Charitable Planning with Retirement Assets

Legacy IRAs and charitable remainder trusts are powerful tools to help defer or avoid certain taxes.

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Individual retirement accounts were created in 1974 to encourage employees without pensions to save for retirement. Almost 50 years later, it's fair to say that Congress never envisioned that IRAs would become a significant source of some taxpayer's wealth and the subject of estate and charitable planning discussions. In recent years, Congress has adopted legislation to, in part, address the lost income tax revenue tied up in IRAs. These laws have provided taxpayers with planning opportunities to defer or avoid income taxes on retirement assets.

Charitable Remainder Trust as Beneficiary

The SECURE Act of 2019 limited, with few exceptions, the "stretch IRA" (whereby a beneficiary was able to "stretch" distributions of the IRA over her life expectancy, thus extending the income tax deferral) and requires beneficiaries of an IRA to liquidate the account within 10 years. Because all the distributions are taxed as ordinary income, this represents a substantial tax bite for the beneficiaries of taxpayers who have a large IRA. Fortunately, there's an alternative planning technique to mitigate these onerous income taxes, especially for charitably inclined taxpayers.

An IRA owner may name a charitable remainder trust (CRT) as beneficiary of the account and obtain two benefits: (1) the taxpayer's estate receives a charitable deduction for the portion of the CRT attributable to charity; and (2) distributions to the beneficiary are only taxed as income is distributed from the trust (thus deferring immediate income taxation on the entire IRA balance). Thus, this type of planning may make sense for a taxpayer looking to reduce their taxable estate while possibly deferring income recognition longer than the 10 years required by the SECURE Act.

CRT Mechanics

Here's the mechanics of a CRT:

- IRA owner sets up an irrevocable trust that will be the beneficiary of the IRA on the taxpayer's death.
- The trust provides the beneficiary with a minimum 5% income interest for either the life of the beneficiary or a term not to exceed 20 years.
- The trust can be either a "unitrust," which requires a percentage of the current value of the trust assets to be distributed to the beneficiary each year (thus adjusting each year based on the value of the trust), or an "annuity trust," in which a set amount based on the initial value of the trust is distributable each year.
- The actuarily-calculated remainder value that will be distributed to the charity must equal at least 10% of the beginning value of the trust.
- Taxes are paid only as distributions are made using a complex tax structure applicable to CRTs: first as ordinary income and qualified dividends to extent generated; next as capital gains; next as tax-exempt income and finally as return of principal.

Because a CRT is a tax-exempt entity, there's an additional benefit if the IRA's assets are concentrated – the assets can be sold to allow for diversification without triggering immediate income taxes.

Example

Assume a taxpayer has a $5 million IRA and names as beneficiary a CRT with a 7% income interest for life of the beneficiary who's 55 years old on the date of the taxpayer's death. The taxpayer's estate will be entitled to a charitable deduction of over $1.1 million (potentially resulting in an estate tax savings of $440,000), and the beneficiary will receive an income stream of $350,000 annually. Any remaining assets in the trust on the death of the beneficiary will be distributed to the named remainder beneficiary.

There are a couple caveats to this type of planning. It's likely not appropriate for IRA owners not otherwise charitably inclined or when the intended beneficiary is so young that the planning likely won't satisfy the rule that 10% of the CRT value must go to charity. The beneficiary also loses option to withdraw more than the unitrust amount annually.

Legacy IRA

More recent legislation, dubbed the "Legacy IRA Act" and passed in December 2022, encourages charitable giving by enabling a taxpayer to make tax-free contributions from IRAs to charities through life income plans. This builds on earlier legislation that allowed an individual to make distributions from his IRA directly to charity of up to $100,000 annually, thereby avoiding income tax on required minimum distributions. Note that donors don't receive a charitable deduction for these distributions.

Specifically, the Legacy IRA Act allows donors over age 70½ to make a qualified charitable distribution in exchange for a charitable gift annuity or to fund a CRT. However, the benefits of this legislation are limited because such distribution is limited to $50,000 and can only be made in one tax year. While this law is a good first step, charities are hopeful for future enhancements to the Legacy IRA Act.

Looking Ahead

Taxes on individuals are poised to increase after 2025, due to the lapse of some of the tax changes made by the Tax Cuts and Jobs Act of 2017 (TCJA). Congress has three choices – extend all those tax changes, extend none or meet somewhere in the middle. In Washington, we can expect Members of Congress to introduce legislation, congressional tax-writing committees to hold hearings on the impact of these tax changes lapsing and a surfeit of debate over the merits of each of the TCJA tax benefits to fill the gap between now and the end of 2025. We believe Congress will negotiate its way toward meeting somewhere in the middle, that is, extending some but not all the individual tax benefits in TCJA.

As Congress focuses attention on these important tax issues, advocates for enhancements to the SECURE Act of 2019 and Legacy IRA Act should look for opportunities to ride along with, what we believe, will be a meaningful extension of some of the TCJA tax benefits.

Advocates might want to point to the Great Wealth Transfer as a very good reason to provide enhanced charitable giving incentives so that a more meaningful portion of that $84 trillion will be captured by the nonprofit sector to support communities around the country.

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