A fundamental tenet of charitable giving is that it is wise to use "tax heavy" assets to make charitable gifts.

Retirement plan assets (other than Roth IRAs) are among the most "tax heavy" assets people own because distributions from retirement plans are fully taxed at ordinary income rates. Estate planners commonly advise their clients to fulfill charitable gifts with retirement plan assets, as that can reduce both estate taxes and income taxes that heirs would otherwise have to bear. This advice is all the more vital following passage of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), which eliminated the ability to leave retirement assets to heirs (other than a spouse) in a way that would allow them to defer that income tax burden by "stretching" required distributions over the heirs' lifetimes. Now, all retirement assets must generally be distributed within 10 years, with each distribution taxable to the beneficiaries.

Since passage of the SECURE Act, advisors have increasingly urged retirement plan owners to use these assets to satisfy their charitable bequests, or perhaps contribute them to "split interest" vehicles such as charitable remainder trusts, which can allow for annual payments to heirs in a way that spreads out the income tax burden on them while leaving a legacy to charity in the form of a remainder interest. With respect to lifetime gifts, since 2006, retirement plan owners who are at least age 70½ have had the ability to give up to $100,000 per year to charities directly from their IRAs as qualified charitable distributions (QCDs). Those QCDs count toward a plan owner's required minimum distribution (RMD) amount and are not included in the plan owner's taxable income at all.

SECURE Act 2.0

By way of the SECURE Act 2.0, enacted at the end of 2022, Congress expanded a plan owner's ability to use QCDs to combine tax savings with philanthropy.

First, Congress added an inflation adjustment to the $100,000 QCD limit starting in 2024. In addition, Congress added a brand-new mechanism allowing people to make a QCD not just outright to charity but also to certain "life income" charitable vehicles, including charitable gift annuities (CGAs) and charitable remainder trusts (CRTs).

Each plan owner can make a QCD to a life income charitable vehicle of up to $50,000 per lifetime (not annually). The hope is that Congress will expand the $50,000 lifetime cap in the future. So how does this new ability to give up to $50,000 to charity and receive annual payments in exchange operate? Below is a brief overview of these life income charitable vehicles generally and how they would work with QCD contributions under the new rules.

Charitable Gift Annuities

Generally

To set up a CGA, a donor makes a gift to a charity in exchange for an annuity that pays out a certain amount each year to the donor (or someone else chosen by the donor, typically a spouse or child). The annuity payout rates are generally those set either by state law or by the American College of Gift Annuities (ACGA), whose published rates are commonly adopted by charities across the country. The right to a lifetime of annuity payments has a "present value," and the amount contributed to charity in excess of that present value can be taken as an income tax deduction. Each year, a portion of the annuity payment received is treated as taxable income and a portion is treated as tax-free return of principal.

For example, a 75-year-old donor with a 75-year-old spouse might give $50,000 to a charity in exchange for an annuity at the applicable January 2023 ACGA rate (in this case, 5.8%).

- The donor and her spouse would receive an annuity of $2,900 each year until both are deceased.
- Each year, $1,061 of that amount would be taxed as ordinary income, and the rest would be treated as tax-free return of principal (until about 16 years later, when all principal has been returned and any remaining payments will be taxed as ordinary income).
- Because the present value of this annuity (using the IRS's methodology) is $30,133, the donor is treated as having given charity $19,867 in excess of the value of that annuity, and so receives an immediate income tax charitable deduction of $19,867.

When Funded by a QCD

A CGA funded under this new mechanism as part of a QCD has to meet certain special requirements:

- **The CGA must be exclusively funded by the QCD.**
    - You cannot partially fund the same CGA with other assets, although it is perfectly fine to have two (or more) separate CGAs with a given charity, one funded by the QCD and the other(s) funded by other assets.

- **The payout rate for the CGA must be at least 5%.**
    - In many states, CGA rates are set by law. In other cases, charities use the ACGA rates. Under current interest rates, the payout required for donors who are age 70½ or older will likely exceed the 5% minimum. However, it is important to confirm that any rate required by law or offered by a charity in fact meets this requirement.
- **The annuity payments must begin no later than one year from the date of funding.**
    - You cannot use a QCD to fund a so-called deferred or flexible charitable gift annuity (which allows deferral of the initial annuity payment).
- **Only the donor and/or the donor's spouse may be annuitants.**
    - You cannot use IRA assets to fund a CGA for a child and have that CGA qualify for QCD treatment.
- **The annuity must be nonassignable.**
    - Pending further guidance from the IRS, CGA agreements should expressly prohibit all assignments of annuity interests, even assignments to the charity paying the annuity.
- **There can be no quid pro quo in exchange for the QCD payment other than the annuity payments.**
    - This is a rule for all QCDs and is the reason why donors cannot, for example, use QCDs from IRAs to buy tickets for the charity's gala.

If these requirements are satisfied, then the $50,000 (or less) of IRA assets used to fund the CGA will (i) count toward the donor's RMD from the IRA and (ii) not be included in the donor's taxable income in the year of the QCD. The donor does not receive an additional income tax deduction in this case, but the exclusion from income is the equivalent of a 100% income tax deduction and applies to both federal and state income tax. That offers an additional benefit in a state that does not have a state-level income tax charitable deduction. In exchange for these tax benefits, all CGA payments to the donor or the donor's spouse will be treated as taxable ordinary income in the years in which the annuity payments are made.

Charitable Remainder Trusts

Generally

Unlike CGAs, CRTs are separate legal entities established as trusts with trustees and beneficiaries. A CRT begins with the creation of a trust instrument, which provides that the designated beneficiaries (typically some combination of the donor, the donor's spouse, and one or more descendants) will receive at least annually either an annuity amount (this is a so-called charitable remainder annuity trust, or CRAT) or a percentage of the trust assets each year (a so-called charitable remainder unitrust, or CRUT).

- Those payments continue either for the life or lives of the designated beneficiary(ies) or for a period of up to 20 years, or certain combinations of the two.
- At the end of the payment period, any remaining assets pass to charity.
- The annuity or unitrust payments have to be at least 5% (of the original contribution amount in the case of a CRAT or of the annual value of the trust assets in the case of a CRUT), and there are various mathematical tests that have to be satisfied for the CRT to qualify, generally intended to establish a certain likelihood that the charity will get a minimum amount at the end of the trust term.

Assuming it does qualify, the CRT itself is not subject to income tax, but the annual payments to the beneficiaries will carry out to those beneficiaries any taxable income realized by the trust. This allows donors to spread out certain tax consequences over many years; for example, many donors give highly appreciated assets to CRTs, and then when the CRTs sell those assets, the capital gains tax is due not right away but only as distributions are made. Similarly, decedents can leave retirement plan assets to a CRT, so that instead of their estates or heirs having to realize taxable income over a short period, that income tax burden can be effectively spread out along with the CRAT or CRUT payments. In addition, donors can receive income tax deductions (for lifetime gifts to CRTs) or estate tax deductions (for testamentary gifts) equal to the present value of the charity's remainder interest.

For example, our 75-year-old couple funding a CRAT in January 2023 with $50,000 for benefit of themselves (or the survivor of them) for their lifetimes will receive $2,500 per year (using the minimum payout rate of 5%) and a 2023 income tax deduction of $24,024.

- If instead they fund a CRUT with the same amount, they will receive $2,500 in the first year, but that annual payment amount may be higher or lower in future years depending on investment performance. With a CRUT, their 2023 income tax deduction will be $24,847.
- Note that the income tax deduction for CRATs can fluctuate greatly as prevailing interest rates change, while the income tax deduction for CRUTs is largely agnostic to changes in interest rates. Where, interest rates are at around 5%, as is the case currently, the income tax deduction is roughly the same when funding a CRUT or a CRAT with a 5% payout.
- In a low interest rate environment (as we have had for many years until recently), CRUTs provide a much better income tax deduction than CRATs.

When Funded by a QCD

A CRT funded under this new mechanism as part of a QCD likewise has to meet certain special requirements:

- The CRT must be exclusively funded by the QCD.
    - While CRATs do not allow additional contributions, CRUTs do. It is not uncommon for a donor to establish a CRUT and then add to it later. However, to qualify for QCD treatment, you cannot mix funding sources. The CRT (whether a CRAT or a CRUT) must be funded exclusively with the QCD amount. It is recommended to write that restriction into the trust agreement.
    - On a practical level, in many or most cases it will not be economical to establish a CRT with only $50,000 (the maximum allowed for this purpose), given the carrying costs of a CRT (trust creation costs, potential trustee fees, tax preparation, etc.). Some charities (in particular higher education institutions) will facilitate the creation and management of CRTs for donors (including possibly serving as trustees of the CRTs), in which case it may be economically feasible to fund a CRT with only $50,000. However, until such time as Congress raises this amount, it will likely be more common for donors to use their $50,000 of QCD to fund CGAs rather than CRTs.
- Only the donor and/or the donor's spouse may be annuitants.
    - As with CGAs, you cannot use retirement fund assets to fund a CRT for a child and have it qualify for QCD treatment.
- The annuity must be nonassignable.
    - As above, pending further guidance, CRT instruments that will receive QCDs should forbid all assignments, even assignments to charitable remainder beneficiaries.
- There can be no quid pro quo in exchange for the QCD payment with respect to the charitable remainder interest.
- *Note that the other requirements noted above for CGAs (minimum 5% payout rate and that payments must begin within a year) are requirements already applicable to all CRTs, whether or not funded by QCDs.*

As with QCDs in exchange for CGAs, if these requirements are satisfied, then the $50,000 (or less) of IRA assets used to fund the CRT will (i) count toward the donor's RMD from the IRA and (ii) not be included in the donor's taxable income in the year of the QCD (in lieu of an income tax charitable deduction). In exchange for these tax benefits, all CRT annuity or unitrust payments to the donor or the donor's spouse will be treated as taxable ordinary income in the years in which the payments are made.

Conclusion

The inflation adjustment for the $100,000 limit for QCDs is overdue and welcome. The one-time ability to give up to $50,000 to a life income vehicle (a CGA or a CRT) is limited in scope for the moment but represents the first time that Congress has allowed lifetime contributions from IRAs to be used to fund life income vehicles while also counting toward a plan owner's RMD and avoiding inclusion in taxable income. It would not be surprising to see Congress build on this new mechanism in future legislation, continuing this trend toward greater flexibility in using retirement assets to support charitable legacies.

Contact Us

Please contact the authors of this alert or a member of our Nonprofit Group if you have questions about using retirement assets to make charitable gifts.

Brad Bedingfield
Partner
617.557.9704
bbedingfield@hembar.com

Nancy Dempze
Partner
617.557.9726
ndempze@hembar.com