

Using Charitable Remainder Trusts to Reduce Income Tax Inefficiency in Retirement Accounts and Give More

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The Federal estate and gift tax exemption is at a historically high level. In 2026, only individuals who make taxable gifts during their lifetime, combined with assets that pass through their estate, in excess of \$15 million, will be liable for any tax. As such, much of the focus of estate planning has shifted from reducing estate tax liability towards creditor protection and succession planning. However, many individuals with significantly less than \$15 million in assets may still leave their beneficiaries with significant tax liability if their assets are held in qualified accounts, such as individual retirement accounts (IRAs) and 401(k) plans. Trillions of dollars are currently accumulated within these tax-advantaged qualified retirement accounts. For many families, their IRA or 401(k) represents their most significant appreciated assets.

Retirement Accounts do not receive a “Step-Up” in Basis

Most appreciated assets receive a “step-up” in capital tax basis at the owner’s death. The “step-up” means that the decedent’s heirs inherit these assets with a capital gains tax basis reset to the fair market value as of the date of the decedent’s death. For example, if an individual acquires a stock at \$100 and later sells it for \$1,000, the individual is liable for capital gains tax on the appreciation in the stock. However, if the individual dies owning the stock and his heirs sell it immediately, there will be zero capital gains tax liability. This step-up can effectively wipe out thousands of dollars in capital gains tax liability.

Unfortunately, IRAs and 401(k)s are an exception to this rule. They do not receive a “step-up” basis. Instead, every single dollar of appreciation in these assets, once distributed from an inherited IRA to an individual beneficiary, is taxed as ordinary income at the beneficiary’s income tax bracket.

Before the enactment of the SECURE Act, beneficiaries of inherited IRAs were permitted to “stretch” these taxable distributions over their lifetime by taking required minimum distributions (RMDs) based on their life expectancy. A beneficiary younger than the original account owner would have much smaller RMDs, allowing inherited IRA assets to appreciate over a long period of time, income tax-deferred. This strategy reduced or eliminated the “income tax bracket creep” that may occur when significant distributions are made from the inherited IRA that would push the beneficiary into a higher income tax bracket and increase the amount of the income taxes that were ultimately paid.

The SECURE Act largely eliminated this strategy. Under current law, most non-spousal beneficiaries must liquidate their inherited IRA within ten years of the death of the original account holder. This is commonly referred to as the “ten-year rule.” The compressed time frame reduces the time that the assets within the inherited IRA can continue to grow without the tax drag. It makes it much more likely that the distributions will push the beneficiary into a higher tax bracket. To make matters worse, most beneficiaries of qualified accounts will be in their peak earning years. Distributions from a modest one-million-dollar inherited IRA will be reduced by hundreds of thousands of dollars after the payment of federal and state income taxes.

Using a Charitable Remainder Trust to Restore Tax Efficiency

Fortunately, there is a solution to replicate the “stretch” and reduce this income tax inefficiency. The account holder can name a charitable remainder trust (CRT) as the designated beneficiary of the IRA. The CRT can be established during the account holder’s lifetime or may be designated under the account holder’s will or revocable trust (a “testamentary CRT”).

A CRT is a split-interest, tax-exempt vehicle. One or more income beneficiaries receive an annual payment for a set term of years (a “CRAT”), or an amount based on a percentage of the trust at the end of the year (a “CRUT”). At the end of the term, which could be as long as the income beneficiary's lifetime, the remaining trust assets are distributed to one or more qualified charities. In this way, the original account owner can support their philanthropic goals and ensure their families are provided for.

When a CRT is designated as the beneficiary of an IRA, the entire IRA balance is transferred directly to the trust upon the account holder's death. Because a CRT is a tax-exempt entity, no income tax is recognized or paid upon the liquidation of the IRA. The full, undiminished account remains intact within the trust. The income beneficiary is guaranteed to receive a predictable flow of income.

Because the distributions are made slowly over time, it reduces the likelihood that the distributions will push the income beneficiary into a higher tax bracket. As such, the beneficiary is likely to pay less overall income tax liability than if they had been named the outright beneficiary of the IRA. In addition, because the CRT is a tax-exempt trust, the assets in the CRT will continue to appreciate tax-deferred.

If the CRT is structured to last for the duration of the income beneficiary's life, the time horizon from which the distributions must be made from the account has effectively been increased from ten years to as much as several decades or longer. This creates significant potential that the total distributions to the income beneficiary will exceed what they would have received had they been named the outright beneficiary of the account.

Finally, the estate of the original account holder benefits from an estate tax deduction equal to the actuarial value of the interest that passes to charity. In states such as New York, Washington, or Oregon, where the state estate tax exemption amount is much less than the federal estate tax exemption amount, this may be a valuable deduction.

Key Considerations and Conclusion

It is important to note that pursuant to Section 664 of the Internal Revenue Code, a CRT must distribute at least 5% (but no more than 50%) of its value annually to the income beneficiary. In addition, at least 10% of the actuarial value of the account must ultimately pass to the charitable remainder beneficiary. This can mean that naming very young income beneficiaries, such as grandchildren, may not satisfy the actuarial test.

Although estate tax concerns have diminished for many individuals, the income tax exposure their heirs will face, with even modestly valued inherited IRAs, remains a significant challenge for wealth transfer. The SECURE Act forces beneficiaries to recognize substantial taxable income in a compressed time frame. For the right client, a charitable remainder trust offers a compelling solution, providing tax-efficient income deferral and reducing overall tax drag while supporting philanthropic goals. A CRT transforms a tax-inefficient asset into a powerful tool for preserving wealth and legacy. In today's environment, proactive income tax planning is not optional; it is essential.