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USE OF RETIREMENT BENEFITS IN CHARITABLE PLANNING

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Use of Retirement Benefits in Charitable Planning

USE OF RETIREMENT BENEFITS IN CHARITABLE PLANNING

1. Introduction: Goals

1.1 To benefit charity.

Tax savings can help finance the cost of passing retirement benefits to charity, but the "cost" is never zero, and of course there is always a substantial financial benefit provided to the charitable organization. Providing those benefits to charity will prevent the donor from maximizing the value of the donor's estate for family members; that can be accomplished by leaving all retirement benefits to family members. Taxes will be higher, but the donor's family will have more money. But charitable gifts via retirement plans can help donors who are interested in helping a charity with maximum tax "subsidies."

1.2 To save taxes.

To benefit both charitable and non-charitable beneficiaries, the most tax-efficient method generally is to fund the charitable gifts with retirement benefits and leave other assets to the non-charitable beneficiaries. Retirement plan assets are worth more to a charity than to a non-charitable beneficiary, while most other assets are worth the same to both types of beneficiaries. This is because retirement plan distributions to a beneficiary are generally considered "income in respect of a decedent" ("IRD") under IRC §691 and are subject to income taxes. Because a charity is tax-exempt, no part of the inherited benefits received by charity are lost to income taxes. The foregoing is also true with other forms of IRD that allow a beneficiary designation, such as an interest in a non-qualified deferred compensation plan and a taxable death benefit under an annuity contract. See LTRs 200618023, 200452004, and 200425027.

1.2.1 **Example 1**

Decedent leaves her house (worth $500,000) and her IRA (also worth $500,000) to child. There is no estate tax, because the estate is under the federal estate tax exemption. Child receives the house tax-free (no income tax either), and if child sells the house for $500,000, no capital gains tax either, regardless of what the decedent paid for the house ("stepped-up basis").

Child will have taxable income, however, as a result of receiving IRA distributions. The $500,000 distribution is included in the child's gross income for the year of the distribution. The IRA, unlike the house, does not get a new basis upon the owner's death.

If decedent wanted to leave only half her estate to child and half to charity, she could leave half of each asset to each beneficiary; she could leave the IRA to child and the house to charity; or she could leave the house to child and the IRA to charity. Would it make any difference to child? To charity?

1.2.2 **Example 2**

1.2.2.1 Assumptions. Mrs. Smith, a California resident widow, has accumulated $2,000,000 in a pension plan. She dies in 2013 at age 65, survived by children and a grandchild. She has designated her grandchild as the recipient of the plan benefits, which are to be paid in a lump sum.

Mrs. Smith's gross estate is $6,000,000, and therefore the marginal federal estate tax rate is 45 percent. The GST rate is also 45 percent. The grandchild's marginal combined U.S. and California income tax rate is 40 percent. Mrs. Smith had used her entire GST exemption before her death. Mrs. Smith's Will contains a tax apportionment clause that allocates estate taxes to the recipients of the transfers subject to estate tax.

1.2.2.2 Calculation of applicable taxes

Gross amount to Grandchild before any taxes			$2,000,000
Estate tax rate			45%
U.S. estate tax (no California estate tax)			**$ 900,000**
Because the GST in the case of a direct skip is tax-exclusive (i.e., it is determined by applying the 45% GST rate to the amount passing after the GST), the GST can be determined by applying the following formula:			
	Amount passing to the recipient before the GST	($2,000,000-$900,000)	$1,100,000
minus	Amount passing to the recipient before the GST	($1,100,000)	
	1+ GST rate	(1.45)	758,621
GST			**$ 341,379**

Amount subject to income tax [$2,000,000 less the IRD deduction of $1,241,379, which is the sum of the federal estate tax ($900,000) and the GST ($341,379)]	$ 758,621
Combined U.S. and California income tax rate	40%
Combined U.S. and California income taxes	**$ 303,448**

1.2.2.3 Net result (after-tax amount passing to Grandchild)

Original Amount		$2,000,000
U.S. estate tax	$900,000	
GST	341,379	
Combined U.S. and California income taxes	303,448	1,544,827
Balance (about 23 cents per dollar)		**$ 455,173**

1.3 Estate planning.

A donor can accomplish other estate planning goals while at the same time fulfilling the donor's charitable intentions. For example, charitable gifts of retirement benefits via charitable remainder trusts can help solve some of the estate planning problems that arise in connection with disposing of retirement funds (see paragraph 4 on pages 11-13).

2. Examples of Charitable Designations

2.1 Sole beneficiary.

Designating a charity as sole beneficiary of the plan death benefit involves the fewest difficulties. Because the benefits are paid directly to charity, all tax on the benefits is avoided (the charity's income tax exemption eliminates income tax and the estate tax charitable deduction eliminates estate tax). The same result obtains if multiple charities are named.

2.2 Fractional share.

A charity can receive a fractional share of the retirement plan (tax-free), with other fractional shares passing to non-charitable beneficiaries (taxable). **This**

approach risks losing the option of a "life-expectancy payout" for the non-charitable beneficiaries.

2.2.1 Multiple Beneficiary Rule: All beneficiaries must be individuals.

Retirement benefits generally can be distributed after the owner's death as slowly as "in annual installments over the life-expectancy of the designated beneficiary." This method ("life-expectancy payout method" or "stretch IRA" method) can provide considerable income tax deferral, depending on the beneficiary's age. *The life-expectancy payout method is not available to a beneficiary who is not an individual.* A "designated beneficiary" must be either an individual or a qualifying "see-through trust." *Individual beneficiaries can use the life-expectancy payout method for an inherited retirement plan only if ALL beneficiaries of the plan are individuals.* A charity is not an individual (and therefore cannot be a "designated beneficiary"). Thus, unless an exception applies, naming charities and individuals jointly as beneficiaries precludes a life-expectancy payout for the individual beneficiaries. This could be a very unfavorable tax result for the individual beneficiaries, especially any beneficiary who is young and has a long life-expectancy. Fortunately, there are two exceptions to this rule that make it possible to name both charities and individuals as beneficiaries of the same account.

2.2.2 First exception: "Separate accounts."

The first exception is the "separate accounts" rule. If the beneficiaries' interests in the retirement plan are expressed as fractional or percentage shares, and the beneficiaries "establish" separate accounts for their respective shares by December 31 of the year after the year of the donor's death, then each separate account is treated as a separate retirement plan for purposes of the multiple beneficiary rule, and each individual beneficiary can use the life-expectancy payout method for that beneficiary's separate "account." If the beneficiaries fail to meet the deadline, however, they will be limited to taking benefits under the five-year rule* (if the participant died before his or her required beginning date or "RBD"), or over what would have been the participant's remaining single life-expectancy (if the participant died after his RBD). RBD is April 1 of the year after the year in which the participant reaches age 70½.

2.2.3 Second exception: Distribution prior to September 30.

The second exception is that a beneficiary is "disregarded" if its interest is entirely distributed by September 30 of the year after the year of the participant's death. Thus, the charity's (and all other non-individuals') share(s) can be distributed at any time prior to the September 30 deadline, and the remaining individual

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* By December 31 of the calendar year in which occurs the fifth anniversary of the participant's death.

beneficiaries are entitled to use the life-expectancy payout method. If for any reason the charity's interest is not entirely distributed by the deadline, the charity would still be considered to be a beneficiary and the individuals would **not** be able to use the life-expectancy payout method. (See LTR 200740018)

2.2.4 Exception problems.

Relying entirely on the exceptions makes sense only in some cases. If use of the life-expectancy payout method would be very advantageous, consider establishing separate IRAs: One payable to the charitable beneficiaries and one payable to the individual beneficiaries. In this way, there is no risk of failing to divide the IRA after death in a timely manner, or of failing to distribute the charity's share in a timely manner. But dividing an IRA now into separate IRAs for the charity and the individual beneficiaries will create an annoyance and extra chores [e.g., keeping values of the separate IRAs in the right proportions; MRDs can be taken from any one IRA or any combination of IRAs for this purpose (IRS Notice 88-38)]. See paragraph 2.3.2 on page 6.

2.2.5 Spouse is sole noncharitable beneficiary.

If the participant's surviving spouse is the sole noncharitable beneficiary, he or she can roll over his or her share to the spouse's own retirement plan, so there is no need to comply with the "life-expectancy payout" rules.

2.3 Specific amount.

A charity can receive a "pecuniary" (fixed-dollar) portion of the account, with the balance (residue) going to individual beneficiaries. This presents some of the same problems as leaving benefits to charitable and individual beneficiaries in fractional shares, and some additional problems.

2.3.1 Problems with the plan administrator.

Some plan administrators will not accept "pecuniary" gifts in a beneficiary designation form; they will accept only fractional share gifts. If this is not a problem, verify how the plan administrator will interpret the form: As a "pecuniary bequest" or as an instruction to divide the plan into two separate accounts as of the date of death, one worth the pecuniary amount and the other containing the balance of the plan. If the plan administrator interprets the beneficiary designation as establishing two separate accounts as of the date of death, with the charity's "account" sharing proportionately in gains and losses that occur after death, then the same options will be available as discussed in paragraphs 2.2.2 and 2.2.3 on page 4 (establish the separate accounts by December 31 of the year after the year of death, or fully distribute the charity's share by September 30 of the year after the year of death). But if the plan

administrator's policy is that the charity should receive the pecuniary amount regardless of any post-death fluctuations in the account value, then the option of "establishing separate accounts" will not be available, because the beneficiaries' respective interests must share pro rata in post-death gains and losses in order to qualify for separate accounts treatment. The option of fully distributing the charity's entire share by September 30 of the year after the year of death is available either way. If the charity receives its full share of the account by that date, it will not be considered to be a beneficiary, and the individuals can use the life-expectancy payout method.

2.3.2 Separate IRAs for large pecuniary bequests.

Because a charitable bequest jeopardizes availability of the life-expectancy payout option for the individual beneficiaries' shares, a separate IRA can be established for the pecuniary bequest(s). For example, a donor desiring to provide a $100,000 gift to charity at death might divide a $1,000,000 IRA into two separate IRAs, one containing something more than $100,000 (perhaps $200,000) of which the beneficiary designation reads "$100,000 to charity, balance to individual(s)," and the other IRA payable only to the individual(s) containing the $800,000 balance of the original $1,000,000 IRA. The separate $800,000 IRA payable to the individual(s) is not subject to any risk of losing the life-expectancy payout method, and the separate $200,000 IRA can take advantage of one of the two exceptions discussed in paragraphs 2.2.2 and 2.2.3 on page 4 to qualify the individuals for the life-expectancy payout method.

2.3.3 Small testamentary bequests.

If the pecuniary bequest to charity is modest, the usual rule ("use retirement benefits to fund charitable bequests") might be ignored by putting the charitable bequest in the donor's other testamentary documents. Although it is generally more tax-advantageous to fund the charitable bequest from the retirement plan, the advantage (if the bequest is very small) may not be worth incurring the risk of jeopardizing the life-expectancy payout for the individual beneficiaries.

2.3.3.1 If income is recognized by the donor's estate (or trust), however, an offsetting deduction for the payment of the charitable bequest under IRC §642(c) may be possible. LTR 200526010 (March 22, 2005).

2.3.3.2 The fiduciary beneficiary might assign its interest in the plan to charity to avoid income inclusion (see paragraph 2.5.2 on pages 8-9).

2.3.3.3 If only **part** of the plan is passing to charity, designating a trust rather than an estate as beneficiary of the balance of the plan may allow the non-charitable beneficiary (trust) to be a "designated beneficiary" if the trust meets certain qualifications ("see-through" trust) and if all charitable interests are distributed by September 30 of the year following the participant's death. An "estate" cannot be a

"designated beneficiary," thus requiring an accelerated payout to the estate. But see paragraph 2.5.1 on page 8: If the **entire** plan is passing to unknown charities or to a to-be-created foundation, designating an estate rather than a trust may be advantageous.

2.3.4 Conditional share.

A charity's gift can be subject to the **condition** that the charity receives its entire share of the retirement plan prior to the September 30 deadline. This guarantees that the life-expectancy payout method will be available for the individual beneficiaries, because as of the September 30 deadline they will be the only beneficiaries of the retirement plan (the charity will either have received or forfeited its share). In order to ensure that this conditional retirement plan gift to charity will entitle the donor's estate to an estate tax charitable deduction, the following testamentary bequest can be made: "I give to Charity [$_____] reduced by any amounts paid to Charity from my retirement plan."

2.4 Formula.

2.4.1 Percentage of estate.

A donor may want to distribute an amount from a retirement plan based on a formula. For example, a donor may want to leave 10% of the donor's estate to charity and the balance to the donor's family. If the donor's $6 million of total assets include a $2 million retirement plan, a $1 million home, and $3 million in other investments, the charity should receive $600,000. The donor may leave the charity 10% of each asset, but that is not the most tax-efficient way to fund the charity's share: The donor could leave more to the donor's family by funding the charity's share entirely from the retirement plan. A beneficiary designation could include a formula. For example, a pecuniary formula might read as follows: "Upon my death, pay to charity an amount equal to 10% of the value of my Estate," after which the donor must precisely define "Estate." The typical IRA provider will not accept a formula beneficiary designation, however, because the IRA provider will not have the information needed to apply the formula (the IRA provider will know only what is in the IRA). In addition, the IRA provider typically charges a nominal fee for providing custodial duties, and its services do not include calculating elaborate formula amounts even if it has all the necessary information. Both of these problems can be overcome with some IRA providers by appointing a specified person to provide the formula amount to the IRA provider, and by providing further that the IRA provider has no responsibility for either calculating the formula or verifying that the supplied amount is correct.

2.4.2 Difference between two amounts.

Another type of charitable formula gift requires the gift to be adjusted by amounts passing to the charity by other means (for example, to satisfy the

unpaid portion of a pledge).

2.5 Via an estate or a trust.

2.5.1 Unknown charitable beneficiaries.

It may not be feasible to name the intended charitable recipient directly as beneficiary of the retirement benefits. For example, the intended charitable recipient may be a charitable foundation that has not yet been created; or amounts payable to charities may be based on a formula that cannot be determined until after death; or the charitable recipients are to be selected after death. In these cases, the plan administrator may not be willing to accept a beneficiary designation under which the plan administrator would not be able to determine at the participant's death who was entitled to the benefits. If the actual charitable recipients are to be selected after the participant's death, the retirement benefits can be distributed to a tax-exempt "donor-advised fund" (see paragraph 3.2 on page 10). In some situations, however, the benefits may have to be made payable to the participant's estate or trust as beneficiary of the retirement plan, with the Will or Trust specifying that the benefits are to be paid to the to-be-created (or to-be-selected) charities. The Executor of the Will or the Trustee of the Trust then will be responsible for completing the post-death actions. There could be an income tax advantage to leaving benefits to an estate rather than to a trust because an estate is entitled to an income tax deduction for amounts paid or "permanently set aside" for charity, whereas generally a trust is entitled to an income tax deduction only for amounts actually "paid" to charity from trust income. It therefore may be more tax-efficient to designate an "estate" rather than a "trust" as beneficiary of retirement plan proceeds [although IRC §645 allows a trust to elect to be treated as an "estate" for income tax purposes; or the trust may be eligible for a pre-October 9, 1969, grandfather exception under IRC §642(c)(2) (LTR 200418040)].

2.5.2 Fiduciary assignments.

2.5.2.1 Residuary gifts. In LTRs 201027031, 201013033, 200850004, 200845029, 200826028, 200803002, 200652028, 200633009, 200618023, 200617020, 200526010, 200520004, 200511174, and 200452004, the IRS ruled that the assignment of some or all of a decedent's IRA to a charity to satisfy the charity's share of the **residue** of a trust was not a "transfer" by the trust and therefore only the charity will include the IRD in its gross income when the IRA distributions are received. See also Treas. Reg. §1.691(a)-4(b), Rev. Rul 60-87, and LTRs 200618023 (involving a deferred annuity contract) and 200617020.

2.5.2.2 Pecuniary gifts. But the IRS, relying on Kenan v Comm'r, 114 F.2d 217 (2nd Cir. 1940), also has concluded that the assignment of some or all of a decedent's retirement benefit to a charity to satisfy a **pecuniary gift** to the charity is a "transfer" by the trust that results in the realization of income by the trust [with no

offsetting charitable deduction under IRC §642(c)(1) because the trust did not require that the pecuniary gifts be satisfied from trust income] (CCAs 200848020 and 200644020, which may not be used or cited as precedent), but this conclusion has been criticized by many commentators and the issue has not been decided by the courts. An IRS representative has announced that LTRs will address this issue regardless of whether a taxpayer requests a ruling (Tax Notes May 19, 2008, at 661). Perhaps one should draft "pecuniary" charitable gifts as fractional shares of the residue, the numerator of which is the desired dollar amount and the denominator of which is the value of the residue, or direct that the fiduciary pay the retirement benefit to the charity.

2.5.2.2.1 If the governing instrument requires the pecuniary gift to be paid from the retirement plan, the assignment should not be a "transfer" [Treas. Reg. §1.691(a)-4(b)(2)]. In LTR 200850004, the IRS ruled that a partial assignment of an IRA to charity by an estate pursuant to a Will that was reformed **after** the decedent's death in satisfaction of the charity's specific share of the estate was not a "transfer" by the estate.

2.5.2.2.2 Similarly, if the fiduciary has no other asset available to satisfy the pecuniary gift, the assignment should not be a "transfer."

2.5.2.2.3 Prop. Reg. §1.642(c)-3(b)(2) provides that whenever a governing instrument specifies a source of income (such as IRD) to be used for a charitable income tax deduction, those instructions must have an independent economic effect in order to be respected. Compare the following:

(i) "Pay $100,000 to Charity, payable first from IRD if any" (Charity receives $100,000 in any event); and

(ii) "Pay all (or first $100,000 of) IRD to Charity" (Charity receives funds only if there is IRD).

2.5.3 IRC §642(c)(1) allows a deduction for "any amount [of the trust's] gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid" to charity. Courts have been strict in applying the statute and permitting the deduction. The issue arose in Chief Counsel Advisory 200848020. An IRA was paid to a testamentary trust. The trust was reformed to provide for outright distribution of the charities' shares so that the trust would satisfy the regulatory definition of a "designated beneficiary trust" under IRC §401(a)(9). The court order changed the rights of both charitable and non-charitable beneficiaries. In stating that the charitable deduction is not allowable, the ruling said that the purpose of the reformation was not to resolve a conflict in the trust; it was to obtain the tax benefits that would ensue if the trust were to qualify as a "designated beneficiary trust" under IRC §401(a)(9). Therefore, the accelerated payments to the charities are not considered to be made pursuant to the

governing instrument, and the trust is not entitled to a charitable income tax deduction for such payments under IRC §642(c).

2.5.4 See LTR 200807025 for a clever way to allow a surviving spouse to receive a total distribution of an IRA payable to the decedent's trust, taking advantage of the (apparent) rule allowing spousal rollovers of IRA proceeds payable to an estate or trust if the surviving spouse could control the distribution from the IRA to himself or herself (see LTRs 201211034, 200940031, 200905040, 200637033, 200634065, and 200324059).

2.6 Disclaimer.

2.6.1 A participant may name an individual as primary beneficiary of the plan, and name a charity as contingent beneficiary, specifying that the charity is to receive any benefits "disclaimed" by the primary beneficiary (see LTR 200149015). Consider stating in the beneficiary designation form that the IRA custodian/plan administrator may rely on the advice of the executor/trustee that a disclaimer has been made.

2.6.2 The charitable beneficiary cannot be either of the following:

(i) A charitable remainder trust (see paragraph 3.3 on page 11) or the issuer of a charitable gift annuity (see paragraph 3.4 on pages 11-12) of which the disclaimant is an income beneficiary (unless the disclaimant is the surviving spouse and no power of appointment exists) [see Estate of Christiansen v. Comm'r., 130 T.C. 1 (2008), aff'd 586 F.3d 1061 (8th Circ. 2009)]; or

(ii) A private foundation of which the disclaimant is a manager having the power to choose recipients of foundation funds (unless the disclaimed property is held in a separate fund over which the disclaimant has no such power). This problem does not exist if the disclaimed property passes to a donor-advised fund (see paragraph 3.2 on page 11), because "advice" is not a "power" (LTR 200518012).

3. Potential Plan Beneficiaries

3.1 IRC §501(c)(3) organization: Public charity or private foundation.

A 501(c)(3) organization is exempt from income tax (except for "unrelated taxable business income"), and bequests qualify for the estate tax charitable deduction. Making a bequest of retirement plan death benefits directly to a charity presents the fewest problems. Amounts received by a private foundation should not be subject to the two percent excise tax imposed on net investment income by IRC §4940 (LTRs 200425027, 200003055, and 9838028).

3.2 Donor-advised fund ("DAF").

A DAF is a "public" charity that receives contributions from individual donors, invests those contributions, and distributes the fund (or the income from the fund) at a later time to other charities. The donor (or other individuals) "advises" (non-binding) the DAF which charities should receive distributions. One use of the DAF is to involve family members in philanthropy. Thus, a donor can designate a DAF [a 501(c)(3) organization] as beneficiary and appoint family members as advisors.

3.3 Charitable remainder trust ("CRT").

3.3.1 Retirement plan death benefits paid to a CRT are received with no income tax. Thus, the non-charitable CRT beneficiaries can receive a life income generated by reinvestment of the entire amount of the retirement benefit, rather than the after-tax proceeds, which could be substantially less. The beneficiaries then will be able to receive more annual income from the CRT than they would receive by investing the after-tax value of any retirement benefits distributed to them directly. In addition, the decedent's estate is entitled to an estate tax charitable deduction for the value of the charitable remainder gift (and an estate tax marital deduction for the value of the income interest if the decedent's surviving spouse is the sole noncharitable beneficiary [IRC §2056(b)(8)]. Designating a CRT as beneficiary does **not**, however, increase total revenue to the individual beneficiaries, especially if the life-expectancy payout method is available. The CRT nevertheless may be more attractive than naming the individual beneficiaries directly if long-term deferral is not available (the retirement plan may not offer a life-expectancy payout), especially after the estate tax benefits of the charitable deduction are considered (see paragraph 4 on pages 12-14 for more details).

3.3.2 Retirement plans generally are transferred via beneficiary designations. Care must be taken in order to designate a CRT as beneficiary. The beneficiary can be a funded CRT, an unfunded CRT, or an estate or revocable trust that provides for the creation of a CRT at death.

3.3.3 See paragraph 3.4 immediately below for a reference to LTR 199901023 regarding the IRC §691 (IRD) deduction.

3.3.4 What are the income tax consequences to a non-charitable CRT beneficiary who commutes or sells his or her interest? (See Appendix)

3.4 Charitable gift annuity ("CGA").

A donor may provide a CGA to a third party in exchange for the balance of the donor's IRA at the donor's death (LTR 200230018). This will guarantee a fixed predictable revenue stream for the life or lives of the noncharitable recipient(s) (maximum of 2), and there is no need to draft a CRT. The full value of the IRA will be

included in the donor's estate, but an estate tax charitable deduction will be available for the value of the charity's remainder interest. The IRA proceeds will be an item of IRD to the charity rather than the donor's estate. The charity of course will not pay any tax because it is an exempt organization. The IRS refused to rule on the character of the payments to be received by the annuitant: Will any part of the annuity payments be excludable from income, which would be the case if the annuitant's "investment in the contract" equals either (i) the IRA proceeds transferred to the charity or (ii) the non-charitable portion of the IRA proceeds that are subject to estate tax? If not, all receipts by the annuitant will be subject to tax as ordinary income. The IRS also refused to rule whether the annuitant would be entitled to the IRC §691(c)(1)(A) income tax deduction for the estate taxes paid on the annuitant's portion of the IRA proceeds. The IRS previously has ruled (LTR 199901023) that with respect to IRA proceeds passing to a CRT the deduction was allowed only to the CRT and not to the income beneficiaries (which probably results in no benefit to anyone in view of the CRT 4-tier system of income allocation).

3.5 Charitable lead trust ("CLT").

A CLT generally is not a good choice as beneficiary of retirement benefits. A CLT is not exempt from income taxes, which means that it must pay income tax on retirement benefits as received. Thus, the CLT will generally begin at a disadvantage (some of the trust principal that would have been available for investment instead will have been used to pay income taxes). This makes it much more difficult for the CLT to "beat" the IRC §7520 rate, and estate taxes may be imposed on more than the family beneficiaries eventually receive (same result as any IRD item, such as qualified retirement plan benefits).

3.6 Pooled income fund ("PIF").

Unlike CRTs, PIFs are not exempt from income tax, so retirement plan death benefits paid to a PIF generally will be subject to income tax in the year received by the PIF to the same extent they would be taxable to an individual beneficiary. A PIF therefore is not a good choice as beneficiary of retirement benefits.

4. Advantageous CRT Scenarios

A CRT can help solve some of the estate and tax planning problems that exist for retirement plan benefits.

4.1 Benefit older individual.

Naming an older non-spouse individual outright as beneficiary of retirement benefits may result in distributing the benefits to the beneficiary rapidly (over the beneficiary's short life-expectancy), so income taxes will be paid rapidly and the senior

adult will have less available in later years. Benefits left to a CRT, however, will result in a steadier income from the CRT that will last for the elderly beneficiary's entire life (rather than terminate at the end of an artificial life-expectancy). The participant's estate also will be entitled to an estate tax charitable deduction for the value of the remainder interest. But the individual beneficiary cannot receive more from the CRT than the specified payout amount, regardless of need. "Inherited IRA" provisions may reduce or eliminate this advantage (see paragraph 4.3 below).

4.2 Income for several adults.

Naming a CRT having several adult beneficiaries as beneficiary of a retirement plan avoids all minimum required distribution ("MRD") problems, because the CRT receives full distribution immediately upon the participant's death with no income taxes. The CRT will produce a relatively steady income that can be split among the adults living from time to time. Because the value of the charity's remainder interest must be at least 10% of the CRT value, this approach is available only for a small group of adult beneficiaries.

4.3 Lump sum only plan.

Many qualified retirement plans offer a lump sum distribution as the **only** permitted form of death benefit. A CRT can be used to approximate the life-expectancy payout that is not available under these retirement plans. If the beneficiaries live a long time, their aggregate payout may exceed the amounts they would have received had they been named outright beneficiaries. The Pension Protection Act of 2006 ("PPA 2006"), however, provides that after 2006 even a non-spouse beneficiary who qualifies as a "designated beneficiary" (see paragraph 2.2.1 on page 4) can transfer funds from an inherited retirement plan account via a direct rollover to an "inherited IRA" established to receive the distribution in the name of the deceased participant and payable to the same beneficiary, provided the rollover is completed in a timely manner. Thus, the beneficiary can preserve the life-expectancy payout ("stretch" IRA) rather than be forced to accept a lump-sum payment (but see paragraph 4.5 on page 14).

4.3.1 The IRS has issued Notice 2007-7, which clarifies a number of issues relating to these new "inherited IRA" rollover rules.

4.3.2 The IRS also has stated that a non-spouse beneficiary can use the life-expectancy payout method provided that the rollover is made by December 31 of the year after the participant's death ("Employee Plan News" dated February 13, 2007). A "direct rollover" (Trustee-to-Trustee) is required.

4.4 QTIP alternative.

A QTIP with a charitable remainder beneficiary can't qualify as a

designated beneficiary eligible to use the life-expectancy payout method, because the charity is not an individual. Thus, a rapid payout from the plan to the QTIP may be required, which would result in rapid income taxation of the benefits. No such problem exists if a CRT is beneficiary rather than a QTIP, because a CRT is tax-exempt. This will ensure a lifetime income for the surviving spouse without a rollover and the decedent can select the ultimate beneficiary (a charity). And if the spouse is the only CRT beneficiary, no estate tax is payable at either spouse's death.

4.5 "Stretch" IRA alternative. How long will the beneficiary continue to implement the "stretch" feature?

5. Lifetime Gifts

5.1 From withdrawals

Withdrawing funds from a retirement plan results in the value of the withdrawal being included in the recipient's income. If the recipient then donates the withdrawn funds to charity in the same year, the income tax charitable deduction theoretically should eliminate the tax on the distribution. Often, however (except in the case of small distributions and small contributions), the income tax charitable deduction does not eliminate the tax cost of the distribution (but see paragraph 5.4 on pages 15-17 for a possible limited exception to the foregoing).

5.1.1 Percentage limitation rules [IRC §170(b)(1)].

5.1.2 Deduction reduction rules ("haircut") [IRC §§67, 68].

5.1.3 Adjusted gross income ("AGI") not reduced.

5.1.4 Split-interest gifts.

5.1.5 Premature distribution penalty [IRC §72(q)].

5.1.6 Nonitemizers.

5.2 From MRDs.

5.2.1 Older donors.

5.2.2 Plan beneficiaries.

5.2.3 But see paragraph 5.4 on pages 15-17.

5.3 Others.

5.3.1 Pre-age 59-1/2 "SOSEPP" [IRC §72(q)(2)(D)].

5.3.2 NUA stock [IRC §402(e)(4)(B)].

5.3.3 Low-tax lump sum distributions from a qualified plan.

5.4 Direct gifts from an IRA ("charitable IRA rollover").

Will the PPA 2006 provision for charitable IRA rollovers be extended after 2011? It isn't quite the ultimate charitable IRA rollover that the nonprofit community desires, but it's a good start: Money can be distributed from an IRA directly to a charity, and the distribution will be excluded from the IRA owner's income, subject to the limitations and restrictions on these "Qualified Charitable Distributions" ("QCDs") discussed below.

5.4.1 **When**: This has always been a temporary measure, available in specified years only (2006-7; 2008-9; 2010-11). The Public Good IRA Rollover Act of 2011 (H.R. 2025) would expend and make permanent the charitable rollover.

5.4.2 **Who**: The IRA owner had to be at least age 70½ (this is the first tax provision that has made the age 70½ "birthday" itself a significant event; MRDs are based on the year in which the participant reaches age 70½, not the *day* of reaching that age). A QCD also could have been made by the beneficiary of an inherited IRA who had attained age 70½. A person attains age 70½ on "the date six calendar months after the 70th anniversary of the (employee's) birth." Treas. Reg. §1.401(a)(9)-2, A-3. An IRA owner born June 30, 1942, or June 30, 1943, will have only 2 days to complete the QCD when he or she attains age 70½ on December 30, 2012, or December 30, 2013, respectively. Standard "delivery" rules should apply.

5.4.3 **How much**: The QCD income exclusion is limited to $100,000 per year. If both spouses have IRAs, the $100,000 limit applies to each spouse separately. This was an ideal way for a wealthy individual to fulfill or help fulfill the MRD requirement while helping a favorite charity.

5.4.4 **Which charities**: A QCD can be made to any public charity [IRC §170(b)(1)(A)] except a DAF (which now for the first time is a defined term in the IRC) or a "supporting organization" [IRC §509(a)(3)]. Also, because of the requirement that the QCD be a contribution that would be 100% deductible (ignoring the percentage limitation rules) if paid from the owner's non-IRA assets, split-interest gifts (e.g., CRTs and CGAs) do *not* qualify. And donors cannot receive any non-incidental quid pro quo benefits that would reduce or eliminate the charitable deduction if the gift were made from other sources (e.g., no raffle tickets, auction purchases, or dinners).

5.4.4.1 Allowing distributions to a DAF could have simplified the process; every IRA became a "charitable donor directed fund."

5.4.4.2 Some supporting organizations exempt under IRC §509(a)(3) also could qualify for public charity status under IRC §§509(a)(1) and 170(b)(1)(A)(vi) or IRC §509(a)(2). The IRS has published a formal procedure for changing an organization's status (Ann. 2006-93).

5.4.5 **Which plans**: Distributions from IRAs only (other than SEPs and SIMPLEs). Funds in a 401(k), 403(b), or similar plan had to be transferred to an IRA in order to use those funds for a QCD. But will IRA providers want to open an IRA if all funds are to be distributed via a QCD soon after the IRA is opened?

5.4.6 **Which assets**: The QCD must come from pre-tax money; but for this purpose, the QCD is deemed to come first from the owner's pre-tax assets in all aggregated IRAs until that amount is used up. Distributions of non-taxable assets do not qualify as QCDs, but those donors can claim a regular charitable income tax deduction for the gift. **Tip**: Don't ask IRA provider to issue a check for non-taxable assets; instead, withdraw these amounts and write your own check and obtain a separate receipt.

5.4.7 **Advantageous QCD Scenarios**

5.4.7.1 **Convenience Donor**: The majority of IRA owners delay taking IRA withdrawals until November or December each year because (i) the longer the funds are in the IRA, the more time there is to benefit from tax-free growth and (ii) many IRA owners do not need the IRA income for living expenses. If an IRA owner wished to make a charitable gift, a QCD might be a good alternative: Major financial services companies and charities have made it easy to complete the gift. The donor can contact the IRA custodian to arrange for the QCD to be made directly to the charity or charities. The Securities Industries Association submitted comments to the Treasury Department identifying several issues to be addressed in guidance relating to QCDs, including 1099-R reporting; IRA provider responsibility or lack thereof to confirm a recipient's eligibility to receive a QCD; IRA provider obligation or lack thereof to inform charity of donor's identity; ability of IRA owner with check-writing privileges to make the transfer (yes); withholding; cash and/or securities distributions; inherited IRAs (OK). The QCD qualifies for the donor's MRD. The IRS prescribed rules under which IRA owners were deemed to elect out of withholding for QCDs. The charity must provide the donor with a contemporaneous written acknowledgment ("receipt") for the QCD. **Tip**: Donors should contact their IRA providers to determine the QCD procedures (e.g., minimum amounts, paperwork, timing). Donors also should inform the charities to expect the QCD and to arrange for the requisite receipt, which should add the words "not used to fund a DAF or a supporting organization."

5.4.7.2 **Generous Donor**: Some very generous individuals are already giving more than 50% of their adjusted gross incomes to charity. This is the maximum permissible deduction level for cash gifts each year; any excess may be carried forward and deducted over the following five years. If such a generous donor has a large IRA, he or she may make "over and above" gifts (maximum $100,000 per year) from that IRA. The QCD amount will not be included in taxable income, and it will have no negative impact on the donor's other charitable gifts.

5.4.7.3 **Major Donor**: It may be desirable for a major donor to give $100,000 per year to charity from his or her IRA via a QCD in view of the potential income tax benefits [avoiding the IRC §170(b) percentage limitation and the IRC §68 exemption phase-out rules]. The QCD could be applied to a donor's outstanding pledge without any adverse consequences (not a "debt" for federal income tax purposes and not a "prohibited transaction" under IRC §4975). And if the donor's IRA constitutes a large portion of his or her estate, a QCD may help "balance" the donor's investment vehicles.

5.4.7.4 **Standard Deduction Donor**: Many seniors may choose to use the standard deduction (e.g., because they do not have mortgages and their medical deductions are less than 7.5% of adjusted gross income). Those donors might benefit from making QCD gifts to charity rather than gifts from other sources, because a non-itemizer's charitable gifts from other sources are not offset by a charitable income tax deduction. Also, taxpayers who are itemizing deductions only because of their charitable contributions may benefit by making QCDs and taking the standard deduction.

5.4.7.5 **Social Security Donor**: Social Security is subject to two levels of taxation. For donors who have income in excess of the first level, 50% of Social Security income is taxed. For donors with income in excess of the second level, up to 85% of Social Security income may be subject to tax. IRA withdrawals might cause the recipient's income to increase to the 50% level or from the 50% to the 85% taxable bracket. Thus, by making the transfer directly to charity via a QCD, a Social Security recipient might reduce the percentage of Social Security income subject to tax. And Medicare Part B premiums can increase at certain AGI levels.

5.4.8 The FTB concluded that California automatically conformed to the 2006 changes to IRC §408 for QCDs.

5.4.9 A donor may satisfy a binding pledge via a QCD gift.

5.4.9.1 No violation of self-dealing prohibited transaction rules [IRS Notice 2007-7, Q&A 44].

5.4.9.2 No income recognition [Rev. Rul. 55-410, 1955-1 C.B. 297; Rev. Rul. 64-240, 1964-2 C.B. 172; IRS Info. Letter 2010-0204 dated August 20, 2010].

6. IRA Loan to Charity

6.1 An IRA can loan funds to a charity. In LTR 200741016, a self-directed IRA made a 20-year loan to a church, with annual interest at five percent (5%), secured by a collateral assignment of the proceeds of the life insurance policy the church purchased with the borrowed funds. The church was owner and beneficiary of the policy; the IRA owner was the insured. The church will repay the loan principal on the earlier of (i) 20 years or (ii) the IRA owner's death.

6.2 The interest payments received annually by the IRA will fund the owner's MRDs.

6.3 The IRS ruled that the loan was not a "prohibited transaction" under IRC §408(e)(2)(A) because the church is not a "disqualified person."

6.4 The IRS also ruled that the IRA does not own a prohibited life insurance investment, because the church is sole owner and beneficiary of the policy.

7. Bibliography

7.1 The most useful retirement plan manual to the speaker is "Life and Death Planning for Retirement Benefits" (7th ed. 2011) by Natalie B. Choate, Esq., of Boston, Massachusetts (Ataxplan Publications, www.ataxplan.com). It is easy to read and understand, and is not too expensive (under $100).

7.2 Natalie B. Choate also has published a Special Report entitled "Charitable Giving with Retirement Benefits" available at www.ataxplan.com ($39.95).

COMMUTATION OR SALE OF CRT INTERESTS

1. **Commutation of CRT**. The beneficiaries of a CRT can agree to terminate the CRT in compliance with state law (the consent of the attorney general may be required). The income and the charitable remainder beneficiaries each will receive a lump sum distribution equal to the present value of their respective interests determined under IRC §7520 and using the methodology described in Treas. Reg. §1.664-2(c) [CRAT] or §1.664-4 [CRUT]; see Section 1.10 below regarding NIMCRUTs. **But see Section 1.14 below.**

1.1 Because no charitable deduction is involved, the IRC §7520 rate for the month of the transaction must be used.

1.2 LTR 200127023 approved the termination of a term-of-years CRT.

1.3 LTR 200208039 approved the termination of a lifetime CRT. The income beneficiary and the beneficiary's physician attested to the fact that there was no knowledge of any adverse medical condition affecting the beneficiary's life expectancy.

1.4 **The income beneficiary will recognize capital gain equal to the value of the income interest. The IRS viewed this transaction as a "sale" to the remainder beneficiary (but see Section 1.14 below). According to the IRS, the income beneficiary has no basis under IRC §1001(e)(1) [sale of term interest]; the exception in IRC §1001(e)(3) does not apply because the entire interest in the CRT's assets is not being sold to a third party (LTRs 200739004 and 200314021); see Section 2 below.**

1.5 The IRS also ruled in LTRs 200739004, 200310024 (partial termination), and 200127023 that no "self-dealing" would result from the transaction.

1.6 LTR 200408031 approved the termination of a CRT involving one current and two successor income beneficiaries at the death of the current beneficiary (see also LTRs 200324035 and 200304025).

1.7 LTR 200441024 concluded that an early termination of a term-of-years 10% CRUT was not a termination of a private foundation under IRC §507; was not an act of self-dealing under IRC §4941; and was not a taxable expenditure under IRC §4945; and the amount realized by the income beneficiary was long-term capital gain [with no basis offset under IRC §1001(e)(i)]. The State Attorney General had no objection to the proposal.

1.8 In 2005, the IRS issued LTR 200525014 allowing a donor and the donor's private foundation to terminate a CRT and distribute the CRT assets between them based on the actuarial values of the parties' respective interests. The IRS ruled the termination would not be self-dealing under IRC §4941(a)(2). In 2006, however, the IRS first revoked that 2005 ruling in LTR 200614032, and then reconsidered the matter after the donor exercised a reserved power to change the charitable beneficiaries of the CRT. Originally, the remainder beneficiary was the donor's private foundation. As amended, the CRT remainder interest instead will pass to six public charities. In LTR 200616035, the IRS ruled that terminating the CRT via a "sale" by the donor of the donor's income interest to the public charities will not be self-dealing.

1.9 LTR 200846037 approved the early termination of a CRT and division of assets between the donors and a remainder beneficiary that was a "supporting organization" of which the donors were directors. The IRS indicated that the supporting organization was a public charity, and that the ruling would not have been granted if the remainder beneficiary were a private foundation. LTR 200727013 concluded that the early termination of two CRTs involving husband and wife donors and division of CRT assets between the donors and the charity would not involve self-dealing and would not result in the imposition of an IRC §507(c) termination tax. The donors would recognize capital gains equal to the value of the income interest, computed using the methodology under Treas. Reg. §1.664-4 using the IRC §7520 rate on the date of termination. LTR 200827009 also approved the early termination of a CRUT.

1.10 LTRs 200733014 and 200725044 approved early terminations of NIMCRUTs involving lump sum payments to the income recipients based on the actuarial values of their interests taking into account the net income provisions of the NIMCRUTs. The LTRs advised that "(o)ne reasonable method to calculate the actuarial value of the income and remainder interests is the following: The computation of the remainder interest is found using a special factor as indicated in section 1.7520-3(b)(1)(ii) of the regulations. The special remainder factor is found by using the methodology stated in section 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where section 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the section 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor. Based on this methodology, the calculation of A's income interest in B may be demonstrated as follows: The section 7520 rate for May 2006 is 5.8 percent. Assuming the termination occurred in May 2006, the lesser of this rate and the trust's stated payout percentage is 5.8 percent. The assumed taxpayer's age as of the nearest birthday is 75. Based on Table 90CM, interest at 5.8 percent, an unadjusted payout rate of 5.8 percent, and quarterly payments made at the end of each quarter, the present value of the

remainder interest in a unitrust which falls in at the death of the person aged 75 is $0.56904 for each $1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is $1.00 minus $0.56904, or $0.43096 for each $1.00 of the trust estate." Note that no value is attributed to the "make-up" aspect of the NIMCRUT. The New York City Bar has requested more guidance about this in a letter to the IRS dated April 4, 2008.

1.11 LTR 200809044 approved the termination of a no make-up NIMCRUT that would terminate on the earlier of the death of the survivor of two individuals or 20 years from its inception, and provided an appropriate actuarial factor.

1.12 LTR 200802033 approved the early termination of a testamentary CRAT and distribution of CRAT assets among the CRAT beneficiaries as agreed by them to settle estate litigation involving disputes among the estate, the trustee of the CRAT, and CRAT annuitant, and the CRAT remainder beneficiaries.

1.13 LTRs 200922013 through 027 approved the premature distribution of a CRAT's "excess" assets to the charitable remainder beneficiaries and the purchase by the remainder beneficiaries of commercial annuities to secure the CRAT annual payments to the current beneficiaries, and held that the modification did not result in any realization of income under IRC §1001(a) or under Cottage Savings Ass'n v. Comm'r.

1.14 The IRS again included CRTs that are to terminate prematurely "in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust" to its "no-ruling" list [Rev. Proc. 2012-3, Section 4.01(39)]. The IRS will not rule whether that transaction is treated as a "sale" [Section 4.01(42)] or as a sale of a "capital asset" [Section 4.01(43)]. Under Section 5.09 of Rev. Proc. 2009-3, the IRS also had refused to rule whether the termination of a CRT prior to its stated term caused the CRT to cease qualifying as a CRT. The topic was under study, with further guidance expected in a revenue ruling, revenue procedure, regulation, or announcement. Rev. Procs. 2010-3, 2011-3, and 2012-3 included no such provision.

2. **Sale of CRT Interests**. The beneficiaries of a CRT presumably can sell their respective interests in the CRT to a third party for their respective fair market values (after which the CRT should terminate in favor of the buyer via "merger" under state law). The IRS recently added CRTs that are to terminate prematurely "in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets" to its "no-ruling" list (Rev. Proc. 2012-3). The IRS will not rule whether that transaction is treated as a "sale" [Section 4.01(40)] or as a sale of a "capital asset" [Section 4.01(41)] or whether the termination of a CRT prior to its stated term causes the CRT to cease qualifying as a CRT (Section 5.09). The topic is under study, with further guidance expected in a revenue ruling, revenue procedure, regulation, or announcement. The

suggestion that such a transaction may disqualify a CRT is unfortunate:

(i) There is no active project to issue guidance on the issue. Rev. Rul. 2008-41 concerned "vertical" divisions (see Section 2.3 below) and did not address "horizontal" commutations. The 2011-2012 Priority Guidance Plan does not promise guidance on the qualification issue. It does promise guidance on the uniform basis rules as applied to trusts, presumably including CRTs, but the value of clarifying the uniform basis rules as applied to the sale transaction described in Notice 2008-99 (discussed in Section 2.2 below), or to a commutation of a CRT discussed in Section 1 above, is lessened if an issue of qualification under IRC §664 continues with respect to these transactions; and

(ii) The significance of disqualifying a CRT upon a commutation or sale of interests would turn on whether, and to when, the disqualification was retroactive. Similar questions arise when a CRT is found to have violated the requirement that it "function exclusively" as a CRT, and that requirement might be the technical basis for attacking a commutation. Cf., Estate of Melvin B. Atkinson v. Comm'r, 115 T.C. 26 (2002, aff'd, 309 F.3d 1290 (11th Cir. 2002; and CCA 200628026 (7/14/06) [A perfectly drafted CRT nevertheless can be disqualified if it is not administered properly].

2.1 The income beneficiary hopes to recognize capital gain equal to the value of the income interest (sale proceeds) reduced by the income beneficiary's basis, relying on the exception in IRC §1001(e)(3) because the entire interest in the CRT is being sold to a third party.

2.2 Example: Donor creates a CRT for the benefit of the donor's spouse and funds the CRT with low basis property. The charitable remainder interest is worth 10% of the value of the property. The CRT sells the property and reinvests in marketable securities. In a later year, the spouse and the charity agree to terminate the CRT with each selling its respective interest to a third party for its actuarial fair market value. If the spouse can receive the income share of the CRT free of tax, the property in effect will have been sold tax-free at a cost of about 6% (10% remainder interest less 4% income tax savings). For this to occur, four hurdles (described below) must be overcome [as a policy matter, this should **not** work because it in effect extends the benefit of a CRT's tax exemption to the non-charitable beneficiary. The IRS 2011-2012 Priority Guidance Plan includes a project to provide guidance regarding the applicability of the uniform basis rules to CRTs, and the IRS now has identified this transaction (and "similar" transactions) as "transactions of interest" under Treas. Reg. §1.6011-4(b)(6) and IRC §§6111 and 6112 in Notice 2008-99]. The four "hurdles" are the following:

(i) Sale must not trigger recognition of gain previously realized by CRT (seems correct);

(ii) Spouse's interest must be a capital asset (seems correct);

(iii) Spouse's basis in the income interest must equal the actuarial share of the CRT's basis (uncertain, but seemed to be correct until Notice 2008-99); and

(iv) Spouse must be able to use basis to offset gain (seems correct).

2.2.1 The ACGA in a letter dated January 12, 2009, has suggested a solution implementing an "adjusted uniform basis" rule, but this is not what IRC §1001(e) provides.

2.2.1.1 The income beneficiary's basis in the income interest would be the beneficiary's pro rata share of the CRT's basis, reduced by the beneficiary's pro rata share of any undistributed amounts then in Tier 2 (capital gains).

2.2.1.2 See Examples in ACGA letter.

2.2.1.3 ACGA letter includes additional recommendations:

(i) That the "adjusted uniform basis" rule also apply to CRT commutation transactions. This may require legislation in view of IRC §1001(e);

(ii) Allow use of a "qualified appraisal" to value a NIMCRUT income interest in these transactions; and

(iii) Other rules relating to early termination of CRTs, including issuance of a reporting form to be used in connection therewith.

2.2.2 Sterling Foundation Management LLC, in a letter dated January 31, 2009, has reviewed the "legitimate" reasons for selling a CRT income interest and urges the IRS to address the "abusive" transactions as narrowly as possible by, for example, not prohibiting these transactions entirely, but disallowing any use by the income beneficiary of any share of the CRT's basis (the Notice did not suggest a prohibition, but rather the imposition of penalties for underpayment of income taxes).

2.2.3 What about a rule applicable to all transactions that the income beneficiary recognizes income in the same manner as though the CRT were deemed to have sold all its assets and the income beneficiary received a CRT distribution (i.e., Tiers 1, 2, 3, 4)? No manipulation seems possible, but again this is not what the IRC provides.

2.2.4 **What should be the income tax consequences to a CRT income beneficiary who commutes or sells the income interest in a CRT funded entirely with income in respect of a decedent (e.g., funded via IRA beneficiary designation)? Capital gain?**