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Where the Money Is: Lifetime Charitable Gifts of Retirement Assets

In medicine, Sutton's law refers to the principle of going straight to the most likely diagnosis. Going to the heart of the matter is forever linked with bank robber Willie Sutton, who, when asked why he robbed banks, famously replied, "Because that's where the money is."[1]

Put Willie Sutton in the 21st century and he surely would have found that "the money" is in financial services—especially retirement vehicles. Americans hold trillions of dollars in retirement accounts, representing 34% of all household financial assets.[2] Nearly all retirement funds are held in these arrangements:[3]

- $5.7 trillion in Individual Retirement Accounts (IRAs)
- $5.3 trillion in defined contribution (DC) plans
- $5.2 trillion in federal, state and local government pension plans
- $2.8 trillion in private-sector defined benefit (DB) plans

Since retirement assets are truly "where the money is," it's worth examining how individuals can use these funds to make lifetime gifts through techniques that not only benefit a favorite charity, but do so in a manner that eases a donor's tax burden. Except where specifically noted, this discussion applies to all IRAs and qualified plan assets, including 457(b) deferred compensation arrangements and 403(b) tax-deferred annuities.

Taking a Distribution, Making a Gift

Prior to 2014, the law permitted a donor to make a Qualified Charitable Distribution (QCD) of up to $100,000 from an IRA directly to charity in a lifetime "rollover" without taxation. As of the publication date, Congress had not extended this provision for tax years after 2013. Thus, under current law, to make an inter-vivos transfer of retirement assets to charity one must first incur a taxable distribution.

Retirement plan assets provide a ready source of funds, but taking a distribution and then gifting it to charity is usually the same as making a cash gift, since retirement plan distributions are most often taxed as ordinary income. Like a simple gift of cash, these distributions still:

- Provide a current income tax deduction for a cash donation (or a deduction for the present value of the remainder interest to the charity if the donor directs the money to a charitable remainder trust or charitable gift annuity)
- Reduce the donor's taxable estate

EXAMPLE: Willie takes a $200,000 distribution from his IRA, which constitutes ordinary income and is fully taxable. If Willie contributes the distribution to a CRT designed to pay him an income for life, his current year tax deduction is based on the present value of the charitable remainder interest. If the remainder interest is 30%, that means a full 70% of Willie's distribution remains subject to ordinary income tax rates.

This is not a bad result, but Willie might be better advised to make a testamentary transfer of IRA assets.[4]

More Effective Giving With Lump-Sum Distributions

Gifts of retirement distributions do not provide the highly beneficial tax results that donors can achieve using other strategies—unless a donor is eligible to receive a lump-sum distribution from an employer-sponsored retirement plan.[5] Let's examine two of these strategies.

Gifts of Employer Stock

Qualified plans frequently offer employer securities as an investment and allow in-kind distributions. Highly appreciated employer stock with net unrealized appreciation (NUA) presents an opportunity for a large charitable deduction.

When a donor receives a lump-sum distribution of employer stock that has a significant amount of NUA, the distribution always generates a long-term capital gain.[6] However, a donor can give the stock to a deferred charitable giving arrangement and claim an income tax deduction based on the appreciated value of the stock rather than its much lower tax basis. The donor doesn't need to hold the stock for more than one year after distribution to qualify for long-term capital gain status, as is usually the case.[7]

EXAMPLE: Roger receives a lump-sum distribution of IBM shares worth $200,000, although the IBM plan purchased them for only $20,000. Roger only has to recognize $20,000 of income until he sells the stock, at which point he will have to recognize the $180,000 of NUA as income.[8] If he holds the stock for one week and sells it for $205,000 (a further appreciation of $5,000), then he will have a $180,000 long-term capital gain attributable to the NUA and a $5,000 short-term capital gain from the additional appreciation.[9] If he gifted the stock worth $205,000, the charitable income tax deduction would be based on the $200,000 value, which includes the $180,000 long-term capital gain but excludes the $5,000 short-term capital gain.[10]

A natural candidate for this strategy is a donor who participates in an employee stock ownership plan (ESOP). An ESOP can be used by C or S corporations, although certain tax benefits are not available to S corporations—most notably, the rule that allows sellers of stock to defer recognition of the gain on the sale if certain requirements are met.

When a plan allows, an employee who leaves the company can receive the vested interest in the ESOP in the form of employer securities. Distributions from ESOPs can result in significant net unrealized appreciation, thereby generating a large deduction if the employee donates the stock directly to charity.[11]

A donor can give S corporation stock to a charity but not to a CRT or a pooled income fund.[12] While this provides an opportunity for S corporation business owners to make charitable gifts of stock, both the donor and the charity face daunting issues. The donor:

- faces questions related to giving ownership rights to a charity
- must receive a "contemporaneous written acknowledgment" from the charity in order for the tax deduction to be successful[13]
- is required to obtain a qualified appraisal on any gift of stock worth more than $10,000 and file IRS Form 8283 with his or her income tax return[14]

As for the charity, all of a charity's income attributable to S corporation stock will be subject to the unrelated business income tax (UBIT), including gain from the sale. In addition, if the charity sells or disposes of the stock within three years of receipt, the charity must notify both the IRS and the donor of the sale price on Form 8282.[15]

10-Year Forward Averaging

An older investor who takes a lump-sum distribution from a qualified plan in cash may be eligible for 10-year forward averaging.[16] The charitable giving strategy in this setting is to pay the low 10-year rate and contribute the remainder to charity while taking a sizable charitable deduction in the process. However, there are a number of conditions that must be satisfied:

- the plan participant must have been born before January 2, 1936
- the distribution must be from a qualified plan (but not an IRA or 403(b) plan)
- the entire plan balance (not including employee contributions) must be distributed in one taxable year as a single distribution or series of distributions, and no part of the distribution can be rolled over
- the plan participant must have been in the plan for at least five years before the distribution

- the plan participant cannot have used the income averaging provision for any previous distribution after 1986

The lump sum must be distributed:

- on account of the employee's death, disability (if self employed), or separation from service[17]
- after the employee reaches age 59½

Once lump-sum treatment is elected, all distributions from qualified plans to the recipient for that taxable year must use lump-sum treatment. Failure to include all lump-sum distributions in the election will invalidate the election for any distributions. An individual is allowed only one forward-averaging election.

Loans of IRA Assets to Charity

Donors can also loan IRA assets to charity without causing a taxable distribution (though also without any charitable deduction). Known as a *Charitable IRA* or *CHIRA*, the IRS approved this strategy in Private Letter Ruling (PLR) 200741016.[18]

The donor addressed in the PLR directed his IRA to lend money to a qualified charity in return for a 20-year promissory note paying 5% annually. The note provided for a balloon payment of the principal after 20 years (or upon death, if earlier). To provide collateral for the note, the charity bought a life insurance policy on the life of the IRA holder, owned by the charity, so that if the donor died prior to the full payment of the note, the death benefit would provide the remaining payments owed, and the rest 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.

EXAMPLE: Anna directs her IRA to lend $200,000 to her favorite charity. The charity allocates $100,000 to pay premiums on a new policy on Anna's life, and $60,000 to pay the required annual interest on the $200,000 loan. This leaves $40,000 for the charity to use immediately. At Anna's death, the charity receives $200,000, which it uses to pay off the principal of the loan. Any excess remains with the charity. Since the charity makes the interest payments directly to the IRA, they are considered tax-deferred gain. Anna's spouse could then inherit the IRA when she dies and either maintain the IRA or roll the proceeds to another IRA in his own name.[19]

Integrating Capital Gains with Retirement Distributions

Usually, donors are better off contributing appreciated long-term capital gain property during life rather than making gifts with distributions from retirement plans. However, donors can combine retirement plan distributions with gifts of capital assets and accomplish a favorable income tax result.

EXAMPLE: June owns $150,000 of Apple stock she purchased for $25,000. She also receives a $150,000 taxable required minimum distribution from her 401(k) plan. June is better off donating the stock to charity rather than the 401(k) distribution. Though either gift would produce a $150,000 income tax charitable deduction, giving the stock forever avoids long-term capital gains tax on the $125,000 of appreciation.[20]

In the combination strategy, June can donate the stock, then use her 401(k) distribution to buy more Apple stock with a fresh cost basis. In this way, the charitable deduction from the gift of the original stock can be used to offset the taxable 401(k) distribution—a nearly tax-free step-up in basis in the stock position.

Heed Sutton's Law

Often, charitably minded clients who want to make major donations will have concerns about where the money will come from or whether there will be enough money left in the estate to cover future expenses. In these cases, we can return to Sutton's law and look first to the obvious. There is a significant amount of money sitting in retirement accounts, and many people are required to take annual distributions whether they need that money or not.

When a person has created a comfortable retirement through personal savings and Social Security, retirement assets can provide interesting planning opportunities for making lifetime charitable gifts. The law respecting distributions from retirement plans is highly complex and creating charitable gifts with these assets is not a matter for the faint of heart. Nonetheless, given the highly favorable results that donors can enjoy with the right plan, it is a strategy worth considering when the time arrives.

Endnotes

1 http://www.medical-dictionary.thefreedictionary.com/Sutton%27s+law. Willie Sutton, responsible for bank robberies totaling some $2 million, denied having said this; see, http://www.snopes.com/quotes/sutton.asp.

2 http://ici.org. As of June 30, 2013.

3 Id. Given current market levels, these figures are most likely significantly understated.

4 An IRA owner who desires to transfer an inheritance to children and leave a bequest to charity is better advised to transfer part or all of an IRA to charity and leave assets to the children that are not considered Income in Respect of a Decedent (IRD). Since charities are exempt from income tax, a charity can receive the entire IRA and avoid payment of the income tax. For example, a $100,000 IRA may be transferred to a charity and the charity will receive the full $100,000. However, if the $100,000 were transferred to a child (subject to the parents' 39.6% tax rate), cashing out the IRA would produce a tax of $39,600.

5 Not all plans allow lump-sum distributions. Spousal consent may be required.

6 Reg. Section 1.402(a)-1(b)(1)(i); Rev. Rul. 81-122, 1981-1 C.B. 202

7 IRS Notice 98-24; PLR 199919039 (IRS sanctioned a contribution of appreciated stock to a Charitable Remainder Unitrust)

8 IRC §402(e)(4)(B)

9 See PLR 199919039

10 IRC §170(e)(1)(A)

11 Donors contemplating gifts of appreciated employer stock should obviously refrain from diversifying investments where allowed under the 2006 Pension Protection Act.

12 Small Business Job Protection Act; Public Law 104-188; August 20, 1996

13 IRC §170(f)(8); Reg. Section 1.170A-9(e)(13)

14 Reg. Section 1.170A-13(c)(2)(ii)

15 IRC §6050L and Reg. Section 1.6050L-1

16 IRC §402(e)(4)(D)(i)

17 See IRS Form 4972 (and instructions) for eligibility requirements.

18 A PLR cannot be relied upon as authority by anyone other than the taxpayer to whom it was issued, but does provide insight as to how the IRS may view similar transactions.

19 Non-spouse beneficiaries do not have the same options as surviving spouses.

20 IRC §170(b)(1)(C)(iv)

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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Legacy Strategies: Creating Testamentary Charitable Gifts with Retirement Assets

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Legacy Strategies: Creating Testamentary Charitable Gifts with Retirement Assets

"Me and my dad are the biggest promoters of an estate tax in the US. It's not a popular position."[1]

- Bill Gates, founder of Microsoft Corporation

With an endowment of some $38 billion as of June 2013,[2] the Bill & Melinda Gates Foundation ranks as one of the biggest philanthropic organizations in the world. The foundation's wealth reflects the success of Microsoft, the personal fortune of Bill Gates (estimated at close to $80 billion at the end of 2013[3]), and substantial gifts from Warren Buffet. While Bill Gates may welcome the current 40% estate tax, most donors with charitable intentions seek out gifting strategies that provide tax advantages as well.

Retirement plan assets present a good choice for testamentary gifts, especially since these assets are highly taxed in an estate as income in respect of a decedent. Gifts of retirement plan assets require careful planning but can prove highly beneficial for charitably minded planners.

In this issue of ***The Good Advisor,*** we will examine how a testamentary gift of retirement plan assets can:

- mitigate the negative tax impact of income in respect of a decedent
- allow other valuable property to pass to heirs on a more favorable tax basis, and
- produce an income stream for surviving family members

Avoiding the "Double Tax" Trap

Income in Respect of a Decedent

Among the first concerns taxpayers face in planning for the future disposition of retirement assets is the issue of income in respect of a decedent (IRD). IRD, of course, is: (1) income earned by an individual prior to death, or (2) income to which an individual had a right prior to death, but (3) that was not includible in the individual's gross income prior to death.[4] Retirement plans are a prime example of IRD.[5] Although this list is not exhaustive, IRD results when any of these assets become part of a decedent's estate:

- Qualified Plans[6]
  - Profit Sharing (including plans with a 401(k) feature)
  - Money Purchase
  - Defined Benefit (including Cash Balance)
  - ESOP (Employee Stock Ownership Plan)
- 403(b) Tax Deferred Annuities
- 457(b) Deferred Compensation
- IRAs (Traditional and Roth), SEPs and SIMPLEs
- Nonqualified Deferred Compensation Arrangements

Note: For purposes of illustration, examples in this issue of **The Good Advosor** typically use IRAs. However, keep in mind that any of the vehicles noted above are likely to be eligible for the tax treatment discussed.

The Effect of Double Taxation

IRD is taxed twice—once to the recipient for federal income tax purposes and once more for federal estate tax purposes. A decedent who was in a 39.6% income tax bracket and a 40% estate tax bracket could potentially lose nearly 80% of IRD property to these combined taxes. Income in respect of a decedent keeps the same tax character when it reaches the ultimate recipient as it had when the decedent possessed it during life (e.g., ordinary income, capital gain, etc.).[7] Therefore, retirement plan distributions are typically taxed to beneficiaries as ordinary income.

If a decedent's estate pays estate tax on IRD, the beneficiary can deduct that portion of the tax attributable to the estate tax as a miscellaneous itemized deduction.[8] The beneficiary determines the amount of the

deduction by establishing the difference between the estate tax due on the entire estate and the estate tax due on the entire estate minus the IRD. Unfortunately, heirs often miss this deduction since the deduction is realized as the IRD is paid out to the beneficiary. In other words, a beneficiary taking lifetime required minimum distributions from an inherited IRA would also take IRD deductions over the same lifetime schedule.

Example: Uncle Norm's estate is well over the current exemption of $5.34 million. He would like his brother, Woody, and the Cheers Foundation to each receive $1 million at his death. He owns $1 million of appreciated stock and has $1 million in a 401(k) plan. A knowledgeable advisor suggests he give the stock to Woody and leave the 401(k) plan to the foundation. Why? As a tax-exempt entity, the foundation is not taxed upon receipt and can apply the entire $1 million to its charitable purposes. Moreover, Norm's estate receives a charitable deduction for the gift of the 401(k) assets. Not only will Woody not owe any income tax on the stock he inherits, he will also benefit from a step-up in basis.[9] (IRD does not receive a similar step-up in valuation when transferred.[10])

Let's consider the potential result if Norm had forged ahead without the help of an advisor. His gut feeling leads him to leave the 401(k) to Woody and the stock to the foundation. The foundation is still able to use the entire $1 million, since charities do not pay income tax or capital gains tax on a gift of stock. Norm's estate still receives a charitable deduction for the gift. However, both Norm's estate and Woody will have to pay sizeable taxes on the 401(k) assets. First, these assets are considered IRD in the estate and are taxed at the 40% estate tax rate. Then, since Norm funded the 401(k) with pre-tax dollars, each distribution to Woody is considered ordinary income and is taxed at Woody's marginal rate. If he takes the distribution as a lump sum, the entire tax is due in a single taxable year. Woody is allowed an itemized deduction on the estate taxes paid.

For philanthropically minded estate owners, making a charitable gift of IRD assets is an ideal strategy for avoiding the potential one-two punch of high estate and income tax liability. By properly threading this income through the estate (or trust) to a charity (or designating a charity as beneficiary on forms available from a custodian) and leaving other assets to family and friends, property owners:

- generate an estate tax charitable deduction
- avoid taxation of IRD assets (thanks to the charity's tax-exempt status), and
- leave heirs property (such as appreciated stock) that will enjoy a step-up in basis

Keep in mind, income in respect of a decedent that passes to a surviving spouse falls under the unlimited marital deduction and therefore generates no federal estate tax. Thus, leaving IRD to the surviving spouse is preferable to leaving it to other beneficiaries (it won't generate a charitable deduction, but the spouse won't need it to offset any tax on the IRD assets). It is important to note that to the extent the surviving spouse does not use up all of the IRD assets during life, these assets will still be subject to estate and income taxes.[11]

A Simple Strategy—Using the Beneficiary Designation Form

The most straightforward method of leaving a testamentary charitable gift of retirement assets is simply to designate the charity as the beneficiary on forms provided by the custodian of the retirement funds.[12] The decedent's estate is entitled to an estate tax charitable deduction under IRC §2055(a) for the amount of IRD passing to charity, and the charity will not be subject to income tax on the retirement plan proceeds it receives since it is exempt from income tax under IRC §501(c)(3).

Example: Maggie's $7 million estate includes an IRA worth $700,000. She intends to give one-tenth of her estate to State University, so she uses the forms provided by the IRA custodian to name State University as the sole beneficiary of her IRA. At Maggie's death, the charity receives the $700,000 tax free, avoiding both the estate tax and the income tax that her heirs would have had to pay on her IRA distribution, and her estate receives a $700,000 charitable deduction. The amount that remains in her estate over and above her exemption is subject to the federal estate tax. The non-IRD assets, less estate tax costs, are distributed to her family under her will. Total tax savings are roughly $400,000—a very cost-effective giving strategy.

Of course, donors must keep in mind that once they make a charity the beneficiary of a retirement plan, that designation takes precedence over any conflicting distribution instructions found in a will or trust.[13]

DEALING WITH REQUIRED MINIMUM DISTRIBUTIONS (RMDS)

For a taxpayer over age 70½, naming a charity as beneficiary of an IRA or other retirement plan instead of a spouse used to raise undesirable issues with respect to the amount of the RMD payments. Under prior RMD rules, the beneficiary's life expectancy was an important measurement because it could stretch out the distribution period for an IRA or qualified plan, thereby allowing a living owner to take smaller annual RMDs. But since a charity has no life expectancy, a charitable beneficiary did not stretch out the distribution period at all. Both the donor and the charity were essentially penalized for this charitable act—the donor was forced to take larger distributions than would have otherwise been required, and the charity was left with less money in the account at the time of the charitable distribution.

However, final regulations issued in April 2002 eliminated this treatment of charitable beneficiaries and account owners.[14] Lifetime RMDs for account owners are now determined under the Uniform Lifetime Table, regardless of the life expectancy of the designated beneficiary (not forgetting the exception for a spouse who is more than 10 years younger than the owner). This encouraged more frequent use of IRAs and retirement plan assets for charitable giving purposes, especially since the IRD advantage enjoyed by charitable beneficiaries was unaffected by the RMD changes.

Transfers of IRD through Wills and Trusts

Instead of naming an individual beneficiary, an owner can transfer retirement assets at death to a trust or to the estate. If the goal is to ultimately transfer the assets to a charity, the will and/or trust must include language that permits the executor and/or trustee to make income distributions and effectively claim the income tax charitable deduction for the IRD assets that go to charity. The owner can also give the trustee discretion with respect to how the donations will be made.

Proceed with Caution

When the owner of a retirement account chooses to transfer income in respect of a decedent through a will or trust, the issue of double taxation remains. IRC §691(a)(2) provides the general rule that the value of the right to receive the IRD is included in the estate's income. However, Treas. Reg. §1.691(a)-4(b) provides an exception if the transfer is of the right to receive IRD by a "specific or residuary legatee." In that case, the recipient, not the estate, includes the IRD in income for the tax year in which it is received.

So, to avoid recognition of IRD by the estate, retirement benefits should not be used to fund a charitable bequest of a specific dollar amount (a "pecuniary" bequest), unless the will specifically authorizes the executor or trustee to use retirement benefits to satisfy the charitable bequest.[15]

Example: Gloria dies and leaves a $1 million pecuniary bequest to a hospital without specifying how the bequest should be funded. She also has an IRA without a named beneficiary. Her executor uses part of her IRA proceeds to satisfy the bequest to the hospital despite a lack of authorization for such a transfer in the will. Because her will did not give instructions allowing the use of the plan assets to fund the bequest, and did not give authorization to the executor to make such a transfer, Gloria's estate must now recognize $1 million of IRD income and face the double taxation that accompanies it.

The Importance of Proper Enabling Language

When proper enabling language exists, the IRS has ruled privately that distributions can be made from IRAs to residuary charitable beneficiaries without recognizing IRD in the estate. In other words, only the residuary beneficiaries would recognize the IRD. Of course, while private letter rulings (PLRs) pertain only to the taxpayer receiving the ruling and cannot be cited as precedent, they do provide an idea of how the IRS views this topic. Let's take a look at a few examples.

Example 1 - PLR 200826028: In this private letter ruling, the trustees assigned an IRA to four charities and did not cause the estate to recognize IRD. The decedent had established a grantor trust during life, and the decedent's will provided that at death, the residuary property should be added to the trust. The residuary property included an IRA without a named beneficiary. The trust provided for a number of specific distributions, including equal distributions to four charities. The trust terms granted the trustees authority to distribute income and principal in cash or in kind or "to allocate or distribute undivided interests or different assets or disproportionate interests in assets." The trustees proposed to fund the residuary bequests by assigning the IRA to the charities.

The IRS ruled that the transfer of the IRA in satisfaction of the decedent's bequest from his trust was not a "transfer" within the meaning of IRC §691(a)(2) and, therefore, not includable in the gross income of the decedent's estate.

Example 2 - PLR 201330011: In this private letter ruling, a decedent who owned several IRAs named the estate as the beneficiary. The terms of the will dictated that all residuary estate assets be poured over to a revocable trust. The trust, in turn, provided that, at death, two charities should share specified percentages of the estate. The trustee was empowered to distribute trust property in cash or in kind in satisfaction of their percentage interests.

Here, the result was the same as in Example 1, even though:

- the trust was distributable only in part to the charities
- the executor and trustee joined together to allocate the IRAs to the charities and the non-IRD assets to the non-charitable beneficiaries

Again in this case, the authorization in the trust instrument for this type of a distribution was essential to the success of the charitable use of IRA assets.[16]

Example 3 - PLR 200850004: In this private letter ruling, an executor transferred an IRA **with an individual as named beneficiary** to a charity without the IRA being taxed in the estate as IRD. The will directed the executor to make gifts to three charitable organizations, but did not specify which assets to use. Considering the named individual beneficiary, how did the executor make this successful transfer of IRA assets to charity?

- The beneficiary filed a qualified disclaimer of the IRA, leaving the estate as the sole beneficiary.
- The probate court approved the executor's petition to reform the will to designate the IRA as the source of the charitable bequests.
- The executor wisely requested a private letter ruling from the IRS that the transfer of the IRA to the charities in satisfaction of the bequests would not result in IRD tax to the estate.
- The IRS determined that the transfer of the IRA in satisfaction of the bequest met the requirements of the §1.691(a)-4(b)(2) exception and was not a transfer within the meaning of §691(a)(2).

This example underscores the importance of applying for a ruling in cases where any uncertainty exists with respect to whether a charity is properly designated as a beneficiary of a retirement asset.

QTIP Trusts

An account owner may choose to use an IRA to fund a Qualified Terminal Interest Property trust (QTIP trust). A QTIP is a marital trust providing income to a spouse during life. Individuals typically use a QTIP when they want to control how assets are distributed at the death of their spouse. They may also use it as a spendthrift precaution.

A QTIP funded with an IRA can have a charitable beneficiary. The first spouse to die (as grantor) specifies that the undistributed IRA fund the trust at death. At least annually thereafter, for the life of the spouse, the trust must pay the spouse the greater of the IRA required minimum distribution or the income created by the IRA account.[17] At the death of the surviving spouse, the remaining IRA assets pass to the charitable beneficiary as directed by the grantor under the terms of the QTIP. The IRA is taxable in the estate of the surviving spouse, but the value of assets passing to charity qualify for an estate tax charitable deduction.

QTIP trusts qualify for the unlimited marital deduction for federal estate tax purposes. A QTIP trust requires that all trust income generated during the spouse's life be paid to the spouse, and no other beneficiary may benefit from the trust during the spouse's lifetime. Since QTIPs are often drafted in complex ways to allow the surviving spouse accelerated access to trust assets prior to the eventual transfer to the charity, there is no guarantee that the total amount intended to pass to charity will ultimately be available. A charitable remainder trust may be a more effective way to provide a certain remainder interest to charity.[18]

Charitable Remainder Trusts

Since a minimum remainder interest is required of a Charitable Remainder Trust (CRT), individuals who want to benefit a loved one and leave a clearly vested remainder to charity may prefer to establish a CRT rather than a QTIP trust.

A CRT is, of course, an irrevocable trust in which the donor (or one or more designees) receives income from the trust for life (or joint lives) or for a period of up to 20 years, after which the trust terminates and trust assets are distributed to a charity. The present value of the charitable remainder interest must be at least 10% or more of the initial value of the property transferred to the CRT. Because a CRT can be arranged to pay income to a non-charitable beneficiary for life, a CRT lets a donor make a major gift to a charitable institution and gain immediate income tax benefits without losing spendable income.

A donor creates a testamentary CRT funded with retirement assets by naming the trust as beneficiary of a retirement account. The donor then grants the trustee the power to distribute assets and use the cash to purchase other income-producing securities. A CRT is a tax-exempt trust so there is no immediate income tax consequence due to distribution of the retirement assets.

The trustee must pay an annual income to the non-charitable beneficiaries for a certain period of time, often the lives of the beneficiaries.[19] These payments may either be a fixed dollar amount (Charitable Remainder Annuity Trust or "CRAT") or a specified percentage of trust assets (Charitable Remainder Unitrust or "CRUT"). CRUTs are used more often under these circumstances due to their flexibility.[20] After the interest of the non-charitable beneficiaries terminates, the remaining assets are paid to the charitable beneficiaries.[21]

There are many advantages to contributing retirement assets to a charitable remainder trust:

- It is easy to name a CRT as a beneficiary of a retirement plan or IRA.
- Initial distributions from the retirement plan to the CRT do not trigger immediate taxation.
- The estate enjoys a charitable deduction for the value of the remainder interest to the charity.
- A CRT can pay a life income to trust beneficiaries and may be used to preserve assets in favor of selected beneficiaries (e.g., first to a spouse, then to children from a prior marriage).[22]
- A CRT can allow an income stream to continue to a beneficiary regardless of changes in the law (for example, the Joint Committee on Taxation's proposal to limit payouts from inherited IRAs to five years).[23]

With a Spouse as the Non-Charitable Beneficiary

It is common for the donor to name a spouse as the non-charitable beneficiary. In this case, when the original account holder dies, the retirement assets pass into the CRT and the surviving spouse receives income in the form of annual payments from the trust. There are positive tax implications, since the transfer to the trust qualifies for the unlimited estate tax marital deduction, and the value of the assets remaining inside the CRT at the death of the surviving spouse will pass to charity and therefore will not be taxable to the estate.

Example: Bill and Meredith have a net worth of $7 million. Bill worked for a large company his entire career and rolled over a lump sum distribution from a defined benefit plan into an IRA at age 65. The IRA is now worth $2 million.

As part of their estate planning, Bill and Meredith establish an unfunded Charitable Remainder Unitrust (this is valid under state law), and Meredith signs a consent and waiver to allow the CRUT to become the beneficiary of the IRA (necessary to comply with state community property laws).

At Bill's death, the IRA flows to the CRUT. As a tax-exempt entity, the CRUT pays no income tax. Meredith will receive an annual 6% payment for life, and these payments will be taxable as ordinary income since the trust was funded with an IRA.

Under the terms of the trust, Meredith can choose to invest for growth and reduce the income, or she can choose to invest for income. She chooses the growth model. If the CRUT fails to return the required minimum amount, Meredith can invoke the flexible trust provisions to adjust her investments to generate the income necessary to pay out the 6% minimum. At Meredith's death, the trust principal is distributed to the charitable beneficiary.

With a Child as the Non-Charitable Beneficiary

When an account owner wishes to provide income for children through an IRA or other retirement plan, a CRT often provides more advantages than naming the child as the IRA beneficiary:

- The bequest to a CRT creates an estate tax charitable deduction, which reduces estate taxes.
- The transfer of the retirement assets to the CRT postpones income taxation until the beneficiary actually receives the income.[24]
- Although these retirement assets are ostensibly "lost" to the family when they eventually pass to the charity, the reduction in income and estate taxes brought about by transferring the IRA to the trust may have preserved additional principal in the IRA, in turn generating additional life income for the non-charitable beneficiaries.

Keep in mind that it is possible to use part of the annual trust income to replace the IRA wealth by paying premiums on a life insurance policy.

Example: Kurt passed away and left all of his assets to his wife, Goldie—the house, the CDs, the securities and Kurt's IRA. Goldie combined her IRA with Kurt's and now has $600,000 in the IRA. She also has approximately $400,000 in other assets.

Goldie wants their four children to benefit equally from her estate, but she faces a common challenge—one of them is likely to squander the assets in a short period of time. Goldie decides to make an outright and equal transfer of non-IRD assets to the children (securities, home, etc.). However, because the IRA is an IRD asset, she designates it to go into a testamentary CRUT with a 15-year term. In preparation, she changes her IRA beneficiary to the CRUT trustee. Under the new IRC regulations, this does not change her minimum distribution requirement for the IRA.

At Goldie's death, after costs of $24,000, the children share roughly $376,000 of non-IRD assets (gaining a step-up in basis). The $600,000 IRA transfers into a 7% CRUT. Since the trust is exempt, there is no immediate tax paid on the ordinary income. The trustee invests the full $600,000 from the IRA and earns new income for the children. While the income is taxable, the trust is able to pay over $676,000 to the children during the 15-year trust term. At the end of the term, the trust distributes the remaining assets to the charity.

This plan has the virtue of treating all children equally while preserving IRD assets for the child that may have difficulty saving money. However, Goldie should be careful in setting up the trust so that it will meet the minimum 10% to charity limitation. With young or multiple beneficiaries, the value of the charity's remainder interest shrinks under the time-value-of-money principles. If the charity's interest dips below the 10% limitation, it will jeopardize the CRT's tax qualification.

Charitable Bequests of Nonqualified Plan Assets

In simplest terms, a nonqualified deferred compensation plan or agreement simply defers the payment of a portion of an employee's compensation to a future date. These plans, which employers utilize in numerous and creative ways, are typically designed to benefit executives and other highly paid individuals. Benefits are not taxed until they are considered "vested" at death, disability or retirement.

Such an arrangement is "nonqualified" in the sense that it is an unfunded arrangement that need not meet the technical requirements imposed on qualified pension and profit-sharing plans under the Internal Revenue Code or the Employee Retirement Income Security Act (ERISA). As such, they can discriminate in

favor of highly paid employees. However, plans must still meet the requirements of IRC §409A.[25]

Since deferred compensation is IRD when it passes into an estate, it is a viable candidate for a charitable bequest. However, due to the issues of vesting and taxation, plan participants have an ongoing concern as to whether the estate will be subject to tax when the deferred compensation is transferred. Fortunately for those who want to bequeath deferred compensation, the IRS has ruled that the IRC §691(a) status of deferred compensation enables a direct transfer to charity through a beneficiary designation.

Let's look at a private letter ruling as an example. PLR 200002011 involved an individual with a right to three different types of deferred compensation:

- compensation deferred under the employer's nonqualified deferred compensation plan
- non-statutory stock options
- a right of the estate to receive additional deferred compensation at death

In this circumstance, the IRS determined that the IRC §691(a) status of all three types of nonqualified deferred compensation enabled each benefit to transfer directly to charity by way of a beneficiary designation. The IRS also reiterated that under IRC §2055, the deferred compensation was to be treated similarly to other assets transferred to qualified charities at death, allowing the estate to make use of the estate tax charitable deduction.[26]

Conclusion

"Melinda and I have the honor and the responsibility to return to society, in the best way we know how, the resources we have received. But you do not need to be the chair of a large foundation to have an impact on the world." [27]

- Bill Gates

Many people agree with the sentiment expressed by Bill Gates—it is both an honor and a responsibility for those who have earned enough to live comfortably to give back to society. But what is the best way to give, and when? One answer is to consider a testamentary gift of assets allocated for retirement. Many strategies exist and the benefits to both donor and donee are significant.

Endnotes

1 www.quotepiper.com. Notwithstanding this sentiment, many would be quick to point to reports of Microsoft's aggressive tax strategies. See, http://realwashingtonstatebudget.info/index.php?option=com_content&view=article&id=105&Itemid=122

2 See http://en.wikipedia.org/wiki/Bill_%26_Melinda_Gates_Foundation

3 See http://www.fool.com/investing/general/2014/01/11/bill-gates-keeps-getting-richer-heres-the-worlds-r.aspx

4 IRC §691(a)

5 IRC §102(b) and §691; see also Rev. Rul. 92-47, 1992-1 CB 198

6 For qualification requirements, see, IRC §401(a) et seq.

7 IRC §691(a)(3)

8 IRC §691(c)

9 IRC §1014(c)

10 Id.

11 Though IRD is always considered taxable, estates under $5.34 million (indexed for 2014) also escape taxation.

12 Qualified plan owners must take care when naming a non-spouse beneficiary as spousal consent is often required. See IRC §401(a)(11); Treas. Reg. §1.401(a)-20

13 For example, see Egelhoff v. Egelhoff 522 U.S. 141 (2001) and Boggs v. Boggs, 117 S. Ct. 1754 (1997)

14 Treas. Reg. §1.401(a)(9)-4

15 IRC §642(c)

16 See also PLR 200845029, in which a defined benefit pension plan assignment to charity was excluded from gross income

17 IRC §2056(b)(7)

18 For example, see Beneficiary Designations for Individual Retirement Accounts and Qualified Plans http://www.actec.org/Documents/misc/Northern_Trust_Beneficiary_Designations_for_IRAs_and_Qualified_Plans_3-2009.pdf

19 IRC §664(d). The income beneficiary of a CRAT must receive the required annuity payout each year, even if the trust does not produce any income.

20 CRUTs comes in four sub-varieties, while a CRAT comes in only one basic form. See http://www.irs.gov/pub/irs-tege/eotopicf01.pdf, p. 86

21 Treas. Reg. §1.664-1(a)(1)(i)

22 The trustee must take care to meet distribution and remainder requirements. See, IRC § 664(d)(1)(A), §664(d)(1)(D), §664(d)(2)(D)

23 See Description of the Chairman's Modification to the Proposals of the "Highway Investment Job Creation and Economic Growth Act of 2012" (JCX-11-12), February 7, 2012

24 With younger income beneficiaries, it is always necessary to determine whether the CRT is practical in light of the requirement that at least 10% of the initial value of retirement assets transferred to the CRT must represent the charity's remainder interest. IRC §664(d)(1)(D), §664(d)(2)(D)

25 See http://www.irs.gov/Retirement-Plans/409A-Nonqualified-Deferred-Compensation-Plans

26 See also PLR 200012076 (allowing bequest of nonqualified stock option to charity) and PLR 200905016 (allowing deduction for deferred compensation plan benefit to charity after valid spousal disclaimer. IRS noted the disclaimer must meet the qualifications for a valid disclaimer under IRC §2518(b)—it must be in writing, the executor must receive the disclaimer within nine months after death of decedent, spouse must not have accepted any benefits from the disclaimed property and the property must pass to a person other than the disclaiming party.)

27 See http://www.forbes.com/sites/randalllane/2012/09/18/bill-gates-my-new-model-for-giving/2/

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