Charitable Trusts vs. Stretch IRAs In Estate Planning

By K. Gene Christian

The minimum distribution rules changed for IRAs in 2002, essentially cutting by approximately 50% the amount a person over 70.5 years old is required to take each year as income. As a result, many people will, at their passing, have IRA account balances that will be twice as large as they would have been prior to 2002.

So, as IRA account balances become an increasingly large asset in many of your client's estates, the question is how we can help them plan well for the ultimate distribution of this class of assets?

The virtues of stretch IRAs are well known. The focus of this article is to consider the advantages that may be gained by some people who would choose to use a testamentary Charitable Remainder Trust (CRT) instead of a stretch IRA.

Background

A commonly accepted principle in estate planning is that after a person's death, distributions from his or her retirement plan should be deferred to the beneficiaries for as long as possible. For example, if a retirement plan distributes $1,000 to a named beneficiary, the beneficiary might pay $400 in Federal and Oregon state income taxes, leaving a balance of only $600 to spend.

So, in order to defer distributions over the longest period of time possible, planners generally help clients establish stretch IRAs in the estate so that upon the account owner's death, the beneficiary can receive payments that are *stretched-out* over that person's lifetime.

However, what if the person receiving the *stretched-out* income simply decides to terminate the plan, pay the taxes, and take a lump sum distribution—even if that was against the wishes of your client?

Or if the client has in mind multiple beneficiaries for the income from the stretch IRA, problems can arise. For instance, stretch IRA rules require that distributions be made over the oldest beneficiary's lifetime, thereby causing very little benefit to remain for additional income beneficiaries when the oldest person passes away.

The CRT Option

In instances where the client wants to have multiple beneficiaries of the IRA's income, a CRT may be a workable solution. A CRT can benefit several individuals for life and then distribute the assets to charity when the final beneficiary passes away. Like an IRA, a CRT pays no income tax and compounds tax-free. Unlike a stretch IRA, the term of a CRT can last until the youngest income beneficiary dies. As a result, a CRT can usually defer distributions from an IRA longer than a stretch IRA can.

Because of the tax-free compounding aspect of testamentary CRTs, the benefits will usually be greatest for a CRT when there is a significant age difference among the beneficiaries and the CRT is expected to exist for a long time. Simply put, the principle of tax-free compounding allows the CRT to look increasingly favorable the longer it remains in existence.

Of course there are complicating factors to consider. For one, ERISA law could prevent one spouse from transferring a retirement account to a CRT. This is true for corporate retirement plans and 403(b)s, but may not be the case for IRAs. Another issue is whether the CRT would pass the 10% charitable remainder test. If any one of the beneficiaries is in their 40s, and the CRT is expected to pay more than 5%, then it will likely fail the 10% remainder test. Finally, if the estate is deemed to be a taxable one, then the strategy should probably not be contemplated, because a private letter ruling concluded that a transfer from a retirement plan to a CRT eliminates the Sec. 691(c) income tax deduction that beneficiaries would otherwise have when they inherit income in respect of a decedent (IRD).

Conclusion

If your client does not have a taxable estate and wants there to be multiple beneficiaries of his IRA, then a CRT may be a viable option to consider. In instances where there are multiple beneficiaries, and it's clear that the trust may be in existence a long time, then the ability to defer payments over a longer period of time—particularly for those clients who are charitably inclined—makes the CRT a compelling tool to consider in your planning quiver.

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