By **Charles Bender**

Using a CRUT to SECURE the Benefits of a Stretch IRA Trust

Eliminate income tax on retirement account assets

The new 10-year payout for most retirement plan accounts has created renewed interest in naming a charitable remainder trust as beneficiary to avoid income tax on retirement account assets. Let's examine whether the juice is worth the squeeze.

On Dec. 20, 2019, the President signed into law the Further Consolidated Appropriations Act, funding the federal government through Sept. 30, 2020. Division O of the new law contained the Setting Every Community Up for Retirement Enhancement (SECURE) Act, which made numerous changes to the rules regarding retirement savings accounts, most of which became effective as of Jan. 1, 2020. Taxpayers and their advisors were given all of 11 days' notice before the new law took effect.

Changes Affecting Estate Planning

Many of the changes loosen the rules related to retirement accounts, such as repealing the prohibition against making contributions to individual retirement accounts after the year in which the account owner attains the age of 70½,[1] changing the age that sets the required beginning date for required minimum distributions (RMDs) from 70½ to 72[2] and expanding the use of Internal Revenue Code Section 529 accounts.[3]

The change having the most immediate impact for trust and estate tax planners is the repeal of the stretch IRA[4] contained in new IRC Section 401(a)(9)(H). Under this provision, most designated beneficiaries must take full distribution of the retirement account balance by Dec. 31 of the year containing the 10th anniversary of the account owner's death.

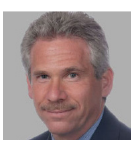
There are a number of exceptions to the new 10-year rule. These include the account owner's surviving spouse, who can still do a spousal rollover, a minor child during his minority, a disabled beneficiary, a chronically ill beneficiary and a beneficiary no more than 10 years younger than the account owner (for example, a sibling).[5] Special rules apply for all of these categories of eligible designated beneficiaries.

Death of the Stretch IRA Trust

The problem for retirement account owners and their planners is that many estate plans were designed to take advantage of the stretch IRA rules to defer the beneficiary's receipt of the retirement assets over the beneficiary's lifetime through the use of trusts. The abrupt change in the law effectively changed the estate plans for these clients with no advance notice. Planners were left scrambling to identify which clients were most affected by these changes.

The planning technique at issue is the use of trusts referred to as "see-through" trusts, the two most common of which are conduit trusts and accumulation trusts. When designed properly, you can look through these trusts to the beneficiary to determine the designated beneficiary for plan distribution purposes. Under prior law, RMDs from a decedent's retirement account to one of these trusts were based on the age of the beneficiary of the trust and taken out over the beneficiary's lifetime. The technique combined the benefits of the stretch IRA with the benefits of a trust. The income tax on the retirement account was deferred over the trust beneficiary's lifetime, and the terms of the trust would allow the deceased account owner to control the beneficiary's access to the funds.

With a conduit trust, when the RMDs from the retirement account are paid to the trust, they're



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distributed to the beneficiary, who pays the income tax at his personal tax rate, which is often lower than the trust tax rate applicable to the distributions. This allows for the distributions, as well as the federal income tax, to be stretched out over the beneficiary's lifetime. An individual designated beneficiary was permitted the same option to take the distributions over his lifetime but could also accelerate the distributions, including taking a lump sum at the account owner's death. By using the conduit trust, the account owner could require the beneficiary to defer the payments over his lifetime.

The accumulation trust is similar in that it's designed so that the beneficiary of the trust is treated as the designated beneficiary for purposes of the retirement plan distributions. The main difference is that the accumulation trust isn't required to distribute the RMD to the beneficiary each year. Instead, the RMDs can be retained in the trust, which then pays the income tax at its applicable tax rate. By keeping the distributions in the trust, the terms of the trust determine when and how the funds are used for the beneficiary. The cost of this added control is that the trust's tax rate applies instead of the beneficiary's tax rate.

> For the charitably inclined client, naming a CRUT as the beneficiary of a retirement account can be a very attractive plan.

CRUT as Beneficiary

A charitable remainder unitrust (CRUT) can produce benefits similar to the stretch IRA trust after the SECURE Act's changes to the law. In July 1996, Edward N. Polisher and I co-authored an article for *Trusts & Estates* entitled, "Appointing a CRUT as a Retirement Plan Beneficiary." The premise of the article was that after paying all of the taxes applicable to retirement account assets, a beneficiary could be better off financially by being the lifetime beneficiary of a CRUT than by being the outright beneficiary of the retirement plan assets.

A lot has happened in the estate-planning world since 1996. The estate tax exemption has gone from \$600,000 to \$11.58 million, the top estate tax has fallen from 55% to 40%, the top marginal personal income tax rate has gone from 39.6% to 37%, the 15% excise taxes applicable to certain retirement balances have been eliminated and the IRC Section 7520 rate has fallen from 7.6%[6] to 1.8%.[7] While all of these changes reduce the potential benefit of naming a CRUT as a beneficiary for retirement plan assets, it can still be an attractive option for many clients. One other change since 1996 is that my former colleague and mentor Edward N. Polisher has passed on. This article is dedicated to his memory.

The Crux of a CRUT

A CRUT is a split-interest trust in which a lead interest is payable to one or more individual beneficiaries in the form of a fixed percentage of the fair market value of the assets, valued annually, and the remainder interest is payable to one or more charities. The unitrust payout must be between 5% and 50%. The actuarial value of the charitable remainder interest can't be less than 10% of the initial contribution to the trust.[8] In low interest rate environments, these two requirements can cause a trust to fail to qualify as a CRUT for younger beneficiaries. For example, in February 2020, the Section 7520 rate used to calculate the value of the charitable remainder interest was 2%. Using the minimum 5% unitrust payout, a CRUT can't satisfy the 10% remainder requirement if the beneficiary is under age 27. For younger beneficiaries, the CRUT could be set up for a fixed term not to exceed 20 years, rather than the life of the beneficiary, to satisfy the 10% remainder test. However, this limits the benefit of the plan, because the CRUT would terminate while the non-charitable beneficiary is still relatively young, with the remaining assets payable to charities.

A CRUT isn't subject to income tax. This is the key feature that makes it an ideal beneficiary of retirement plan assets. If a \$1 million IRA is payable to an individual beneficiary in the 37% income tax bracket, the after-tax benefit is \$630,000. If a \$1 million IRA is payable to a CRUT, the tax is zero, and the full \$1 million

remains in the CRUT. The non-charitable beneficiary gets the benefit of the entire retirement account value generating income to support the unitrust payment. It grows on a pre-tax basis for the life of the non-charitable beneficiary, producing the same tax-free return as an IRA. And, no income tax is paid on the retirement account distribution to the CRUT.

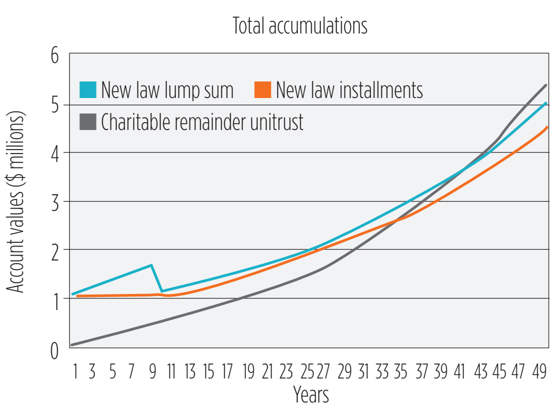
While the CRUT doesn't pay income tax, the distributions paid to the individual beneficiary carry out the trust income, which is reportable on the beneficiary's personal income tax returns. The character of the income is determined at the trust level, and the distributions carry out income in the following order:[9]

1. Ordinary income, such as interest and dividends.
2. Short-term capital gains.
3. Long-term capital gains.
4. Tax-exempt income.
5. Tax-free return of principal.

The CRUT maintains accounts for each of these buckets of income, which are cumulative year to year. The income is distributed on a worst in, first out basis. When a retirement account is paid to the CRUT, the income in respect of a decedent (IRD) is added to the ordinary income bucket. As a result, all unitrust distributions paid to the individual beneficiary will be taxed as ordinary income, unless and until the annual distributions carry out all of the IRD and all future ordinary income earned by the CRUT. This is similar to the income tax treatment on RMDs.

Rollover IRA of $1 Million

Lump sum versus annual installments



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How the Plan Works

Consider a married couple with one child. On the death of the first spouse, the beneficiary of the decedent's retirement account will be the surviving spouse. The surviving spouse directs the retirement assets into a spousal rollover IRA and designates a CRUT with a 5% unitrust payout as the beneficiary of the rollover IRA. The CRUT is unfunded during the surviving spouse's lifetime, to be funded after death with the balance of the assets in the rollover IRA. Assume that when the surviving spouse dies, the child is 55 years old. The CRUT will pay the child a 5% unitrust distribution for the child's lifetime. The child will pay income tax on these distributions and put the balance in an account. For purposes of our calculations, assume a 6% rate of total return and a 37% tax rate.

Let's compare the above plan to an alternative plan of naming a conduit trust for the benefit of the child as the beneficiary of the rollover IRA. The conduit trust: receives the distributions; pays them to the beneficiary who pays the taxes; and puts the net amount into an account. In one version of this alternative, the distributions will be paid in 10 annual installments, and in a second version, they'll be paid in a lump sum at the end of 10 years.

For the first example, let's look at the simple situation in which the only asset of the surviving spouse is the rollover IRA worth $1 million. "Rollover IRA of $1 Million," this page, shows how much will accumulate in the child's account over time under each scenario. For the conduit trust alternative, the IRA balance is included in the account balance until it's fully distributed.

The blue and orange lines show the difference between taking the retirement account in a lump sum at the end of the 10-year period versus taking the retirement account in 10 annual installments. The blue line is above the orange line because of the extra 10 years of tax-free return inside the IRA. The gray line representing the accumulated unitrust distributions from the CRUT starts at zero and eventually catches up and then exceeds the accumulated values from the outright distributions. The crossover point is 35 years for the installment alternative and 41 years for the lump sum alternative. This is beyond the 30-year life expectancy of the beneficiary.

Clients concerned about the shortfall in the accumulations account under the CRUT alternative could consider having a life insurance policy acquired on the life of the child beneficiary to replace the value of the assets going into the CRUT. The viability of this solution depends on the insurability of the child beneficiary.

But, this view places no value on the charitable remainder. For clients who are charitably inclined, the charitable remainder in the CRUT can have as much value to their estate plan as the assets going to their children and grandchildren. "Assets Going to Charity Included," this page, adds the assets in the CRUT to the assets in the child's accumulations account under the CRUT alternative, showing the total combined assets going to the child and the charities. The fact that, on top of what goes to their family, as much as $1.275 million will go to their chosen charitable beneficiary, or perhaps a donor-advised fund controlled by their family, is a significant benefit to these charitably inclined clients.

For the second example, consider an individual with the following assets:

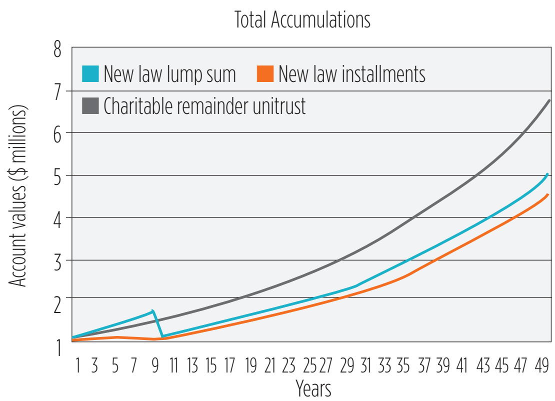
Value of non-retirement assets	$10,000,000
Value of retirement account	$5,000,000
Total estate	$15,000,000
Federal estate tax (no CRUT)	$1,348,000
CRUT charitable remainder percentage	32.105%
Estate tax charitable deduction	$1,605,250
Federal estate tax with CRUT	$705,900
Federal tax savings by using CRUT	$642,100

This example adds the benefit of the estate tax charitable deduction to the plan. "Estate Federal Tax Charitable Deduction Benefit," this page, compares the two alternatives described above with this asset mix.

The relative position of the three lines doesn't change. The lump sum alternative is best in the early years, and the CRUT alternative catches up and eventually exceeds both the installment and lump sum alternatives under the new law. The crossover point is 31 years for the installment alternative and 36 years for the lump sum alternative, much closer to the 30-year life expectancy of the beneficiary. The crossover point occurs sooner in this example because of the $642,100 federal estate tax savings created by the deduction for

Assets Going to Charity Included

Charitable remainder unitrust is a clear choice for charitably inclined clients



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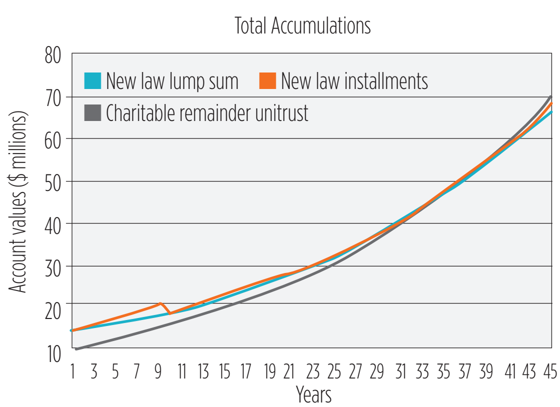
Estate Federal Tax Charitable Deduction Benefit

The crossover point occurs sooner



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the charitable remainder interest in the CRUT.

If your client lives in a state with an inheritance tax, the CRUT alternative becomes even more attractive. For example, in my home state of Pennsylvania, there's a 4.5% inheritance tax on children and grandchildren. If we add in the Pennsylvania inheritance tax to the example above, the crossover point is 30 years for the installment alternative and 35 years for the lump sum alternative, another year sooner, and now within range of the child's 30 year life expectancy.

Income Available to the Beneficiary

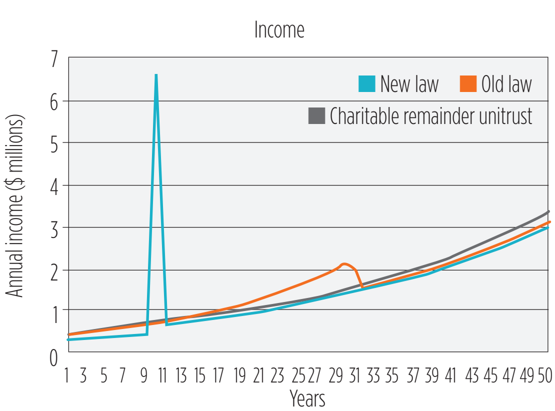
The examples above focus on the total accumulation of assets passing to the beneficiaries. Another way to look at the benefit of the CRUT plan is how it affects the income available to the beneficiary. "Cash Flow," this page, shows the after-tax income available to the beneficiary under the old law, when the stretch IRA was available, the new law with a lump sum payment after 10 years and the unitrust payment from the CRUT.

The CRUT provides the smoothest income stream to the beneficiary. Under the old law, as the beneficiary approaches his life expectancy, the distributions become larger, because the principal amount of the retirement account is being distributed. The beneficiary gets a pay cut once the account is fully distributed, while the income from the CRUT continues to grow. For clients who are interested in providing income security to their children for their entire lifetimes, I would argue that the CRUT alternative provides the greatest income security, even better than the stretch IRA trust that's no longer available after the SECURE Act. And, it's better than the 10-year payout under the new law in every year except the year when the full retirement account balance is paid to the beneficiary.

If you include the beneficiary spending patterns in the analysis, the CRUT looks better, because the assets in the CRUT can't be spent. The engine generating the

Cash Flow

New law versus old law



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SPOT LIGHT

Pruning Away

Paysanne Dans Les Vignes (Marie-Louise)—Recto Marie-Louise Assise Au Soleil—Verso by Henri Martin sold for GBP 60,000 at Sotheby's Impressionist & Modern Art Day Sale on Feb. 5, 2020 in London. Martin was a renowned French Impressionist painter. Born in Toulouse, France, he received scholarships, which allowed him to live and paint in Paris and later in Italy.

income will continue to throw off income each year, regardless of how much the beneficiary spends. And, in the extreme example in which the beneficiary spends all of the income received each year, the CRUT provides income security, while the beneficiary will run out of money under the other approaches. This may be particularly important to a client whose retirement account represents the bulk of the estate.

Food for Thought

There are many variables that affect these calculations, including income tax rates (for both ordinary income and capital gains), federal estate tax and state death tax rates, the ages of the client and children, rates of return, the applicable federal interest rate and the beneficiary's spending patterns, to name a few. There's no one-size-fits-all approach. But, for many clients, naming a CRUT as the beneficiary of their retirement plan deserves serious consideration.

For the charitably inclined client, naming a CRUT as the beneficiary of a retirement account can be a very attractive plan. But, it's also worthwhile for clients who have only a mild interest in charitable beneficiaries. I expect more clients will be interested in charitable beneficiaries when they realize how little it may reduce the value of their assets that will pass to their families.

Endnotes

1. Setting Every Community Up for Retirement Enhancement (SECURE) Act Section 107.
2. SECURE Act Section 114.
3. SECURE Act Section 302.
4. SECURE Act Section 401.
5. Internal Revenue Code Section 401(a)(9)(E)(ii).
6. IRC Section 7520 rate for May 1996.
7. Section 7520 rate for March 2020.
8. IRC Section 664(d).
9. Section 664(b).

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