THE ESTATE PLANNER

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CAN A CHARITABLE TRUST REPLICATE A STRETCH IRA?

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Can a charitable trust replicate a stretch IRA?

The "stretch" IRA is no more. But if you have a substantial balance in a traditional IRA, a properly designed charitable remainder trust (CRT) can allow you to replicate many of its benefits.

SECURE Act's effects on stretch IRAs

For years, a CRT has been a simple yet highly effective tool that allows one's children or other beneficiaries to stretch inherited IRA savings over their life expectancies. This was a big advantage, because it allowed funds to continue growing and compounding on a tax-deferred basis potentially for decades. But in late 2019, the SECURE Act essentially killed the stretch IRA by requiring most beneficiaries of inherited IRAs (other than your spouse) to withdraw all of the funds within 10 years.

Requiring heirs to withdraw IRA funds more quickly means they'll have to pay income taxes on those funds whether they need the money or not — it may even push them into a higher tax bracket. Note that the new rules don't apply to spouses who inherit IRAs. As before, they may roll the funds into their own IRAs and defer distributions until they reach age 72. In addition to your spouse, the SECURE Act designates several other potential beneficiaries for which a stretch IRA is still an option:

- A person who isn't more than 10 years younger than you (whether related to you or not),
- A disabled or chronically ill person (as defined by the SECURE Act), or
- A minor child, provided he or she is the sole beneficiary of a separate share of the IRA, either outright or in trust.

For a minor child, annual distributions may be based on the child's life expectancy until he or she reaches the age of majority (usually 18 or 21), after which the remaining IRA funds must be distributed within the next 10 years. The SECURE Act also provides that the beginning of the 10-year distribution period may be delayed until age 26 if the child is pursuing a "specified course of education."

The charitable solution

Leaving your IRA to a CRT can come close to duplicating the benefits of a stretch IRA. It allows your beneficiaries to receive

How long can you go?

Although a charitable remainder trust (CRT) can mimic the benefits of a stretch IRA, there are limits to how long it can spread out distributions to your heirs. That's because IRA rules require that the actuarial value of the remainder interest left to charity — determined at the time the trust is funded — must be at least 10% of the trust's initial value. This requirement creates a floor for how young the noncharitable beneficiaries can be and still receive distributions over their lifetimes.

Although the floor depends on several factors, including the applicable federal interest rate, generally speaking, a lifetime CRUT requires the beneficiaries to be at least in their 40s, and substantially older for a CRAT. Any younger and the trust will not be able to pass the 10% test. Note, however, that even if a lifetime CRT isn't possible, the noncharitable beneficiaries will still enjoy significant benefits by spreading distributions over a 15 or 20-year term rather than 10 years.

distributions over a term of up to 20 years, or in some cases over their lifetimes (or joint lifetimes). And even though the trust must preserve some of its assets for charity, the tax savings enjoyed by your heirs often make up for the loss of principal.

A CRT allows your beneficiaries to receive distributions over a term of up to 20 years, or in some cases over their lifetimes (or joint lifetimes).

Here's how it works: You provide in your estate plan that on your death your IRA will be transferred to a CRT. A CRT is an irrevocable trust that pays out a percentage of its assets to your children or other beneficiaries for life (or for a term of up to 20 years) and then distributes its remaining assets to one or more charities. A CRT is a tax-exempt entity, so any assets you contribute to the trust — including IRAs — aren't subject to tax unless they're distributed to noncharitable beneficiaries.

There are two types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT). Both pay out a fixed percentage of the trust's assets, ranging from 5% to 50%, to your beneficiaries. The difference is that CRATs pay out a percentage of the trust's *initial* value while CRUTs pay out a percentage of its value, recalculated annually.

The longer distributions can be stretched out, the closer a CRT comes to replicating a stretch IRA. It's important to note, however, that the trust's ability to do so depends on the age of your beneficiaries when you die. (See "How long can you go" above.)

Explore your alternatives

The CRT is just one potential strategy for replicating the benefits of a stretch IRA. If a significant portion of your wealth is in a traditional IRA, consult your estate planning advisor to discuss additional alternatives for easing the tax and financial impact of an inherited IRA on your heirs. Other possibilities may include converting your traditional IRA into a Roth IRA, naming your spouse as primary beneficiary of your IRA or purchasing life insurance. ▮

Power up your trust with Crummey powers

The unified gift and estate tax exemption is set at an inflation-adjusted $11.7 million for 2021, up from $11.58 million for 2020. This means that for many families, estate tax liability isn't a factor. However, for others, the annual gift tax exclusion continues to be an important estate planning strategy. For this reason, using a Crummey trust in your estate plan remains an important estate planning strategy. Here's why.

Using the annual gift tax exclusion

Under the annual gift tax exclusion, you can give gifts to each recipient, valued up to a specific limit, without incurring any gift tax. The limit for 2021 is $15,000 per recipient, the same as it was in 2020. (This amount is indexed for inflation, but only in $1,000 increments.)

Therefore, if you have, for example, three adult children and seven grandchildren, you can give each one $15,000 this year, for a total of $150,000, and pay zero gift tax. The exclusion is per donor, meaning that for a married couple the amount is doubled.

If you give outright gifts, however, you run the risk that the money or property could be squandered, especially if the recipient is young or irresponsible. Alternatively, you can transfer assets to a trust and name the child as a beneficiary. With this setup, the designated trustee manages the assets until the child reaches a specified age.

A trust with Crummey powers satisfies the rules for gifts of a present interest without requiring the trustee to distribute the assets to the beneficiary.

But there's a catch. To qualify for the annual exclusion, a gift must be a transfer of a "present interest." This is defined as an unrestricted right to the immediate use, possession or enjoyment of the property or the income from it. Without certain provisions in the trust language, a gift to the trust doesn't qualify as a gift of a present interest. Instead, it's treated as a gift of a "future interest" that's not eligible for the annual gift tax exclusion.

Giving Crummey powers to a trust

This is where a Crummey trust can come to the rescue. It satisfies the rules for gifts of a present interest without requiring the trustee to distribute the assets to the beneficiary.

Typically, periodic contributions of assets to the trust are coordinated with an immediate power giving the beneficiary the right to withdraw the contribution for a limited time. However, the expectation of the donor is that the power won't be exercised. (The trust document cannot expressly provide this.)

As a result, the beneficiary's limited withdrawal right allows the gift to the trust to be treated as a gift of a present interest. Thus, it qualifies for the annual gift tax exclusion. Note that it's the existence of the legal power — not the exercise of it — that determines the tax outcome.

Avoiding pitfalls

To pass muster with the IRS, the beneficiary must be given actual notice of the withdrawal right, along with a reasonable period to exercise it. Generally, at least 30 days is required.

It's recommended that you spell out the notification in writing. Also, you should obtain a written acknowledgment from the beneficiary or the beneficiary's representative. Furthermore, the trust may limit the withdrawal right to the lesser of the amount of the annual gift tax exclusion or the fair market value of the property contributed to the trust.

Finally, the IRS may challenge arrangements that provide limited withdrawal rights without any other economic interest in the income or principal of the trust. These are sometimes referred to as "naked" Crummey powers. Accordingly, the IRS has ruled that the beneficiaries of a Crummey trust must have an actual economic interest in the trust property to meet the present interest requirement. (For example, the beneficiaries should have a vested right to principal or income.)

Handle with care

A Crummey trust can be an effective estate planning tool, however, it must be carefully designed and operated not to run afoul of the IRS. Consult closely with your estate planning advisor before taking any action. ▮

Net gift technique can reduce your gift tax rate

If you're concerned about the impact of transfer taxes on your gifts, consider making "net gifts" to your loved ones. A net gift is simply a gift for which the recipient agrees to pay the gift tax, thereby reducing the value of the gift for tax purposes. It may also be possible to reduce its value further through the "net, net gift" technique. You can even finance your loved one's tax liability to ensure that he or she receives the full amount of your gift.

How does a net gift reduce taxes?

The easiest way to demonstrate the benefits of a net gift is through an example. Suppose you wish to make a $1 million gift to your adult son. For purposes of this example, also assume that you've already exhausted your federal gift and estate tax exemption amount, so the gift is fully taxable. At the current 40% marginal rate, the tax on your $1 million gift would be $400,000. However, if your son agrees to pay the gift tax as a condition of receiving the gift, then the value of the gift would

be reduced by the amount of tax, which in turn would reduce the amount of gift tax owed.

Rather than get caught up in an endless loop of calculating the tax, reducing the gift's value, recalculating the tax, and so on, there's a simple formula for determining your son's tax liability: Gift tax = tentative tax/(1 + tax rate). In our example, the tentative tax is $400,000 (the tax that would have been owed on an outright gift), so the gift tax on the net gift would be $400,000/1.4 = $285,714. You can confirm that the math works out by assuming that you give your son $1 million and that he agrees to pay $285,714 in gift taxes. That tax liability reduces the gift to $1 million - $285,714 = $714,287, resulting in a tax liability of .40 x $714,287 = $285,714.

It may be possible to reduce the effective gift tax rate even further by using a net, net gift.

By using a net gift technique, you reduce the effective tax rate on the $1 million transfer from 40% to only 28.57%. Note that if the gift is in the form of appreciated assets rather than cash, the recipient's payment of the tax liability can result in capital gains taxes for the donor.

What is a net, net gift?

It may be possible to reduce the effective gift tax rate even further by using a net, net gift. Under this technique, in addition to assuming liability for gift taxes, the recipient also agrees to pay any estate tax liability that might arise by virtue of the so-called "three-year rule." Under that rule, gifts made within three years of death are pulled back into the donor's estate and subject to estate taxes. The U.S. Tax Court has given its blessing to the net, net gift technique, allowing the value of a gift to be reduced by the actuarial value of the recipient's contingent obligation to pay estate taxes that would be owed if the donor were to die within three years of making the gift.

How does a financed net gift work?

Going back to our example, suppose you'd like to take advantage of the net gift technique, but you'd like your son to enjoy the benefits of the full $1 million gift. It's possible for you to finance the

net gift by lending your son the $285,714 he needs to cover the gift tax liability. To ensure that the loan is respected by the IRS, and not challenged as an additional gift, it's important to charge interest at the applicable federal rate (AFR) or higher, and to execute a written promissory note.

Handle with care

If you're considering a net gift, be sure to consult your estate planning advisor. The IRS is naturally suspicious of tax reduction strategies, so it's critical to document the transaction in an agreement signed by you and the recipient.

ESTATE PLANNING RED FLAG

You haven't named contingent beneficiaries

Although your will or revocable trust governs the distribution of many or most of your assets, certain assets — such as retirement plans, insurance policies, and bank or brokerage accounts — require you to name a beneficiary. This can be an advantage, because when you die the funds can pass directly to your beneficiary without going through probate. But to avoid unpleasant surprises, it's critical not only to choose your beneficiaries carefully, but also to name contingent beneficiaries in case your primary beneficiary dies before you.

Suppose a beneficiary predeceases you but you don't get around to updating the beneficiary form before you die. If you haven't named a contingent beneficiary, then the disposition of the funds depends on the type of asset.

For retirement plans, the plan document might call for the funds to go to your spouse or, if you're not married, to your estate. Leaving retirement plan assets to your estate can have undesirable consequences. For one thing, they'll pass according to the terms of your will, which may be contrary to your wishes. Plus, they'll have to be distributed and taxed under a five-year rule, depriving your beneficiaries of opportunities to defer those taxes for 10 years or more.

For other types of assets, the funds will likely end up in your estate, which can lead to unfortunate results. Suppose, for example, that your will leaves your entire estate, valued at $1 million, to your son. You also have a $1 million life insurance policy naming your daughter as beneficiary. If your daughter predeceases you and you haven't updated the beneficiary designation or named a contingent beneficiary (your grandchild, for example), then your son will receive everything, effectively disinheriting your daughter's family.

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