IRAs and Trusts, Donor Advised Funds, and Charitable Remainder Trusts

Friday, October 27, 2023

Take-Away: Giving an IRA to a charity on the IRA owner's death provides many tax benefits to the owner's estate. It is also possible to be creative in what kind of trust is named as the IRA's beneficiary to meet the decedent's estate planning objectives.

Background: Individuals are often reminded of the benefit of leaving an asset in their estate to a charity on their death. Not only will that bequest fulfill the individual's charitable objectives, but that bequest to charity will also provide a federal estate tax charitable deduction, which might come in handy after the scheduled 2026 *sunset* of the currently large applicable exemption amount that is available to the individual's taxable estate.

Income Tax Benefit: Since distributions from a traditional IRA are taxed as ordinary income, it is better for a charity, a tax exempt entity, to receive distributions from the IRA rather than the decedent's heir who would otherwise have to pay income taxes on the distributed IRA.

> Example: Don owns a traditional IRA that has a balance of $1.0 million at the time of his death. Don names his favorite charity as the beneficiary of his IRA. The charity will receive the $1.0 million and will not have to pay any income tax on that distribution, since the charity is tax exempt. In contrast, if Don named his four children as the beneficiaries of his traditional IRA that distribution might be worth as little as $630,000 to the children based on the current maximum federal income tax rate of 37%. That tax erosion of the IRA would be even worse if Don left his IRA to an *accumulation trust* for the benefit of Don's children, since an irrevocable trust will be at the 37% federal income tax bracket once it accumulates taxable income above $14,450 for the year. Added on top of that any state

income tax, and the result is significant income tax erosion of that $1.0 million IRA bequest.

Use a Separate Charitable IRA: For a variety of practical reasons, if an IRA is going to be used to make a charitable bequest on the IRA owner's death, it would be best to use a separate IRA that is dedicated solely to naming charitable beneficiaries instead of naming a charity as one of many named beneficiaries of the decedent's IRA. This separate IRA may be necessary due to the income tax complications of naming a non-designated beneficiary (the charity) of the IRA which must be eliminated no later than September 30 of the year that follows the IRA owner's death, in order to permit the other *designated beneficiaries* a longer period of time in which to take their required taxable distributions from their share of the inherited IRA.

Irrevocable Trust as Beneficiary: A decedent's IRA could be left to an irrevocable trust with a charity named as one of the trust's beneficiaries. It is important, however, to specify in the trust instrument that the bequest to the charity from the trust must be satisfied from the decedent's traditional IRA, or the proceeds from that IRA, to the maximum extent possible. The failure to specify that the source of the trust's charitable bequests is the decedent's IRA paid to the trust could result in the trust having to pay income tax on IRA distributions to it but with no offsetting estate tax deduction for the charitable bequest from the trust.

Donor Advised Fund as Beneficiary: With their recent exponential growth and public's growing familiarity of donor advised funds (DAF), a decedent's IRA could name a donor advised fund (DAF) as the recipient of that IRA to fulfill his/her charitable bequest. The decedent could direct the DAF's advisors in his/her Will or Trust how much each charity should receive as a distribution from that DAF. Naming a DAF as the IRA beneficiary will also appeal to the IRA custodian since only one check will have to be delivered to the DAF sponsor as opposed to dealing with, and delivering checks to, multiple charitable beneficiaries. By naming only a single DAF as the IRA beneficiary will also avoid the problem associated with naming several charities as the beneficiaries of the decedent's single IRA. Some IRA custodians will not directly deliver checks from

the decedent's IRA to a designated charity and instead the custodian will require each named charity to open an *inherited* IRA in the name of that charity into which its share of the IRA funds will be transferred; this can all be avoided by naming a single DAF as the sole beneficiary of the decedent's IRA. Balanced against naming a DAF as the IRA's beneficiary is the current concern of Congress that charitable dollars can be held for long periods of time in a DAF before they are distributed to charities, while the decedent's estate gains the immediate benefit of a charitable federal estate tax deduction. So we may be looking at more governmental regulation of DAFs in the coming years.

Charitable Remainder Trust as Beneficiary: There may be occasions where an IRA owner wants to fulfill philanthropic impulses but also wants to provide for survivors, first. In this case the IRA owner could name a charitable remainder trust (CRT) as the beneficiary of his/her IRA. Natalie Choate, the nationally respected author and lecturer on retirement plan distributions, recently provided an excellent example of how a CRT would function as the decedent's IRA beneficiary.

Natalie's Example: Bill, age 76, wants to leave his $1.0 million IRA to his three siblings who are ages, 74, 80 and 83. None of Bill's siblings is disabled or chronically ill. Bill also has charitable intent, but he intends to delay the charitable contributions until after his siblings have died. Bill could name his siblings individually as one-third IRA beneficiaries. Alternatively, Bill could leave his IRA to a trust that would provide for all of his siblings. Bill would like to state that that annual distributions to his siblings could be disproportionate, if needed, and that the fund would remain intact until the last surviving sibling has died.

> Bill could take advantage of the fact that all of his siblings are *eligible designated beneficiaries* (EDBs) under the SECURE Act since all are not more than 10 years younger than Bill. An EDB is still entitled to the life expectancy payout that the SECURE Act eliminated for most other designated beneficiaries. A 'family pot trust' for Bill's siblings could provide that the trustee would withdraw from the IRA each year (1) the RMD for that year plus (2) such additional amounts as the trustee deemed

advisable for the health, support and welfare of the siblings. The trust would provide that all amounts so withdrawn from the IRA each year would be promptly paid or applied for the benefit of the siblings in such relative amounts as the trustee deemed best, in other words a *conduit see-through trust.* Any amount remaining in the IRA on the death of the last surviving sibling would pass to a specified charity. However, any IRA payable to such a *conduit trust* generally would not last for the sibling lifetimes involved since a complete IRA payout would have to be made no longer than the life expectancy of the oldest sibling. At age 83, his/her IRS life expectancy is only 9.3 years. At age 74, the youngest sibling's life expectancy is 16 years, but he/she would not receive any tax benefit from that.. and the trust definitely will not remain in existence that long. The problem is that the oldest beneficiary's life expectancy dictates the payout period for a 'pot trust', which in turn pushes planning towards having a separate *conduit trust* created for each sibling. In addition with this 3-separate *conduit trust* approach. there will be no estate tax benefit from Bill's ultimate charitable gift.

If Bill left his IRA to a charitable remainder unitrust (CRUT) that approach would take Bill much closer to his overriding goals. The CRUT would be structured to provide a fixed annual payout of 5% of the IRA to Bill's surviving siblings. The siblings will divide that 5% payout equally. The remainder of the CRUT then goes to charity at the death of Bill's last surviving sibling. The tax-exempt CRUT would receive and invest Bill's entire $1.0 million IRA without diminution for paid income taxes. The 5% payout would be based on the IRA's entire $1.0 million value, not its after-tax value. Unlike the life expectancy payout, which calls for depletion after the eldest sibling's life expectancy, the CRUT's 5% income stream would last as long as any sibling remains alive. Distributions from the CRUT to the siblings would be includible in their gross income. It is true that this structure would not allow varied distributions to Bill's siblings base on their need. However, it would provide each sibling a lifelong income, with the surviving sibling(s) receiving an increased portion at the deaths of the first and second siblings, thus providing a crude form of inflation

protection. As a possible valuable bonus, Bill's estate would receive an estate tax deduction for the present value of the projected future charitable remainder gift on Bill's death.

Conclusion: Leaving a traditional IRA to charity makes a lot of tax sense, so long as the IRA owner is charitably inclined. How that testamentary charitable gift is structured is where things can get a bit complicated, and the tax savings vary. Using an IRA is something that most individuals who want to carry out philanthropy on their deaths should consider first.