THE CATHOLIC FOUNDATION

Charitable Giving and Retirement Assets

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Important Note

In 2001, Congress passed estate tax legislation that scheduled repeal of the federal estate tax for one year (2010). The law also requires a carryover in the decedent's adjusted basis in any property transferred at death in 2010 (subject to numerous exceptions and additions under IRC Sec. 1022(b)(2)(B)). In 2009, lawmakers had expected to enact a law to prevent the temporary repeal, but failed to do so. No law was enacted and the scheduled repeal went into effect on January 1, 2010.

The problematic nature of the federal estate tax in 2010 poses a problem for those advisors and commentators who want to discuss estate tax strategies. Be sure to stay updated on what Congress passes and the President signs into law regarding the federal estate tax.

For purposes of this response booklet and its discussion of Income in Respect of a Decedent, we have assumed that the federal estate tax exists in its 2009 form.

Introduction

Individuals who save for retirement likely own an Individual Retirement Account (IRA), or hold one or more qualified retirement plan accounts (e.g., a 401(k) plan), or both. However, there are rules and limitations on how much one can save for retirement using these accounts. And, there are rules on how distributions from these accounts during retirement are taxed.

Many of your clients likely own substantial wealth in IRAs or qualified retirement plans. Careful attention is needed to distribute this wealth in a tax-efficient way. This is true whether it is the owner making distributions during his or her lifetime, or a spouse or heir making distributions after inheriting an IRA or qualified retirement plan account.

For clients who are philanthropically inclined, there are ways of using retirement assets to make charitable gifts that simplify some or all of the difficulties posed by taxation of these assets. The following is a basic summary of IRA and qualified retirement plan operating rules and some approaches for integrating these assets into charitable giving plans.

Basics of IRAs

An IRA allows workers and their spouses to set aside funds for retirement on a tax-deferred basis. The purpose of an IRA is threefold. First, an IRA provides retirement benefits to workers and spouses who may not be covered by another plan. Second, the tax-deferral of IRA earnings and the tax deduction for contributions—if available—give the IRA owner an opportunity to conserve dollars that would otherwise be lost to current income taxes. And third, the IRA owner has more dollars at work than if the IRA was depleted by annual taxes on investment earnings.

A variation on the traditional IRA is the "Roth IRA." Contributions to a Roth IRA by eligible individuals are nondeductible, but earnings grow income-tax-free and distributions are also income-tax-free if certain requirements are met [IRC Sec. 408A(d)].

An IRA takes the form of a trust or custodial account. Trustees or custodians of these accounts must be a bank, a federally insured credit union, a savings and loan association, or a person or organization that receives IRS permission to act as trustee or custodian.

Anyone under age 70 1/2 who receives compensation—salary, self-employment income, commissions or alimony—or is married to someone who receives compensation and files jointly is eligible to make a contribution to an IRA [IRC Sec. 219].

Annual contributions to a traditional IRA, a Roth IRA, or a combination of the two are limited to the lesser of 100% of earned income or an annual contribution limit (that can change periodically) [IRC Sec. 219(b)(1)]. Compensation includes earnings from wages, salaries, tips, professional fees, bonuses, any other earnings a taxpayer receives for providing personal services, plus alimony and separate maintenance payments.

Compensation does not include income derived from investments or retirement income. Disability payments and nonqualified deferred compensation are NOT considered compensation for IRA purposes. Taxpayers may contribute less than the full deductible amount. Also, a person who has only investment income may not contribute to an IRA.

Taxpayers who have reached at least age 50 by December 31 of a year are permitted to make additional "catch-up" contributions to IRAs [IRC Sec. 219(b)(5)]. Currently, the combined annual contribution and catch-up limit for an individual is $6,000. And since 2009, these annual limits on IRA contributions and catch-ups are inflation-indexed.

A working spouse may set up and contribute to an IRA for a non-working (or part-time) spouse, based on the earnings of the working spouse. The non-working spouse's IRA is often called a "spousal IRA." The spousal IRA deduction is $5,000 in 2010 when a non-working spouse has compensation or earnings of less than $5,000 for the year ($6,000 for age 50 and over). However, the combined annual IRA contributions of both spouses cannot exceed their combined compensation for the year [IRC Sec. 219(c)(1)].

Contributions to traditional IRAs are fully deductible up to the current year's contribution limit when neither the taxpayer nor his or her spouse is an active participant in an employer's qualified retirement plan. Although anyone with earned income (and certain spouses of workers) can open an IRA and accumulate tax-deferred earnings, only workers who are not active participants in (1) a qualified employer plan, (2) a Keogh plan, (3) a Section 403(b) plan or certain other designated retirement plans are eligible to take a full IRA federal income tax deduction without regard to their Adjusted Gross Income (AGI) level [IRC Sec. 219(g)(2)].

Furthermore, the deduction may be reduced or eliminated depending on marital status and modified adjusted gross income (MAGI)—an adjusted gross income with certain items added back including the IRA contribution. This is necessary because the IRA contribution is an "above the line" deduction taken in arriving at adjusted gross income.

Retirement Plan Basics

Generally speaking, there are two types of qualified retirement plans: defined benefit plans and defined contribution plans. For purposes of this discussion, we will consider defined contribution plans. The purpose of a defined contribution plan is to set aside funds to the individual accounts of participants based on an established contribution formula. Employers are generally committed only to making annual contributions. These plans are often easier to administer than defined benefit plans, and the employees bear all investment risk.

Employer contributions are not currently taxable to the employee; if an employer makes a contribution to a qualified plan on behalf of an employee, that contribution is not subject to current federal income tax until the money is distributed from the plan account [IRC Sec. 402(a)]. For this reason, the defined contribution plan enjoys the same tax-deferral benefits as the traditional IRA.

There are several types of defined contribution plans: Section 401(k) plans, other profit sharing plans, employee stock ownership plans, etc. Each plan has particular rules on participation and the amount each employee can have set aside each year (contribution limits). For instance, an employee under age 50 can defer up to $16,500 from salary in a 401(k) plan account.

Lifetime Taxation of Distributions from Retirement Accounts

Distributions from an IRA—whether paid in a lump sum or installments—are taxable under the Section 72 annuity rules [IRC Sec. 408(d)(1)]. Although taxpayers are free to make withdrawals whenever they want, distributions that occur before age 59 1/2 are subject to tax penalties (unless certain exceptions apply) in addition to the regular income tax [IRC Sec. 72(t)]. When the IRA owner reaches age 70 1/2, distributions must begin in minimum annual amounts or the owner will incur tax penalties.

There is a premature distribution tax aimed at taxpayers who withdraw funds before retirement. This rule places a 10% federal tax on the amount of any taxable distributions that occur prior to age 59 1/2, in addition to the regular tax on the distributions. Besides the age 59 1/2 safe harbor, there are other exceptions (e.g., disability) [IRC Sec. 72(t)(2)(A)(ii)].

Distributions from qualified retirement plans are includible in the participant's gross income. Depending on the plan terms, distributions can be received as annuity payments, as periodic installments, as a lump sum distribution, or as partial distributions. Qualified retirement plans stipulate the normal form of benefit under the plan. It is possible that a married participant must have his or her spouse's written consent to elect a form of benefit other than a qualified joint-and-survivor annuity.

Like an IRA, a premature distribution tax applies when taxpayers withdraw funds before retirement. This rule places a 10% federal tax on the amount of any distributions that occur prior to age 59 1/2, in addition to the regular tax on the distributions. And, also like an IRA, there are exceptions to the penalties made for distributions made under certain circumstances.

Required Minimum Distribution (RMD) rules apply to both traditional IRAs and qualified defined contribution plans. Owners of qualified retirement plans and traditional IRAs (but not Roth IRAs) may not accumulate tax-deferred earnings indefinitely. Eventually, the owner must begin to take required minimum distributions or suffer a heavy penalty tax. RMDs are included in the recipient's gross income as paid out.

In general, the required beginning date for distributions is April 1 of the year following the year in which the account owner attains age 70 1/2 [IRC Sec. 401(a)(9)(C)]. This is the latest date that the owner has to take the first RMD from the account without incurring a penalty tax. The penalty tax for taxpayers who fail to comply with the RMD rules is severe: a 50% excise tax is levied on the difference between the RMD—the amount that should have been distributed—and the amount that was actually distributed [IRC Sec. 4974].

Estate Taxation of IRAs and Tax-deferred Retirement Accounts – The Problem of Income In Respect of a Decedent

The primary problem posed by retirement assets within an estate lies in its status as income in respect of a decedent (IRD). IRD is income earned by a decedent or income to which the decedent had a right prior to death, but which was not properly includible in his or her gross income prior to death.

IRD is generally includible in the gross income of the recipient [IRC Sec. 691(a)(1)]. This may be the decedent's estate or an individual who acquires the right to receive the income directly from the decedent. It does not matter whether the property passes through the probate estate or outright to the recipient. While the income retains the same character it would have had in the decedent's hands, it is taxable at the recipient's income tax rate [IRC Sec. 691(a)(3)]. If the income in respect of a decedent represents gain (capital or ordinary) on the sale of an asset, the recipient may utilize the decedent's basis to offset the gain [IRC Sec. 691(a)(2)]. The basis of appreciated property does not step up to the fair market value at death, even though the income in respect of a decedent is included in the gross estate [IRC Sec. 1014(c)].

IRD is includible in the decedent's gross estate as a property interest or right that passes at death. Income in respect of a decedent is taxed twice: once for federal estate tax purposes and again to the recipient for federal income tax purposes. However, the beneficiary may be able to deduct the federal estate tax attributable to IRD.

The deduction for estate tax attributable to income in respect of a decedent is a "miscellaneous" itemized deduction, but it is not subject to the usual 2%-of-adjusted-gross-income floor on such deductions [IRC Sec. 67(b)(7)].

Strategies for Creating Lifetime Charitable Gifts with Retirement Assets

Qualified Charitable Distribution from an IRA

Also known as an IRA Charitable Rollover, the Qualified Charitable Distribution from an Individual Retirement Account (IRA) permits a person age 70 1/2 or older to direct a charitable gift directly to a qualified charity from an IRA [IRC Sec. 408(d)(8)]. The charity must be a public charity or private foundation that may receive general contributions (except not a Donor Advised Fund, nor a Sec. 509(a) Supporting Organization) and the gift must otherwise qualify as a charitable income tax deduction [IRC Sec. 408(d)(8)(B)(i)]. A person may direct up to $100,000 per year in this manner. The distributed amount is excluded from income so the taxpayer does not need to report the distribution as taxable income for federal tax purposes. Furthermore, the distribution counts toward the taxpayer's annual required minimum distribution for tax-deferred accounts. However, the distribution does not qualify for a charitable deduction [IRC Sec. 408(d)(8)(E)].

At the time of publication, the Qualified Charitable Distribution from an IRA is not available. However, a provision to extend availability into 2010 is part the Tax Extenders Act of 2009. It is possible that Congress will enact this law so that the IRA Rollover will become available for all of 2010.

Loan from an IRA to a Charity

One instance of the creative use of an IRA to benefit a charity (though without any charitable deduction) is the CHIRA or Charitable IRA plan.

In PLR 200741016, the donor proposed directing his IRA to lend a sum of money to a qualified charity in return for a twenty year promissory note that pays 5% annually. The note would be accelerated upon the death of the owner. A life insurance policy owned by the charity on the life of the donor would provide the collateral for the note. Under the terms of the note, in the event of the donor's death prior to the full payment of the note, the death benefit would pay off the remaining payments owing under the note and the excess benefit would go to the charity.

The loan payments from the charity to the IRA would provide the needed cash for the donor to take required minimum distributions from the IRA.

The loan itself was an investment permitted under IRC Sec. 408 and not a prohibited transaction. Nor did the purchase of a life insurance policy by the charity as collateral on the note violate the prohibition on an IRA investing in life insurance. Furthermore, the charity needs to establish an insurable interest in the donor's life under state law in order to meet the note requirements.

Note that a Private Letter Ruling (PLR) is not considered precedent, but it does provide an illustration of how an IRA and a life insurance arrangement might work in tandem.

Regular Charitable Gifts Made with Lifetime Distributions from Retirement Assets

Lifetime plan withdrawals by a donor may be used to fund charitable gifts. Such withdrawals may be used for direct gifts, or to establish a charitable life income gift such as a charitable remainder trust (CRT) or charitable gift annuity (CGA). The charitable deduction created by an outright gift or by the creation of the CRT or CGA will reduce the income tax liability incurred by the withdrawal. If the charitable gift is a life income gift, the donor (or someone selected by the donor) may receive payments during his or her lifetime(s).

The benefits of a charitable gift using the distribution from a retirement asset would be a reduction to the donor's taxable estate by the value of the property transferred, and the creation of an immediate income tax deduction for the present value of the gift to the charity [IRC Sec. 170].

Strategies for Creating Testamentary Charitable Gifts with Retirement Assets

Because of the difficulty posed by both its estate and income tax liability, property within an estate that contains Income in Respect of a Decedent (IRD) is an appropriate choice for charitable giving. Retirement assets such as an IRA or 401(k) are inherently IRD. By properly donating this income as a bequest through the estate, an individual generates both an estate tax charitable deduction and an income tax charitable deduction for the estate. Other non-IRD assets are better to bequeath to non-charitable heirs.

Naming a Charitable Beneficiary

There are effective ways to make a charitable bequest of an IRA or qualified retirement plan asset:

- One, the owner could designate the charity as the beneficiary for the retirement plan or IRA. This designation controls the distribution of the account (instructions left in a will or trust have no effect if the asset is not left to the estate or the trust). The plan or account administrator will have a beneficiary designation form for the owner to complete. This is the straightforward way to do it.
- Two, the owner could leave the retirement plans to his estate or trust and include language within the will or trust that permits the executor or trustee to make income distributions and effectively claim the income tax charitable deduction for the IRD-plagued asset that goes to charity.

If the account owner names both a charity and a live person as beneficiaries of an IRA or qualified retirement plan, there is the issue of how the person measures the required minimum distributions from that account. The person prefers to take the RMD over his or her lifetime. But how the account is owned between the beneficiaries makes a difference in how the person takes the RMD.

- If the beneficiary designation lists fractional interest in the account, it is possible to divide the account into separate sub-accounts. Each beneficiary will follow RMD rules specific to his or her own account. This division of the original account must take place before the end of the year following the year the owner dies.
- If the beneficiary designation lists specific amounts to go to a beneficiary, the money can be paid out of the account to the named charity. This payment must be completed by September 30th in the year following the year the owner dies. Since the charity has been paid, the charity is no longer considered a beneficiary and its (non)life is not included in RMD calculations for that account.

Qualified Terminal Interest Property Trust with a Charity as the Remainder Beneficiary

Qualified Terminable Interest Property (QTIP) trusts qualify for the marital deduction for federal estate tax purposes. A QTIP trust requires that all trust income generated during the spouse's life must be paid to the spouse; no other beneficiary may benefit from the trust during the spouse's lifetime [IRC Sec. 2056(b)(7)]. To use an IRA to fund a QTIP trust would provide that the greater of the IRA required minimum distribution or the income created by the IRA account must be paid to the spouse at least annually during the spouse's lifetime.

Under the QTIP charitable trust arrangement, the first spouse to die (as grantor) would mandate that the undistributed principal remain in the account. After the death of the surviving spouse, the trust assets would go to charity as the first spouse had directed by the terms of the trust. The value of such principal would be taxed in the estate of the surviving spouse, but the value of assets passing to charity would qualify for an estate tax charitable deduction.

If it is desirable to provide the surviving spouse with access to the principal of the trust prior to the eventual transfer to the charity, the QTIP can be drafted to permit such access. The value of the QTIP remaining at the spouse's death will be included in his or her estate; however, that value which is transferred to the charity will give rise to an estate tax charitable deduction.

Charitable Remainder Trust with a Spouse as the Non-Charitable Beneficiary

Individuals wishing for the charity to have an interest that is clearly vested might prefer to establish a Charitable Remainder Trust rather than a QTIP. When the account balance is transferred to the CRT upon the account owner's death, there will be the estate tax charitable deduction for the value of the portion bequeathed to the charity. The account owner's estate will also be entitled to an estate tax marital deduction with respect to the spouse's income interest in the assets transferred to the CRT. Since the CRT is income tax-exempt, there will be no income tax liability as a result of the transfer of the qualified retirement plan or IRA assets to the CRT.

If a Charitable Remainder Trust (CRT) is used, either a fixed dollar amount (Charitable Remainder Annuity Trust) or a specified percentage (Charitable Remainder Unitrust) will be received at least annually by the non-charitable beneficiary or beneficiaries [IRC Sec. 664(d)]. After their interest terminates, the remaining assets will be paid to the charitable beneficiaries named in the trust [Reg. Sec. 1.664-1(a)(1)(i)].

At the time the original account owner dies and assets pass to the CRT, the value of the interest going to the surviving spouse as beneficiary will qualify for the estate tax marital deduction and the value of the charitable remainder interest will qualify for the estate tax charitable deduction. Any value of the IRA remaining inside the CRT at the death of the surviving spouse will not be taxable in his or her estate.

Note that the payout amount of a CRT—both the annuity trust and the unitrust—must be a percentage of the trust assets. This might pose a problem if the surviving spouse needs more money from the CRT. But this inflexibility may not be troublesome if the surviving spouse has other available wealth.

Charitable Remainder Trust with a Child as the Non-Charitable Beneficiary

When an account owner wishes to provide for his or her children through an IRA or qualified retirement plan, the use of a CRT may be in some cases more advantageous than an outright bequest of an asset to the child.

There are several reasons why. One is that a bequest to a CRT will create an estate tax charitable deduction, which could reduce estate taxes. Further, the transfer of the IRA or qualified retirement plan to the CRT will not trigger immediate income taxation. Income generally will be taxed to the beneficiary of the CRT as it is received by him or her. A bequest to a CRT benefiting a child may be limited or impractical, however, because of the requirement that at least 10 percent of the value transferred to the CRT must represent the charity's remainder interest [IRC Sec. 664(d)(1)(D), 664(d)(2)(D)].

When the IRA asset eventually passes to the charity following the death of the non-charitable beneficiaries or the expiration of the trust term, the asset is essentially "lost" to the family. However, the tax savings created by the transfer of the IRA to the CRT may have preserved additional principal in the IRA which will have generated additional income for the non-charitable beneficiary. And using part of this income to replace the IRA wealth by obtaining insurance on the lives of the beneficiaries is a possibility.

Note that the Sec. 691 income tax deduction attributable to the estate tax paid on IRD does not pass through the charitable remainder trust to the non-charitable beneficiaries.

Conclusion

The deferral of taxation for qualified retirement plans and IRAs is a clear benefit, but also a potential tax problem when it is time to make distributions. If your clients are philanthropically inclined, the use of these assets for charitable gifts may be an excellent, tax-efficient option. A gift made during the donor's lifetime or a gift using a beneficiary designation to a charity or to a charitable remainder trust can be a rewarding and practical solution.

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