

The Testamentary CGA: A “Stretch IRA” Alternative

The “Stretch IRA” was a popular tool for extending the benefits of a tax-deferred account to a non-spouse beneficiary at the death of the account owner. The goal was to minimize the tax impact of the Required Minimum Distributions (RMDs) when the beneficiary received the account as an Inherited IRA. Typically, it worked by having the account owner designate a child or grandchild as the beneficiary of their IRA, who was then allowed to stretch the RMDs out over their own lifetime rather than the lifetime of the decedent. This meant smaller required distributions, less tax paid, and more tax-deferred growth on the remaining assets in the IRA account.

SECURE ACT – 2019

However, in late 2019, the *Setting Every Community Up for Retirement Enhancement Act* (“SECURE Act”) was passed into law. A major change is that it requires non-spouse beneficiaries of Inherited IRA accounts to withdraw the balance of the account within 10 years after the death of the original IRA account owner. This can radically change the timing and amount of taxation on the account in the hands of the beneficiary. Therefore, the new law effectively ends the use of the Stretch IRA strategy. Are there other options which can replicate the benefits of that approach?

Another approach might be to designate a charity as the beneficiary of the IRA. This means the charity simply receives some or all of the balance of the IRA account at the IRA owner’s death.¹ However, this approach does not provide any income for the decedent’s children or grandchildren – which was the purpose of the Stretch IRA! Thankfully, there are other charitable options which do provide income for the heirs and “stretch out” that tax liability for them.

T-CRUT ALTERNATIVE

One such option is to use a Testamentary Charitable Remainder Unitrust (T-CRUT). Conceptually, this is quite simple. The IRA owner simply designates a T-CRUT as the beneficiary of their IRA at death. Upon death, the T-CRUT is funded with the decedent’s IRA account assets, and then pays out a percentage of those trust assets to named lifetime beneficiaries. The beneficiaries will pay tax on the income received each year over their lifetime, much like they would have under the old Stretch IRA rules. Upon the death of those beneficiaries, the remaining T-CRUT assets pass to the charity chosen by the original IRA account owner.

There are some up-front costs and hurdles to using a T-CRUT, so it may not be appropriate for everyone. First, the account holder needs to have a T-CRUT agreement drafted so it can be named the beneficiary of the IRA with the IRA Custodian. This requires the assistance of an

¹ Lange, J. (Dec. 26, 2019), “Guide To Beating The New Death Tax: The End Of The Stretch IRA,” Forbes, <https://www.forbes.com/sites/jlange/2019/12/26/guide-to-beating-the-new-death-tax-the-end-of-the-stretch-ira/#4eb7af3b49e9>.

attorney, which is an up-front expense the account holder will incur for a trust which will not be used until the account holder's death which could be many years down the road.. Further, the trust will require trustees, investment advisors, and tax accountants once the CRUT goes into effect. That means additional fees for each of those professionals during the administration of the T-CRUT for the lifetime of the beneficiaries. For these reasons, a T-CRUT may only be appropriate for IRAs with significant value – perhaps half a million dollars or more.

T-CGA ALTERNATIVE

Thankfully, there is an alternative to using the T-CRUT as the beneficiary designation for the IRA. A Testamentary Charitable Gift Annuity (T-CGA) can be used to guarantee fixed lifetime payments to the IRA holder's beneficiaries, and has several advantages over the T-CRUT. The T-CGA is a contractual agreement with a charity where it agrees to provide an annuity income for the life/lives of a person(s) exchange for lump sum contribution to the charity up-front. Any excess funds following the death of the annuitant(s) go to the charity to be used for charitable purposes. The CGA payout rates are typically determined by reference to the published schedule of the American Council on Gift Annuities, an independent not-for-profit dedicated to providing guidance o Gift Annuity administration by charities.

A T-CGA may be appealing to the IRA owner instead of a T-CRU because it is considerably less expensive and time-consuming to set up and administer. Administrative costs are much lower, because the accounting and investment costs are typically shared with other CGAs in a larger pool that the charity is managing. Further, the recommended CGA payout rates account for investment and administration expenses at least in part.²

There are other advantages as well. Unlike a T-CRUT, which pays out a fixed percentage on a moving value that changes each year, a T-CGA will pay out a fixed dollar amount for the life of the annuitant, which takes any market risk out of the equation. That dollar amount is determined by reference to the annuitant's age and the recommended rates published by the ACGA as referenced in the prior paragraph. Better still, the T-CGA does not have a minimum payout requirement, unlike the CRUT, which means that younger beneficiaries can benefit from the IRA-to-CGA-at-death strategy (T-CGA).

How would an IRA account owner implement the T-CGA stretch out plan? There are a number of considerations to keep in mind when utilizing this strategy. First, the account holder will of course be deceased when the annuity goes into effect. It is vitally important to ensure that expectations regarding the designation and annuity agreement are clearly understood. If the transfer is completed properly, it is likely that there would be no taxable income realization for either the estate or the annuitant at the time the T-CGA is funded. Thereafter, the annuity payments to the annuitant are likely to be taxed to them as Ordinary Income, much like IRA

² American Council on Gift Annuities, "Current Rates," last updated November 25, 2019, <https://www.acga-web.org/gift-annuity-rates/current-rates>.

distributions would have been. But with the T-CGA those taxable distributions are spread out over the beneficiary's lifetime rather than compressed into a 10-year period.

TAX RULES

An important consideration is that the IRS has only weighed in on T-CGA technique by way of private letter ruling.³ A private letter ruling is not binding legal precedent,⁴ however it can illustrate the thinking of the Internal Revenue Service when it comes to specific tax strategies and issues. As such, donors and advisors alike should remember that this is somewhat new territory. However, the outright donation of IRA assets directly to a charity is a well-established testamentary gift.⁵

In Private Letter Ruling 200230018, the IRS responded to a request for rulings "concerning the tax treatment of funding a testamentary charitable gift annuity with assets from an individual retirement account."⁶ The specific rulings addressed five points in turn:

1. Impact on the charity's tax-exempt status

The ruling here was quite straightforward – the charity's tax exempt status would not be adversely affected by receiving the IRA proceeds. Additionally, receipt of the IRA proceeds would not cause the charity to recognize unrelated business taxable income.

2. The character of the annuity payments

The Service declined to issue a ruling on this question, since it was a hypothetical situation assuming a now-living annuitant would survive the IRA account holder.

3. Whether the IRA account holder's estate would include the value of the IRA at the time of death

The Service confirmed the value of the IRA at death would be included in the account holder's gross estate. This was because the account holder either made contributions to the IRA personally or through an employer, and the account holder had the right to receive payments from the account during life.

4. Whether the IRA account holder's estate could claim an estate tax charitable deduction

The Service stated that it would allow an estate tax charitable deduction equal to the excess of the IRA's value over the present value of the annuity. It referred to prior revenue rulings

³ I.R.S. Priv. Ltr. Rul. 200230018 (July 26, 2002).

⁴ Internal Revenue Service, "Tax Exempt Bonds Private Letter Rulings: Some Basic Concepts," last updated October 24, 2019, <https://www.irs.gov/tax-exempt-bonds/teb-private-letter-ruling-some-basic-concepts>.

⁵ Fidelity Charitable, "Donating Retirement Assets," <https://www.fidelitycharitable.org/guidance/philanthropy/donating-retirement-assets-to-charity.html>.

⁶ Supra note 4.

allowing deductions for gift annuities and code sections allowing estates deduction for transfers to charitable entities.

5. Whether the proceeds from the IRA are included in the estate' income

Finally, the Service concluded that since a charity would be named a designated beneficiary of the IRA, then the proceeds from the IRA would not be income to the estate, but would be income to the charity (which is, of course, tax-exempt). Interestingly, the Service also noted that the character of the income in the hands of the charity would have the same character as it would have in the hands of the account holder.

HOW TO IMPLEMENT A T-CGA

With those considerations in mind, the charity and IRA account holder will need to decide whether a Testamentary Charitable Gift Annuity is appropriate for their situation. If so, they will need to jointly determine what terms for the annuity agreement are acceptable. These terms should include:

1. Who the annuitant(s) will be (children, grandchildren, etc.)
2. Legal name, date of birth, address, and social security number of the annuitant(s)
3. Age at which the Rate of the annuity will be based
4. Frequency of annuity payments
5. What charity(s) the remaining assets should go to following the annuitant's death

Luckily, these are normal questions when creating a lifetime CGA contract, and the contract will generally be similar to standard Charitable Gift Annuity agreements which have been used for over 160 years.

There are some special contractual considerations, however. Note that the T-CGA should be issued to the annuitant at the Payout Rate in effect by the ACGA at the IRA account holder's death, since it could be many years before the account holder dies. To prevent the charity from incurring any tax liability due to unrelated debt financed income, the agreement should provide that the annuity rate will be reduced "to the extent necessary to pass the greater than 10% actuarial remainder test required by Internal Revenue Code section 514(c)(5)."⁷ Additionally, the agreement need only be enforceable against the charity. To that end, the agreement should indicate that it is contingent on the beneficiary designation actually taking effect. Finally, the agreement should not be assignable to any party other than the charity, and the assets in the IRA should be liquidated as quickly as possible to avoid any decline in value following the death of the account holder and prior to the funding of the annuity.⁸

⁷ Katzenstein, L. (February 10, 2020), "Testamentary Charitable Gift Annuities as Alternative to a 'Stretch' Charitable Remainder Trust?," LISI Charitable Planning Newsletter #292.

⁸ *Id.*

EXAMPLE

Consider a simple example. An 85-year-old, single man named Mr. Smith owns an IRA account worth \$100,000. He would like his 35-year-old grandchild (Ms. Jones) to receive income, after his death and would have made the grandchild a beneficiary of his IRA under the old, pre-SECURE Act tax regime. Instead, he approaches a charity (“Charity”) willing to issue a T-CGA. Charity agrees to issue an immediate annuity to Ms. Jones at the prevailing rates when Mr. Smith passes away in exchange for the charity being named the beneficiary on the IRA account at Mr. Smith’s death. Mr. Smith and Charity execute a T-CGA contract, and Mr. Smith includes the following beneficiary designation language in his IRA account with the IRA Custodian:

“Charity, pursuant to the gift annuity agreement dated January 1, 20XX between Mr. Smith and Charity, as the same may have been later amended.”

In turn, the T-CGA contract stipulates that it is contingent on the beneficiary designation remaining in place and on the transfer of the IRA account to Charity. Ten years later, Mr. Smith dies, and the IRA account passes to Charity as planned. A now 45-year-old Ms. Jones will receive an income stream at the prevailing rate. Note that many charities will not issue a CGA to a person under 55 years old, in which case, the deferral option discussed below may be appropriate.

Deferral on the T-CGA is also a possibility, just like with a more traditional CGA design (and unlike CRTs, where deferral is not an option). If the charity and account holder decide a deferral is appropriate, they can include that language in the agreement as well. For instance, a 10-year-deferral in the first example would still result in the IRA account passing to Charity after Mr. Smith dies. The T-CGA will be fully funded at that point, and the payout will begin at the end of the deferral period when Ms. Jones turns 55 years old.

Another common situation would be where the account holder wants to use the account proceeds to give income to more than one person. It is, of course, very common for grandparents to have multiple grandchildren. Can the T-CGA structure be adapted for cases like that? The simple solution is to execute multiple T-CGA agreements, one for each annuitant. When working with the account holder, the charity should be certain to establish how the IRA will be divided up. The proportions should be clearly laid out in each individual annuity agreement. For example, if Donor wanted to split the IRA account unevenly between three grandchildren (perhaps giving other, non-IRA assets to the grandchildren receiving smaller T-CGAs), the agreements should indicate which percentage of the account funds each T-CGA. If Donor wants to split the IRA 50/30/20, each agreement should indicate that it is being issued to the appropriate annuitant grandchild for the corresponding percentage.

CONCLUSION

A Testamentary Charitable Gift Annuity can be a great solution for the needs of a donor with an IRA account that they want to protect from creditors and taxes in the hands of their heirs.

Since the SECURE Act effectively stopped the Stretch IRA option, financial advisors have been scrambling for alternatives. A charitably-inclined IRA owner who would also like to secure some income for a younger family member should consider a T-CGA. A simple beneficiary designation change on the IRA account is all that is required to transfer the funds to charity at the IRA owner's death. The charity and donor will also execute an annuity agreement contingent on that designation remaining in place. The T-CGA can be a simple and elegant solution for IRA account holders and charities alike.

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