GIVING RETIREMENT ASSETS TO A CHARITABLE REMAINDER TRUST

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Giving retirement assets to a charitable remainder trust is an alternative to giving retirement assets to the surviving spouse outright or in a QTIP trust.

As of 6/30/18, total assets in U.S. retirement plans[1] totaled $28.3 trillion.[2] While many retirement plan participants want their spouse or children to benefit from the accumulated plan assets, they are reticent about giving the spouse immediate access to the funds. Thus, rather than giving the plan assets to the surviving spouse outright, the participant will instead name a qualified terminable interest property (QTIP) trust as the beneficiary.[3] By naming a QTIP trust as the beneficiary, the participant can control the ultimate distribution of the principal, while still obtaining the marital deduction for the plan assets. However, as set forth in more detail below, there are a number of negative income tax consequences involved in naming a QTIP trust as a designated beneficiary of a retirement plan. While the nontax reasons to avoid naming the surviving spouse as the beneficiary of a retirement plan might justify this action, for charitably minded individuals a third option—designating a charitable remainder trust (CRT) as the beneficiary—could accomplish the nontax goals in a more tax-efficient way than the QTIP trust.

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Income tax drawbacks of leaving retirement assets to QTIP trust

There are several income tax drawbacks of leaving retirement assets to a QTIP trust, as discussed below.

Distributions start immediately instead of being deferred until spouse reaches age 70 1/2. If the surviving spouse has income from other sources, the spouse could be in a higher tax bracket than if the spouse had waited until age 70 1/2 to receive the benefits. A designated beneficiary of retirement benefits must generally take the required minimum distributions (RMDs) over his or her life expectancy.[4] Alternatively, if benefits are left outright to the surviving spouse, the spouse can roll them over to the spouse's own IRA[5] and defer commencement of distributions until the spouse reaches age 70 1/2.[6] If benefits are paid to a QTIP trust, the benefits must be paid out over the life expectancy of the oldest beneficiary of the trust (typically the spouse).[7]

Distributions during spouse's life will be based on a single life expectancy rather than the more favorable Uniform Lifetime Table or the Joint and Last Survivor Table. If the benefits were paid to the spouse personally, the spouse could roll them over into an IRA, defer distribution of the RMDs until age 70 1/2, and take such distributions over the Uniform Lifetime Table, which is based on the joint life expectancy of the spouse and a hypothetical 10-years-younger designated beneficiary.[8] If the spouse is more than 10 years younger, the Joint and Last Survivor Table can be used.[9] Conversely, if benefits are paid to a QTIP trust, RMDs are calculated based on the spouse's life expectancy.[10]

The marital deduction requires that the surviving spouse be entitled to distribution of all income annually. Distributions of retirement plan income in excess of the RMD may be wasteful if the spouse does not need or want the additional income for current spending. Although Rev. Rul. 2000-2[11] states that income does not actually have to be distributed so long as the spouse has the right to compel distribution of the income, income in excess of the RMD that is accumulated by the trust instead of distributed to the spouse will be considered "principal" for purposes of trust accounting and will be subject to tax at the trust rates.[12]

If the surviving spouse has children, the ability to distribute benefits over the life expectancy of the surviving spouse's children will be lost. If benefits were paid directly to the decedent's children, their life expectancies would be used to measure RMDs. This would maximize income tax deferral (except in the unusual scenario where the surviving spouse is younger than the decedent's children). However, when the benefits are paid to a QTIP trust of which the children are the remainder beneficiaries, the life expectancy used to measure the RMDs is the life of the oldest trust beneficiary (the surviving spouse).[13]

Using a CRT as a QTIP alternative

Designating the surviving spouse as the beneficiary of a retirement plan has favorable income tax conse°quences, but only if the spouse rolls the benefits over to his or her own retirement plan after the participant's death. There is no guarantee the spouse will do so, and further, nontax considerations might make the participant reluctant to leave benefits outright to the surviving spouse. For example, the participant might believe that the surviving spouse is not capable of handling the retirement assets, or the participant might be worried that the surviving spouse will designate a beneficiary the participant would not endorse.

There are a number of negative income tax consequences involved in naming a QTIP trust as a designated beneficiary of a retirement plan.

Leaving benefits to a CRT gives the spouse an income stream for life while avoiding the income tax drawbacks of leaving benefits to a QTIP trust. Thus, the participant can achieve the nontax goals of limiting immediate access to funds and controlling the ultimate distribution of principal in a tax-efficient manner. Below is a general overview of the pertinent rules governing CRTs.

1 For purposes of this article, "retirement plan" or "plan" refers to a defined contribution plan (such as a Section 401(k) plan or a profit-sharing plan), a tax-deferred Section 403(b) plan, or an individual retirement account (IRA) under Section 408 or Section 408A.

2 ICI Research & Statistics, Retirement Assets Total $28.3 Trillion in Second Quarter 2018 (9/27/18), *available at https://www.ici.org/research/stats/retirement/ret_18_q2*.

3 Note that retirement plans subject to the Employee Retirement Income Security Act (ERISA) generally require spousal waiver and consent whenever a beneficiary other than the spouse is designated.

4 Section 401(a)(9)(B)(iii); Regs. 1.401(a)(9)-3, A-1(a) and 1.401(a)(9)-5, A-5. All Section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury Regulations thereunder, unless otherwise specified or otherwise clear from context.

5 Sections 402(c)(9) and 408(d)(3)(c)(ii)(II).

6 Section 401(a)(9)(B)(iii); Reg. 1.401(a)(9)-3 A-3(b).

7 Section 401(a)(9)(B)(iv)(I); Reg. 1.401(a)(9)-5 A-7.

8 TD 8987 (4/16/02); Reg. 1.401(a)(9)-9, Q&A 2. The Uniform Lifetime Table (as well as the Joint and Last Survivor Table) are subject to change by the IRS through future revenue rulings, notices, and other guidance. *See* Reg. 1.401(a)(9)-9, Q&A 4.

9 TD 8987 (4/16/02); Reg. 1.401(a)(9)-9, Q&A 3.

10 *Supra* note 6.

11 2000-1 CB 305; *see also* Rev. Rul. 2006-22, 2006-1 CB 687.

12 For 2018, nongrantor trusts reach the top income tax rate of 37% when taxable income exceeds $12,500, whereas a single individual does not reach the top rate until taxable income exceeds $500,000. *See* Section 1(j)(2)(C), (E) as amended by P.L. 115-97, 12/22/17, section 11001(a)(2). The tax brackets are subject to annual adjustments for inflation. *See* Section 1(f).

13 *Supra* note 6.

14 The regulations also permit a CRT to pay a unitrust or annuity amount to the noncharitable beneficiary for a term of years not to exceed 20 years and then another individual for life or a term of years (not to exceed 20 years) whichever is shorter (but not longer). *See* Regs. 1.664-2(a)(5)(i) and 1.664-3(a)(5)(i).

15 Sections 664(d)(1)(D) and 664(d)(2)(D). The income and remainder interests are valued using the tables under Section 7520 and the Mortality Table 2000CM. In addition, if the annuity interest in a CRAT is payable to the noncharitable beneficiary for a measuring life or lives (as opposed to a term of years), the CRAT is subject to the 5% "probability of exhaustion test" under Rev. Rul. 77-374, 1977-2 CB 329. Until recently, the low-interest rate environment made lifetime CRATs possible only for individuals in their 70s or older. However, in August 2016, the IRS created a "safe harbor" whereby all individuals could utilize a CRAT, regardless of age, so long as the trust instrument included a trigger provision terminating the CRAT and distributing the assets to the charitable remainder beneficiary if the CRAT's assets ever fall below 10% of the CRAT's initial value. *See* Rev. Proc. 2016-42, 2016-34 IRB 269.

CRT overview

In general, a CRT is a trust that pays out an annual income to one or more noncharitable beneficiaries (such as the donor's spouse and/or children) for life or a term of years not to exceed 20 years.[14] At the end of the life (or term) interest, the remaining trust assets are paid to a charitable organization described in Section 170(c). The value of this charitable remainder interest (determined actuarially using IRS tables) must be at least 10% of the initial fair market value of the CRT's assets.[15] The donor to a CRT is entitled to a charitable deduction equal to the value of the remainder interest.[16] Except with respect to the tax on unrelated business taxable income (UBTI), a CRT is exempt from income tax.[17]

The main attraction of leaving retirement assets to a charitable remainder trust is that benefits are paid to the CRT with no income tax, thus allowing the noncharitable beneficiary(ies) to receive life income from the reinvestment of the entire amount of the plan assets.

There are two types of CRTs: a charitable remainder annuity trust (CRAT) and its more common counterpart, a charitable remainder unitrust (CRUT).[18] A CRAT provides for payment of a *fixed dollar amount* at least annually to the noncharitable beneficiary or beneficiaries,[19] whereas a CRUT provides for payment at least annually to the noncharitable beneficiary or beneficiaries of a *fixed percentage* of the value of the trust principal, revalued on an annual basis.[20] In addition to annually filing Form 1041 (U.S. Income Tax Return for Estates and Trusts), a CRT must file Form 5227 (Split-Interest Trust Information Return).

Funding a CRT with retirement assets[21]

The main attraction of leaving retirement assets to a charitable remainder trust is that benefits are paid to the CRT with no income tax, thus allowing the noncharitable beneficiary(ies) to receive life income from the reinvestment of the *entire amount* of the plan assets.[22] There is no need for the spouse to roll benefits over on the participant's death and the participant can choose the remainder beneficiary of the plan assets (which must be a charity). If the surviving spouse is the sole noncharitable beneficiary of the CRT, the combination of the marital and charitable deductions will shelter the retirement assets from estate tax at the participant's death *and* at the surviving spouse's death.[23] Conversely, if retirement assets are left to a QTIP trust, such assets will be included in the estate of the surviving spouse.

Pecuniary bequest of retirement assets to CRT. If the executor of the participant's estate uses the estate's right to receive retirement assets to fund a pecuniary bequest to the CRT (for example, the participant's estate is the designated beneficiary of the retirement plan and the participant's estate plan provides for a pecuniary bequest to fund a CRT), the estate's transfer of its right to receive the retirement assets to the CRT will be treated as a sale made by the estate and will thus accelerate the estate's recognition of income in respect of a decedent (IRD).[24] The estate will be

16 Reg. 1.664-2(c), (d); Reg. 1.664-3(c), (d).

17 Section 664(c)(1). If a CRT has UBTI within the meaning of Section 512, a 100% excise tax is imposed on such UBTI. *See* Section 664(c)(2)(A).

18 The statutory framework for CRATs and CRUTs is set forth at Section 664(d)(1) and (d)(2), respectively. Because distributions from a CRUT (but not a CRAT) may be limited to the actual income of the trust, there are a number of possible variations of the CRUT.

19 Section 664(d)(1)(A).

20 Section 664(d)(2)(A). The fixed percentage must be equal to at least 5% but not more than 50% of the net fair market value of the trust's assets.

21 This article only discusses bequests of retirement plan assets, rather than lifetime gifts, because under current law, if an amount is withdrawn from a retirement plan and then contributed to a CRT, the amount withdrawn would be included in the participant's income. Legislation has been proposed whereby certain direct transfers from a retirement plan to a CRT (i.e. , a "charitable rollover") would be excluded from the participant's income. SeeH.R. 5171 (introduced 5/6/16) and H.R. 1337 (introduced 3/2/17).

22 *See* Ltr. Rul. 9253038; Ltr. Rul. 9237020 (ruling that retirement benefits do not constitute UBTI and thus, retirement benefits can be distributed to the CRT and reinvested on a tax-free basis). While private letter rulings are binding only on the taxpayers to which they were issued, they nevertheless may be indicative of the IRS' thinking on a particular issue. *See* Section 6110(k)(3).

23 *See* Section 2056(b)(8) (spouse's annuity or unitrust interest in CRT qualifies for the estate tax marital deduction if the surviving spouse is the only noncharitable beneficiary).

24 *See* Section 691(a)(2); Reg. 1.1014-4(a)(3). IRD consists of untaxed income which a decedent had earned or had a right to receive during the decedent's lifetime. IRD is taxed to the individual or entity that inherits the income.

25 Regs. 1.642(c)-3(a) and 1.642(c)-2(d). A revocable trust that becomes irrevocable upon the grantor's death can also receive a charitable deduction for amounts paid to the CRT if the trust makes the election under Section 645 to be treated as part of the grantor's estate for income tax purposes. *See* Reg. 1.645-1(e)(2)(i), (iv).

26 Unless the CRT is an "income-exception" CRUT as described in Section 664(d)(3)(A) (otherwise known as a NICRUT) whereby only the trust accounting income (and none of the principal) is distributed to the income beneficiary, the CRT's trustee will have the power to invade principal to pay the unitrust or annuity amount.

27 *See* Fox, Charitable Giving: Taxation, Planning, and Strategies: Thomson Reuters/WG&L (2018), ¶ 12.7[4][d].

entitled to a set-aside deduction under Section 642(c) only to the extent the IRD is irrevocably set aside for charity.[25] While the set-aside deduction would likely be disallowed if the CRT's trustee has discretion to invade principal to pay the unitrust or annuity amount,[26] the distribution deduction under Sections 661 and 662 will be available.[27]

Specific bequest of retirement assets to CRT. If a specific bequest of retirement plan assets is made to a CRT (*i.e.*, a CRT is the designated beneficiary of the retirement plan or the participant's will/trust provides for retirement assets to be distributed to a CRT), the CRT will recognize the IRD. Because the CRT is exempt from income tax (other than the tax on unrelated business taxable income) under Section 664(c)(1), it will not incur tax upon recognition of the IRD.

Taxation of distributions to beneficiary. A CRT has an internal accounting system pursuant to which income the CRT receives is allocated to one of four tiers and distributed to the noncharitable beneficiary on a "worst-in, first-out" basis.[28] Thus, for example, the CRT cannot distribute any capital gain income to the noncharitable beneficiary until it has distributed all income from the ordinary income tier; after distribution of all ordinary income and capital gain income, the CRT distributes tax-exempt income; and finally, principal. Generally, when the beneficiary of an "inherited" retirement plan receives a distribution from the plan, the beneficiary must include the distribution as IRD, but the beneficiary is entitled to an income tax deduction for any federal estate taxes that were paid on those benefits.[29]

When retirement benefits are payable to a CRT, the IRS has ruled that the deduction reduces the taxable income of the CRT that is assigned to the first tier (the ordinary income tier), rather than being distributed out to the noncharitable beneficiary.[30] However, some practitioners argue

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that the income distributions to the noncharitable beneficiary should carry out the IRD deduction to the noncharitable beneficiary along with the taxable income.[31] If the surviving spouse is the sole noncharitable beneficiary of the CRT, the spouse would not be entitled to the IRD deduction (because no estate tax would have been payable on the retirement assets passing to the CRT).

Limitations on funding a CRT with retirement assets

Nonspouse beneficiary. If retirement benefits are left to a CRT, the entire value of such benefits will be included in the participant's gross estate for estate tax purposes.[32] While the estate tax deduction shelters the charitable remainder interest from estate taxes, the noncharitable income interest is not eligible for the marital deduction if the surviving spouse is not the sole beneficiary.[33]

If the participant's estate will not exceed the applicable estate tax exclusion amount, loss of the marital deduction might not be a concern.[34] Con-

[28] Section 664(b).

[29] Section 691(c). The deduction for IRD is *not* a miscellaneous itemized deduction and thus, is not suspended for taxable years beginning after 12/31/17 and before 1/1/26. *See* Section 67(b)(7). Furthermore, the deduction for IRD is not subject to the 2% of adjusted gross income threshold applicable to miscellaneous itemized deductions under Section 67(a) and is not disallowed for purposes of calculating alternative minimum taxable income under Section 56(b)(1)(A)(i).

[30] Ltr. Rul. 199901023 (ruling that the deduction for IRD under Section 691(c) does not flow out from a CRT to its noncharitable beneficiaries but is netted by the CRT against first-tier ordinary income, thus resulting in an increase in the principal the CRT is deemed to have received). Because most CRTs funded with retirement assets never distribute principal, the deduction would effectively be wasted if it is netted against the CRT's first-tier income.

[31] *See* Reg. 1.691(c)-2(a)(1)(ii) (providing that IRD received by a trust, including the Section 691(c) deduction, is deemed distributed to the trust beneficiaries); *see also* Zaritsky, Lane & Danforth, Federal Income Taxation of Estates and Trusts (WG&L), ¶ 15.04[9] ("There is no legislative or regulatory authority for converting the Section 691(c) deduction into a reduction in Tier 1 (ordinary) trust income and the Code and regulations appear to require a different result.").

[32] Estate tax inclusion is required under Section 2039.

[33] There does not appear to be a policy reason to deny an estate tax marital deduction where the surviving spouse is not the sole beneficiary, given that the value of the surviving spouse's interest can be easily calculated. Nonetheless, Section 2056(b)(8) appears to condition availability of the estate tax marital deduction on the surviving spouse being the sole annuity or unitrust interest holder. *See* Ltr. Rul. 8730004 (ruling that Section 2056(b)(8) requires the surviving spouse to be the sole noncharitable beneficiary for the annuity or unitrust interest in a CRT to qualify for the estate tax marital deduction).

[34] For estates of decedents dying after 12/31/17 and before 1/1/26, the basic exclusion amount is $11,800,000, with an annual adjustment for inflation. *See* Section 2010(c)(3)(C), added by P.L. 115-97, 12/22/17, section 11061(a); *see also* Rev. Proc. 2018-18, section 3.35, 2018-10 IRB 392. For estates of decedents dying after 12/31/2025, the basic exclusion amount under Section 2010(c)(3)(A) (*i.e.*, $5 million adjusted for inflation for years after 2011) will apply unless the sunset date is extended or the increased exclusion amount is made permanent.

versely, if the participant's gross estate exceeds the applicable exclusion amount, the noncharitable beneficiary's interest will be subject to estate tax.[35] Because a CRT is not permitted to make payment of any estate tax or other obligations of the participant, funds to pay the estate tax must come from other sources.[36]

Young beneficiaries. If any of the noncharitable beneficiaries of the CRT are "too young" and have a life interest, the CRT will fail the 10% remainder requirement in Section 664(d). For example, using the 3.4% applicable federal rate under Section 7520 for February 2019,[37] if a CRUT provides a 5% payout to a 55 year-old beneficiary for life, the successor life beneficiary cannot be younger than 28; if the income interest is payable more frequently than once a year, or the successor life interest will be split among a group of beneficiaries, the minimum age will be higher. However, if a life interest for the successor beneficiary would result in the CRT failing the 10% minimum remainder requirement, the CRT can provide for a term interest for the successor beneficiary (up to 20 years).

Alternatively, the participant could leave a share of the plan assets to a CRT for the benefit of the surviving spouse, while leaving a separate share to younger children either outright or in a "see-through trust."[38] In order to avoid application of the "five-year rule," which requires that if the participant dies before age 70 $^{1}/_{2}$, the participant's entire interest must be distributed within five years if any of the beneficiaries are not individuals or see-through trusts,[39] the CRT's interest must be paid out in its entirety by September 30 of the year following the participant's death,[40] or, separate accounts must be created for all beneficiaries no later than December 31 of the year following the participant's death.[41]

Conclusion

If retirement plan assets are left to a CRT for the life of the surviving spouse, the spouse will get an income stream for life, without the income tax drawbacks associated with leaving plan assets to a QTIP trust. No action will be required of the surviving spouse, the spouse will not be able to withdraw the benefits in a lump sum, the participant can choose the ultimate charitable beneficiary, and, if the spouse is the only noncharitable beneficiary, the retirement assets will be shielded from estate tax at the participant's death and the surviving spouse's death. Thus, if the participant does not want to leave retirement plan assets outright to the surviving spouse, using the plan assets to fund a CRT for the surviving spouse is an excellent alternative to leaving such assets to a QTIP trust.

35 The maximum estate tax rate under Section 2001(c) is currently 40%.

36 *See* Section 664(d)(1)(B), (d)(2)(B)*; see also* Rev. Rul. 82-128, 1982-2 C.B. 71 (if estate tax is paid from assets of the CRT, the CRT will be disqualified).

37 *See* Rev. Rul. 2019-3, Table 5, 2019-2 IRB 272. The IRS announces the applicable federal rate tables in a monthly Revenue Ruling. For purposes of valuing an income, estate, or gift tax charitable contribution for a transfer of property to a CRT, the taxpayer may elect to use the Section 7520 rate for either of the two months preceding the month in which the valuation date falls. *See* Section 7520(a) (last sentence).

38 A "see-through trust" is one where the beneficiaries of the trust (and not the trust itself) are treated as the designated beneficiaries for purposes of applying the RMD rules. A trust will qualify as a see-through trust if: (1) the trust is valid under state law (or would be valid if funded); (2) the trust is irrevocable, or by its terms, will become irrevocable upon the death of the participant; (3) the beneficiaries of the trust are identifiable; and (4) a copy of the trust instrument and a list of all trust beneficiaries are provided to the plan administrator. *See* Reg. 1.401(a)(9)-4, Q&A 5, 6.

39 *See* Section 401(a)(9)(B)(ii); Reg. 1.401(a)(9)-3, Q&A 4(a)(2). Proposed legislation passed by the Senate Finance Committee in September 2016 would eliminate so-called "stretch IRAs" and require non-spouse beneficiaries to take all distributions from an inherited retirement account within five years of the participant's death. *See* S. 3471 (introduced 11/16/16).

40 *See* Reg. 1.401(a)(9)-4, Q&A 3, 4(a) (determination of the plan's beneficiaries for purposes of the RMD rules is based on the beneficiaries designated as of the date of the participant's death who remain beneficiaries as of September 30 of the year following the year of the participant's death).

41 *See* Reg. 1.401(a)(9)-8, Q&A 2(a)(2). The separate accounts are not aggregated for purposes of the RMD rules.