

Where Should a Testamentary CRT Document “Live”?

Timothy J. Prosser, JD, Relationship Manager

A charitable remainder trust (CRT) is typically created during the donor's life, paying an income stream to the donor for her lifetime with the remainder passing to charity at death. However, a CRT may also be a testamentary gift, created upon the donor's death to benefit other individuals for their lifetimes or a term of years, with a remainder gift to charity. While the value of the testamentary CRT funding is included in the donor's taxable estate, an estate tax charitable deduction is available for the present value of the charity's remainder interest. Although the charity might not receive its remainder interest for many years, testamentary CRTs tend to be funded with large dollar amounts and therefore can be very worthwhile gifts.

Donor interest in retirement plan-funded testamentary CRTs has increased since the passage of the SECURE Act in 2019, which largely eliminated the possibility of stretching distributions from inherited qualified retirement plans over individual beneficiaries' lives. Today some planners recommend naming a testamentary CRT as the beneficiary of a retirement plan as a way to achieve tax benefits comparable to those of the “stretch IRA.”

Location of the Governing Instrument?

To work properly, a testamentary CRT needs a funding source and a governing trust instrument. Funding might come from the donor's probate estate (that is, from her Will), from her revocable living trust, or by means of a beneficiary designation in a life insurance policy or in a retirement plan such as an IRA or 401(k) plan.

The source of funding often drives what type of document is used to contain the terms of the CRT—in other words, where the testamentary CRT document “lives.” For example, if the funding source is the probate estate, then the CRT provisions are often included in the donor's Will, which governs the disposition of probate assets. Of course, many decedents use revocable living trusts as their principal estate planning documents in order to avoid the time and expense of probate administration. If a donor's testamentary CRT is to be funded with assets held in her living trust, often the CRT provisions will also be included in the governing document that contains the provisions of the living trust.

When the CRT’s funding source is the beneficiary designation of a life insurance policy or retirement plan, the donor will likely find it difficult or unwieldy to include the CRT provisions as an attachment to the beneficiary designation. What then is the best place to record the CRT provisions? One option would be for the donor to incorporate the CRT provisions in a newly-executed Will or a codicil. If this path is chosen and funding will come from an IRA or retirement plan, the IRA or retirement plan beneficiary designation form and the terms of the Will should be drafted to ensure that the IRA or retirement plan funding is allocated specifically to the CRT and not generally to the donor’s estate as that could create an unnecessary income tax liability for the estate.

It is also perfectly fine to incorporate the CRT provisions into a revocable living trust document even though the funding will come from an IRA and not from assets owned by the revocable living trust. The IRA beneficiary designation might specify, for example, that the IRA account balance at the donor’s death be distributed “100% to ABC Charity, trustee of a charitable remainder trust described in Clause X of a trust document executed by me on Month, Day, Year.”

The “Dry” Trust

Sometimes a donor will create an inter vivos trust instrument, completely separate from her revocable living trust instrument, which is intended to serve as the CRT’s governing document following her death. In order to create a legally valid and operative entity under state law that can accept the IRA distribution upon the donor’s passing, this type of trust is sometimes funded with a small amount of money, for example, \$10. There is no intent that the trustee actually invest the \$10, make payments to the income beneficiaries, or file tax returns. Often this approach is referred to as creating a “dry” trust.

If this approach is chosen, care must be used to make certain that the dry trust is not created in an irrevocable format. IRS regulations require that a CRT be administered from the date of its creation as a CRT.¹ For example, if the so-called “dry” trust is drafted as a 5% standard charitable remainder unitrust and funded with \$10 in order to make it a valid trust under state law, then in order to administer it as a CRT from the date of its creation the trustee would have to apply for a taxpayer ID number, annually file the federal tax return required of a CRT, and make the tiny payments to the income beneficiaries from the date the trust was funded with \$10. Failure to do so would risk disqualification as a CRT, resulting in a taxable trust for income tax purposes when the intended funding comes from the IRA upon the death of the donor. It could also risk the loss of the estate tax charitable deduction for the value of the remainder interest.

¹ Treasury Regulation § 1.664-1(a)(4).

A better approach for a donor who wishes to create a stand-alone “dry” trust is to create it as a revocable trust funded with a nominal dollar amount (for example, \$10) that specifies that the trustee need not invest the nominal funding. The revocable trust has no income, requires no beneficiary payments, and has no tax reporting of its own—but the trust exists under state law and contains provisions for establishing a CRT after the donor dies. Upon the donor’s death, the funding source (whether a Will, a living trust, or life insurance or retirement plan beneficiary designation) directs funds to create a CRT governed by the provisions described in the revocable trust instrument.

Summary

A testamentary CRT can be an important source of income for a donor’s surviving family members, while providing significant benefits to a charitable remainder beneficiary. In order to achieve all of its potential benefits, care must be taken in drafting the CRT’s governing instrument to coordinate with the funding source and to be sure the trust will qualify as a CRT under the tax code. For additional information on other aspects of the planning and administration of testamentary CRTs, please see “Testamentary Funding of Charitable Remainder Trusts,” and “Testamentary Charitable Remainder Trusts: Early Communication Pays Off,” which are available in the Learning Center of Kaspick Connect. ■

Disclosures: TIAA Kaspick does not provide legal or tax advice. TIAA Kaspick provides tax preparation services under the terms of each client’s gift administration agreement. This publication is not intended or written to be used, and cannot be used (i) for the purpose of avoiding tax-related penalties, or (ii) to promote, market, or recommend to another party any transaction or matter addressed. (IRS Circular 230 Notice)