New Ideas for Charitable Remainder Trusts

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Charitable remainder trusts may be due for a bigger role in IRA planning. The primary factors are demographic, with millions of baby boomers entering retirement each year. Boomers have higher divorce rates than preceding generations, different values and greater life expectancies that extend the need for cash flow for more years.

An additional issue centers on a current proposal to mandate a five-year withdrawal of inherited IRAs.

To minimize estate taxes, advisors have focused estate planning efforts in recent years on the bypass trust (also called a credit shelter or applicable exclusion trust). Such a trust would allow a surviving spouse to benefit from the assets in the trust, while keeping them from being included in his or her estate.

A common approach to estate planning for IRA assets was to name the bypass trust as a beneficiary of the IRA account. This would let clients use an IRA to fund the bypass, and by doing so reduce the estate tax owed. But the IRA balance must then be withdrawn based on the surviving spouse's life expectancy.

The 2012 Tax Act made high estate-tax exemptions permanent, at $5.34 million in 2014 for a single taxpayer and $10.68 million for a married couple. At the same time, it also locked in new portability rules allowing the surviving spouse to capture, or port, the unused exemption of the spouse who dies first.

INCOME TAX VS ESTATE TAX

When dealing with IRAs, it is often more advantageous for income tax purposes to permit the surviving spouse to roll over the IRA account. The surviving spouse can then withdraw funds from the IRA using the recalculation method that stretches payments furthest.

In the past, capturing that income tax benefit could result in losing estate-tax protection. Under the new rules, however, the surviving spouse can roll over the IRA and use portability to retain the estate-tax benefit.

Planners should be sure to review all old beneficiary designations and determine when to revise these more complex bypass trust funding designations. Naming the surviving spouse instead of the trust as beneficiary will greatly simplify the beneficiary designation.

If an irrevocable trust was created distinct from the will and is no longer needed, it might be advisable to terminate that trust once the beneficiary is updated so the client's records are clear.

CHARITABLE STRATEGY

For charitably minded clients, there's another set of options: Upon death, the balance in the IRA could be paid out to a charitable remainder trust instead of the spouse.

There are several reasons that clients might want to consider naming a charitable remainder trust as beneficiary of their IRAs.

Because that trust is a tax-exempt entity, the payout from the IRA shouldn't trigger any income tax at the time. (This could be a significant consideration, given the new higher tax brackets.)

The charitable benefit may also appeal to many boomer clients, as could the trust's required cash flow.

There are different ways to designate beneficiaries of the trust. A client could create a charitable remainder trust that is structured only to make payments to the spouse. On the surviving spouse's death, the assets remaining in the trust could pass to charity. But during the spouse's lifetime, the trust could then make a minimum 5% annuity payment to the surviving spouse - assuring a cash flow stream for his or her full lifetime.

FAMILY ISSUES

When the client has children from multiple marriages, a charitable trust might also become an important safeguard for the family. Rather than merely naming the surviving spouse as the IRA beneficiary, the client effectively keeps the surviving spouse from draining the entire IRA balance and depriving children from a prior marriage of any benefit.

The client could set up the charitable remainder trust to pay 5% of the value of the trust assets to the surviving spouse for his or her lifetime. Then, after that spouse dies, the children can receive the 5% payment for their lifetimes.

This approach assures a significant payout for the children as well as the spouse.

The amount estimated to be distributed to the charity upon the death of the last child must be at least 10%. Thus, the surviving spouse and the children must all be of sufficient age so that this test can be met.

POSSIBLE RULE CHANGE

There's another factor that could change the face of estate planning for IRAs.

A key estate planning strategy for IRAs was to stretch the payout period from the IRA as long as possible for heirs. Generally, advisors tried to have withdrawals made over the life expectancy of the beneficiary.

Now, however, federal lawmakers are considering a significant change in the rules governing distributions from inherited IRAs. (As of last month, the change was included in an amendment to a transportation bill that passed the Senate.)

If the measure becomes law, it would require distributions of inherited qualified retirement plans and IRAs to be made within five years of the death of the account holder.

Such a change would make it even more desirable for a client to name a charitable remainder trust as beneficiary of his or her IRA because it would extend the period over which the beneficiary could defer the distributions.

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