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Wealth Planning Update

Using a Charitable Remainder Trust as a Substitute for the Stretch IRA after the SECURE Act

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Key Takeaways:

- The SECURE Act eliminated the stretch IRA strategy for many non-spouse beneficiaries, replacing it with a 10 year rule.
- The new 10 year rule may significantly reduce the amount that will ultimately be received by the beneficiary.
- An IRA owner may choose to use a charitable remainder trust to mimic some of the effects of the stretch IRA strategy.

What this may mean for you:

- Even though the SECURE Act eliminated the stretch IRA strategy, you may be able to still get some of the benefits of the stretch IRA strategy by using a charitable remainder trust.

Overview

The Setting Every Community Up for Retirement Enhancement (SECURE) Act became law on December 20, 2019, making a number of changes to the then existing law regarding retirement plans. One of these changes eliminated the ability for many non-spouse beneficiaries inheriting an individual retirement account ("IRA") to stretch the payments over their lifetime. Since the inherited IRA assets continued to grow tax-free during the distribution period, this was previously a significant benefit to the beneficiary. The new law requires many non-spouse beneficiaries to withdraw the inherited IRA within 10 years. IRA owners who are updating their estate plans and would like to find a potential substitute for the stretch IRA strategy may want to consider using a charitable remainder trust ("CRT").

New Limitation

As of January 1, 2020, IRA designated beneficiaries (DB) which are non-spouse individuals and qualified "look-through" trusts, can no longer stretch out the distributions over their life expectancy, and instead must withdraw the funds within 10 years (10 Year Rule). This new rule does not apply to eligible designated beneficiaries (EBD) which are surviving spouses, disabled beneficiaries, chronically ill beneficiaries, beneficiaries not more than 10 years younger than the IRA owner and minor children of the IRA owner (but only until they reach the age of majority; yet to be determined, then the 10 Year Rule applies).

It is important to note that the beneficiary of an IRA is required to fully distribute the Inherited IRA by the end of the 10th calendar year following the year of the IRA holder's death. In other words, the IRA does not need to be distributed ratably over the 10 year period. Until the money is withdrawn, the assets continue to potentially grow tax-advantaged, so a beneficiary may keep the assets in the IRA for the entire 10 years; however the tax impact of a lump sum payment in the 10th year is something to be discussed with your tax professional.

Charitable Remainder Trusts

A CRT is a trust that distributes an annual income to one or more beneficiaries, either for life or for a term of not more than 20 years. At the end of the life (or term) interest, the remaining trust assets are paid to charity.[1]

The annual distribution to the beneficiary must be either a fixed dollar amount, in which case the trust is a "charitable remainder annuity trust," or a fixed percentage of the annually determined value of the trust, in which case the trust is a "charitable remainder unitrust." The annual payment of the CRT must be at least five percent, but not more than 50 percent of the value of the trust. Additionally, the present value[2] of the remainder interest that will go to the charity must be at least 10 percent of the contribution to the CRT.

Typically when a beneficiary receives a payment from an inherited IRA, the proceeds are subject to income tax; however, when a CRT receives the IRA proceeds, they are received with no income tax. Thus the entire amount can be invested for the benefit of the lifetime CRT beneficiary, rather than only the after-tax amount if a CRT is not used.

There are very specific and complicated rules regarding the taxation of distributions received from a CRT. Distributions can be taxed as ordinary income, capital gain, tax free income, and return of capital. The general rule is that the tax treatment of any distributions are allocated as "worst first." Therefore, for a significant period of time, the tax treatment of the distributions payable to the lifetime beneficiary of a CRT will be ordinary income. It will be necessary to engage a tax professional to determine the correct character of each distribution.

[1] According to IRC Section 664

[2] Present value applies a discount rate to the future value of the gift. It is calculated using the period of time for discounting, the discount rate, the payment frequency of the income, the payout percentage and the amount being transferred.

Who Should Consider This Strategy?

You may want to consider a CRT strategy if you are planning to leave your retirement account assets to your children or grandchildren, and are concerned about the beneficiaries having access to these funds too soon and/or you want to maximize the amounts available to their children.

Risks and Considerations of using a CRT

- If you select a life interest, the remaining assets in the CRT are distributed to the charity, whether the beneficiary dies after 2 years of distributions or 30.
    - You may find a 20 year payout rather than a lifetime payout more attractive to insure that the payments will last for at least 20 years, regardless of the beneficiary's lifespan.
    - Alternatively, the beneficiary may want to purchase life insurance with a portion of the payment he or she receives from the CRT to replace funds that will pass to charity upon her death.
- Unlike an IRA, the beneficiary of the CRT will get a certain dollar or percent each year; if they need additional funds they are not able to access those assets.
- You also should consider that there may be trustee fees involved; if an individual acts as trustee, there are investment and accounting considerations that need to be dealt with.

Example

To illustrate how a CRT substitute will work, we have calculated the IRA benefits using a specific fact scenario. This can be a complicated concept; this example has been included to give you perspective of what the impact of a CRT strategy may be. Your fact situation will be different, so it is important for you to speak with your legal and tax professionals to determine how a CRT substitute will work for your situation; additionally the cash flow is just one aspect when considering a CRT. In this case, the assumption is that there is a single beneficiary of a parent's IRA worth $1,000,000. The table below reflects the distributions and taxes before the SECURE Act, under the SECURE Act, and if a CRT is put in place. This is a calculation input into NaviPlan, our financial planning software with the beneficiary and return assumptions provided and consequent results.

Beneficiary Assumptions	**Return Assumptions**
Current Age: 50 Female Other income (salary) = $150,000 Retire at age 65 and begins receiving Social Security Lives to age 85	IRA = $1,000,000 7% return (net of fees) - 5% growth, 2% income 2.5% discount rate

	Before SECURE Act (1)	**Present Value Before SECURE Act**	**Under SECURE Act (2)**	**Present Value Under SECURE Act**	**Under SECURE Act-CRT (3)**	**Present Value Under SECURE Act - CRT**
Gross Received	$ 4,090,910	$ 2,360,162	$ 1,956,427	$ 1,566,567	$ 2,234,603	$ 1,612,826
Federal Income Tax	1,021,266	592,854	800,913	640,838	403,369	337,528
Net Amount	$ 3,069,644	$ 1,767,308	$ 1,155,514	$ 925,729	$ 1,831,234	$ 1,275,298

This information is hypothetical and is provided for illustrative and informational purposes only. It is not intended to reflect the performance of any specific investment or security and is not representative of any particular structure or situation.

(1) Required minimum distribution over beneficiary's lifetime using IRS life expectancy tables.
(2) Lump sum taken 10 years after death of the IRA owner.
(3) Annual payout rate of 9.859%.

With use of the CRT:

- The unitrust was developed to maximize the payments to the beneficiary.
- The parent's estate receives a $100,000 charitable deduction at his/her death.
- At the beneficiary's death, the charity receives $351,829.

Conclusion

As illustrated above, using a CRT as a substitute for the former stretch-out, as opposed to using the new 10-year rule, can net a much better financial result for the income beneficiary. That being said, the configuration and implementation of a CRT is complicated and one should seek the advice of legal counsel prior to using this or any other tax strategy. Further, this is not the only strategy available as a substitute for the 10-year rule. Please talk to your Wells Fargo Wealth Planning Team for strategies that may be applicable to your situation.

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