addition, by having to take the complete distribution within 10 years, the income will be bunched into fewer years and may be taxable in higher brackets than if the beneficiary received CRT payments over his lifetime.

Of course, the family's actual result will depend on how long a particular beneficiary lives. The result will be better if the beneficiary of the CRT lives a long time and worse if he doesn't. A beneficiary of a CRT can protect against the risk of dying early and losing out on the expected unitrust payments by buying life insurance.

If the children or grandchildren are old enough to satisfy the 10% rule, the CRT could provide for unitrust payments to be made to the children or grandchildren and the survivor or survivors of them, with the remainder to charity at the death of the last survivor of them. If not, then the remainder of each child or grandchild's share would go to charity on his death.

A CRT is best for a young beneficiary because he's likely to live for a longer period of time. As set forth above, using the Section 7520 rate of 2.2% in effect in February 2020, the beneficiary has to be at least 27 years old for a 5% unitrust to satisfy the 10% rule. IRA owners with grandchildren who are at least 27 years old should consider leaving their IRAs to them in CRTs, assuming their children are otherwise provided for.

Depending on the ages, it may also be possible to create a CRT for two generations. For example, a 5% unitrust for the life of a child age 54 and then for the life of a grandchild age 30 will satisfy the 10% rule.

The IRA owner may specify the charities that will receive the remainder or may permit the beneficiaries to select the charities. If the IRA owner permits the beneficiaries to select the charities, the IRA owner should select the charities that will receive the remainder of the trust if the beneficiaries fail to select charities.

Tradeoffs

While a CRT is likely to provide the beneficiaries with more money than if they received the IRA outright, there are some tradeoffs to a CRT.

A CRT is less flexible than an accumulation trust because the payments may not vary from year to year except based on changes in the value of the trust. Therefore, an IRA owner probably wouldn't use a CRT unless a beneficiary had other money available (either the beneficiary's own money or the IRA owner's other

assets) to cover any nonrecurring needs he may have.

With a limited exception for special needs beneficiaries, the payments to the noncharitable beneficiaries must be outright. This will throw the payments into the beneficiaries' estates and expose them to the beneficiaries' creditors and spouses.

Because the payments to the beneficiaries must generally be outright, a CRT works best for beneficiaries who'll likely need substantial distributions, aren't likely to have taxable estates and are likely to use, rather than accumulate, the money.

There's an economic cost to a CRT because the value of the charitable remainder interest has to be at least 10% of the value of the trust as of the inception.

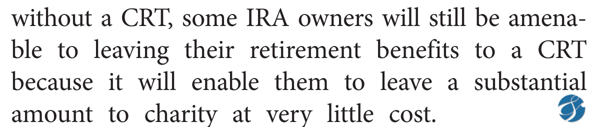
The IRS has issued sample forms for CRTs in Revenue Procedures 2005-52 through 2005-59.

There's also some cost and complexity to administer a CRT. A CRT has to file annual income tax returns on Form 5227. This form is more complicated than the Form 1041 for a noncharitable trust.

Some states require CRTs to register with the attorney general. Also, two states (New Jersey and Pennsylvania) don't exempt CRTs from state income tax purposes. The state income taxes in New Jersey and Pennsylvania aren't based on the federal income tax. New Jersey taxes trusts based on the residence of the testator or grantor. However, New Jersey doesn't tax a trust if there's no trustee in New Jersey, no real or tangible property in New Jersey and no New Jersey source income.[9] Nor does Pennsylvania tax a trust created during lifetime and not by will if there's no trustee in Pennsylvania, no real or tangible property in Pennsylvania and no Pennsylvania source income.[10] Moreover, neither New Jersey nor Pennsylvania has a throwback rule. So, IRA owners in New Jersey and Pennsylvania can avoid New Jersey or Pennsylvania income tax, respectively, on the IRA proceeds by making sure there's no trustee in the state in the year the CRT receives the IRA proceeds, and in the case of Pennsylvania, creating the trust under a separate trust instrument rather than under the will.

The IRA owner may select the trustee(s). The beneficiary of the CRT may be a trustee and may have the power to remove and replace his co-trustee. If there are subsequent individual beneficiaries, the replacement trustee should be someone not related or subordinate to the child. The trustees may receive commissions (fees) for serving as trustees.

Even if the family would be slightly better off



without a CRT, some IRA owners will still be amenable to leaving their retirement benefits to a CRT because it will enable them to leave a substantial amount to charity at very little cost.

Endnotes

1. H.R. 1865 (116th Cong., 1st Sess.), P.L. 116-94.
2. Internal Revenue Code Section 664.
3. IRC Sections 664(d)(1)(A) and 664(d)(2)(A).
4. Section 664(d)(1).
5. Section 664(d)(2).
6. Section 664(c)(1).
7. Section 664(b); Treasury Regulations Section 1.664-1(d)(1)(a).
8. Treas. Regs. Section 1.664-1(d).(1)(b).
9. *Pennoyer v. Director*, 5 N.J. Tax 386 (1983) (testamentary trust); *Potter v. Director*, 5 N.J. Tax 399 (1983) (inter vivos trust).
10. *McNeil Trust v. Commonwealth of Pennsylvania*, 67 A.3d 185 (Commonwealth Ct. of Pa. 2013).

SPOT LIGHT

Serenity

La Bretagne, La Vallée Du Guilly, Moëlan by Maxime Maufra sold for GBP 62,500 at Sotheby's Impressionist & Modern Art Day Sale on Feb. 5, 2020 in London. Though he was encouraged to start painting by some prominent artists, Maufra didn't fully embrace art as a full-time career right away. He eventually gave up his business to pursue art and focused on painting landscapes and marine scenes.