

IRAs and Qualified Retirement Plans

Qualified retirement plans and individual retirement accounts are trusts or custodial accounts that hold a person's tax deferred retirement assets. Their principal tax advantage is income tax deferral. They include IRC Sec. 401(a) Qualified Retirement Plans (profit sharing, ESOP, 401(K) and "Keogh" plans); Sec. 408 (IRAs, SEPs and SIMPLE Plans) and Sec. 403(b) (tax sheltered annuities and custodial accounts). This memorandum discusses the income and estate tax economics of lifetime and testamentary charitable and noncharitable transfers of retirement plan assets, along with guidelines planners should consider in structuring such transfers.

by

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IMPORTANT NOTICE: On January 17, 2001, Treasury issued proposed regulations affecting the Required Minimum Distribution rules for qualified plans and IRAs under IRC § 401(a)(9). During the subsequent public comment period, the IRS has received numerous recommendations. At such time the regulations are finalized or the IRS provides a clear indication they will remain in proposed form, we will update the text in this section. In the meantime, we direct you to the following articles for a review of the new rules as proposed:

Gift Planner's Digest:

Proposed Minimum Required Distribution Regulations Afford Charitable Gift Planning Opportunities

Planned Giving Online:

Simplifying the Required Minimum Distribution Regulations

Introduction

Qualified retirement plans and individual retirement accounts are trusts or custodial accounts that hold a person's tax deferred retirement assets. Their principal tax advantage is income tax deferral. They include IRC Sec. 401(a) Qualified Retirement Plans (profit sharing, ESOP, 401(K) and "Keogh" plans); Sec. 408 (IRAs, SEPs and SIMPLE Plans) and Sec. 403(b) (tax sheltered annuities and custodial accounts).

In the context of charitable giving, the rules, complexity, and tax benefits of transferring retirement plan assets to charity vary greatly depending on when the contribution is made. With limited exceptions, there are few tax advantages to be gained for the donor by transferring retirement assets to charity during the life of the plan participant. Conversely, retirement plan assets may be one of the most tax efficient assets to transfer to charity on a testamentary basis.

The balance of this section discusses the income and estate tax economics of lifetime and testamentary charitable and noncharitable transfers of retirement plan assets, along with guidelines planners should consider in structuring such transfers.

Lifetime Charitable Transfers of Retirement Plan Assets

In general, every distribution from a retirement plan, IRA, or 403(b) plan to a plan participant is taxable as ordinary income.¹ Distributions received before age 59^{1/2} are also subject to a 10% penalty, although there are some exceptions.²

Under current law, there are no tax-free lifetime transfers from a retirement plan to a charity or deferred gift vehicle. A person can take a distribution from a retirement plan and give it to charity, but the retirement plan distribution will have to be reported on the owner's income tax return. The donor can usually claim an offsetting charitable income tax deduction for a charitable gift of the distribution so that virtually no tax will be due from the transaction. However, that might not be the case if the donor is subject to the annual deduction limitations such as the 50% charitable deduction limitation or 3% itemized deduction floor. In addition, deduction limitations for state income tax purposes may vary from federal rules.

Comparing Lifetime Contributions of Retirement Plan Assets to Capital Gain Property

Given a choice, most donors will be better off contributing appreciated long-term capital gain property during their lifetimes rather than a distribution from a retirement plan. However, as illustrated in the following example, the retirement plan can be integrated into the gift to accomplish a favorable income tax result:

Example: Jane owns \$100,000 of XYZ stock she purchased for \$20,000. She also receives a \$100,000 distribution from a retirement plan (taxable income). Jane is better off contributing the stock to a charity than giving the \$100,000 retirement plan distribution. Either gift will produce a \$100,000 income tax charitable deduction, but by giving the stock she will forever avoid paying a long-term capital gain tax on the \$80,000 of appreciation.³

If Jane still desires to own XYZ stock, she can use the proceeds of her IRA distribution to purchase new shares of stock with a fresh cost basis. In this way, the income tax charitable deduction arising from the gift of the original stock can

be used to offset (subject to the percentage limitation deduction rules) the taxable distribution from the IRA. The result is a virtually tax-free stepped-up basis in her stock.

An exception to the stock-is-better-than-cash principle occurs when a donor has exceeded the annual deduction limitation for gifts of long-term capital gain property (usually 30% of the donor's AGI). An additional gift of stock will not provide any additional income tax benefits that year. If the donor has not yet reached the 50% of income limitation for cash gifts, the donor can receive taxable distributions from the plan and use the proceeds to make tax-deductible charitable gifts.⁴ A person may also be advised to take large distributions from an IRA or retirement plan if the five-year carry forward from their charitable gifts is about to expire. By offsetting the distributions with the charitable income tax deductions they will pay an effectively lower tax rate on the distributions.

Lifetime Deferred Gifts of Retirement Plan Distributions

With two important exceptions discussed below, a lifetime gift of retirement plan assets to a charitable remainder trust or pooled income fund, or to a charitable organization in exchange for a charitable gift annuity does not make good tax planning sense because only a portion of the taxable distribution from the plan used to fund the gift is offset by the income tax charitable deduction.

Example: Pearl is considering withdrawing an extra \$100,000 from her IRA and contributing it to a CRT. The CRT will pay her an income stream for life with the remainder to charity upon her death. Under this arrangement, she will have \$100,000 of extra income from the IRA distribution. She will be able to claim an income tax charitable deduction (based on the present value of remainder interest) for the gift to the CRT of just 35% of the amount that she contributed. Pearl will therefore have to pay income tax on the \$65,000 non-charitable portion of her contribution to the CRT.

Consequently, unless "charitable IRA rollover" legislation is enacted that would permit lifetime charitable transfers of plan assets free of income recognition, the best strategy for a deferred gift from a retirement plan or IRA is to leave as much as possible in the retirement plan or IRA and then have the account transferred to charity at death. As will be discussed, however, this may be easier said than done.

By comparison, an individual who is already past age 70^{1/2} and is receiving large mandatory distributions from an IRA may be looking for an offsetting income tax deduction. She could use some of these distributions to contribute to a charitable remainder trust or pooled income fund, or to purchase a charitable gift annuity to generate some offsetting income tax charitable deductions.

Exceptions to the General Rule

There are two situations when an outright or deferred charitable gift of a retirement plan distribution can actually save taxes. Both involve receiving a "lump sum distribution" from a company retirement plan:

Exception #1: Lump Sum Distributions of Employer Stock

Ltr. Rul. 199919039 involved an individual who wanted to make a contribution to a charitable remainder unitrust. He had just received a *lump sum distribution* that included *employer stock* from his company's retirement plan, and the stock had a significant amount of *net unrealized appreciation* ("NUA"). This is most likely to occur with a distribution from an Employee Stock Ownership Plan ("ESOP").

The transaction is basically a twist on the standard practice of contributing appreciated stock to a charitable remainder trust. Since NUA will always generate a long-term capital gain, a person who receives a distribution of employer stock from a company retirement plan can contribute the stock at anytime to a deferred charitable giving arrangement and claim an income tax deduction based on an appreciated value of the stock rather than the lower tax basis. There is no 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.⁵

Example: If an employee of Proctor & Gamble receives a lump sum distribution from the company's retirement plan of P&G stock worth \$100,000 that the plan had purchased for only \$10,000, the employee only has to recognize \$10,000 of income and does not have to recognize the \$90,000 of NUA as income until the stock is sold.⁶ If he holds the stock for only one week and sells it for \$105,000, then he will have a \$90,000 long-term capital gain attributable to the NUA and a \$5,000 short-term capital gain from the additional appreciation.⁷ In this example, if the stock was worth \$105,000, the income tax deduction would be based on the \$100,000 value which includes the \$90,000 long-term capital gain but excludes the \$5,000 short-term capital gain.⁸

Exception #2: Lump Sum Distribution That Qualifies For "Forward Averaging Tax"

A person born before 1936 who receives a *lump sum distribution* from a company or Keogh retirement plan (but not from an IRA or 403(b) plan) can pay a special low tax rate on the distribution: the ten-year forward averaging tax. There is no requirement the distribution include any employer stock. The entire distribution could be cash.

For example, the maximum forward averaging tax on a lump sum distribution of \$100,000 is 14.5%, regardless of the tax rate the recipient pays on other sources of income. The maximum rate is 20% for a distribution of \$200,000 and 22.5% for a distribution of \$300,000.⁹ The charitable giving strategy is to take a lump sum distribution from the account, pay a low tax rate of 15%, 20% or 22.5%, and then

make a charitable contribution of the assets which will produce income tax savings at the donor's usual rate (e.g., 39.6%). It is a form of *tax rate arbitrage*. Before taking a lump sum distribution, it is advisable to check the eligibility requirements listed on IRS Form 4972 to see if a person is eligible for ten year forward averaging or not.

Testamentary Charitable Transfers of Retirement Plan Assets

IRA and QRP assets do not pass through probate, unless the owner makes the mistake of naming the probate estate as the beneficiary of these assets. Instead, these assets are transferred directly to the beneficiary who is named as the successor beneficiary on the forms provided by the retirement plan. If the assets are to be transferred to a charity or a charitable remainder trust, the charity or a charitable remainder trust will usually have to be named as the successor beneficiary on these forms.

Transfers to Charity Avoid Tax on IRD

Retirement plan assets are often ideal candidates for a charitable bequest because they generate "income in respect of a decedent." Reg. §1.691(a)-1(b) provides that the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but that were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of death or for a previous taxable year under the method of accounting employed by the decedent. In simplified terms, income in respect of a decedent ("IRD") is an inherited payment that would have been taxable income to the decedent had he or she received it before death.

Distributions from a retirement plan of a decedent are considered IRD. It is important to note that unlike conventional assets, which receive a stepped-up cost basis in the estate of a decedent, IRD assets are taxed for income tax purposes in the hands of the recipient just as they would have been taxed if received by the decedent prior to death.

If the retirement plan directs plan proceeds to the participant's estate, they will be included on the income tax return of the participant's estate. If directed to a beneficiary such as a spouse, child, or other individual, they will be included in the gross income of that individual in the year they are received.¹⁰ The income tax is imposed in addition to any estate tax; although, as will be discussed, the recipient will receive a deduction against taxable income for any federal estate tax paid in connection with the distribution.

If the retirement plan directs plan proceeds to a charitable organization or charitable remainder trust, neither the donor's estate nor heirs will realize income from the plan; rather, the income will be realized by the tax-exempt recipient organization or trust. Thus, no tax will be paid in the year of distribution.¹¹

If the proceeds will be paid to a private foundation, the Service has ruled that such income will be exempt from the 2% private foundation excise tax on investment income under IRC 4940.¹² In addition, if a private foundation is required by the terms of a living trust to pay to the estate IRD assets in order to pay recomputed estate tax, such a transaction will not be a prohibited act of self-dealing under IRC 4941.¹³

Why Giving IRD Assets to Charity on a Testamentary Basis Makes Sense

Whereas the highest estate tax rate on standard assets is basically 55%, the combination of estate and income taxes on IRD assets triggers an effective marginal tax rate in excess of 75% for taxable estates over \$3 million (see the sample computation ahead). The charitable tax deduction offers relief from both of these taxes. Thus, at a cost to the heirs of less than 25% of these types of assets, an individual can apply 100% of the assets to his or her specific charitable objectives.

A Common Planning Mistake

Individuals considering a charitable bequest are usually better served by transferring income-taxable assets to charity and non-income-taxable assets to heirs. Under current practices, however, many people do exactly the opposite; they transfer income-tax-free cash, securities, or real estate to charities and taxable income to their heirs. They do this by making specific bequests from their estates to charities while naming their heirs as the beneficiaries of their qualified retirement plan and IRA accounts. From a tax planning perspective, this situation should be reversed.

Combining Estate and Income Taxes on Income in Respect of a Decedent

The relationship between IRD income tax and estate tax calculations are illustrated in the following example:

Example: Assume that Mother's total taxable estate is \$3,200,000 placing her firmly in the 55% marginal estate tax bracket. Her sole beneficiary is her daughter. Mother's estate includes a \$100,000 IRA account, which will be transferred to Daughter immediately in a lump sum. Daughter is in a 39.6% marginal income tax bracket. The following computation illustrates the estate tax and income tax attributable to the IRA distribution:

Step 1: Calculation Federal Estate Tax Attributable to IRA Distribution

IRA Account Value	\$100,000
Allocable Federal Estate Tax (@ 55%)	\$55,000
Less: State Tax Credit	(9,600)
Equals: Net Federal Estate Tax	\$45,400

IRC §691(c)(1)(A) provides that a person who receives "income in respect of a decedent" can deduct against his or her taxable income the federal estate tax attributable to IRD items paid by the decedent's estate. The §691(c) deduction has the effect of reducing the income tax paid by the recipient on IRD items. The deduction for estate tax attributable to IRD is only for the federal estate tax; the Section 2011 state tax credit (9.6% for an estate over \$3,100,000) has therefore been eliminated.¹⁴

Step 2: Calculation Income Tax Attributable to Income in Respect of a Decedent

IRA Account Value	\$100,000
Less: IRC §691(c) Deduction*	(\$45,400)
Equals: Net Taxable Income**	\$54,600
Net Income Tax on IRD (@ 39.6%)	\$21,622

Step 3: Combined Estate and Income Tax

Federal Estate Tax	\$55,000
Plus: Net Income Tax on IRD	\$21,622
Equals: Total Taxes	\$76,622
Tax Erosion	76.6%
Net to Daughter	\$23,378

* The deduction is an itemized deduction on Schedule A that is claimed on the last line of the form ("other miscellaneous deductions"). It is not subject to the 2%-of-adjusted-gross-income ("AGI") limitation otherwise applicable to most miscellaneous deductions.¹⁵

** The net taxable income from the IRD might actually be greater than this amount. The IRD will increase the recipient's AGI by \$100,000 which generally will decrease the recipient's itemized deductions by 3% (\$3,000 in this example).¹⁶ The 3% reduction was omitted from this calculation in order to simplify the computation.

Naming Charity as Successor Beneficiary of Retirement Plan

Based on tax efficiencies presented in the foregoing analysis, it would seem logical that anyone with any modicum of donative intent would designate one or more charitable organizations as the successor beneficiary of their retirement plans. However, there are several factors that must be weighed in determining whether or not naming charity as a successor beneficiary is in the best interests

of the donor and donee. The decision is based on a thorough understanding of the minimum distribution requirements applicable to such plans, the plan participant's age, available elections, and other factors.

Minimum Distribution Rules May Discourage Naming Charity as Successor Beneficiary

The primary purpose of all retirement plans is to maximize the accumulation of assets via income tax deferral. However, income cannot be deferred indefinitely. With limited exceptions, plan distributions prior to age 59^{1/2} are subject to a 10% premature distribution penalty tax. Once the participant reaches 59^{1/2}, he or she can begin making withdrawals in any amount without penalty. However, once the participant reaches the "required beginning date" (hereafter, the "RBD"), the rules require the participant to withdraw at least a minimum amount annually. This ensures the plan is indeed used for retirement purposes rather than merely as a tax-deferred estate accumulation device.¹⁷ The RBD is April 1st of the year following the calendar year in which the participant turns 70^{1/2}. Subsequent distributions must be made by the end of the calendar year in which they are due.

To make sure participants comply with the minimum distribution requirements, a 50% penalty tax is imposed on any distribution shortfalls after the RBD. The penalty tax is over and above the income tax paid and the distribution. In essence, it is intended to enforce distributions by nearly confiscating any shortfalls.¹⁸

Depending on which distribution option they select, people living long lives may deplete their retirement account by the time of their death.

Minimum Distribution Options

If the participant is the sole beneficiary of the plan, the minimum required distributions are based solely on his or her life. The minimum required distribution can be calculated one of two ways-*fixed life method* or the *recalculation method*. The general rule is the recalculation method, but a person can make an irrevocable election at the RBD to use the fixed life method. Once a minimum distribution calculation method has been selected it becomes irrevocable as of the RBD. It is important to note that only the life expectancies of the participant and his or her spouse can be recalculated. Non-spouse beneficiaries are always frozen as of the RBD of the participant and must use the fixed life method.

Recalculation Method

The default rule is the recalculation method. Under this method, the account owner's life expectancy is recalculated each year rather than once. Compared to the fixed life method, the recalculation method results in smaller distributions

based on the principle that the longer a participant survives, the longer his or her overall life expectancy will be. Using this method, the life expectancy tables go to age 110; thus, it is possible that a participant could receive distributions until that age.

Fixed Life Method

Rather than recalculate one's life expectancy every year, the participant can elect at the RBD to take distributions over a fixed period, like an installment payout. Under the fixed life method, the participant's life expectancy is determined as of the RBD. Each year the value of the plan is divided by the remaining number of years of life expectancy. For example, if the participant's life expectancy at age 70^{1/2} is 16 years, the minimum required distribution for that year is determined by simply dividing the account balance by 16. In the following year, the account balance is divided by 15, and so on. The remaining account balance is distributed in the 16th year at age 86.

Distributions at Death

If the participant is the sole beneficiary of the plan and dies **before** the RBD, the entire account must be paid out no later than the end of the fifth calendar year following the year of death.¹⁹

If the participant dies **after** the RBD and has elected the fixed life method, periodic payments can continue to a successor beneficiary over the participant's life expectancy. If the recalculation method was used, the entire account must generally be distributed in the year following the year of death.²⁰

An important exception to the five years-one year requirement is if there is a "designated beneficiary" (described below). Even if the entire amount is distributed in one year, a spouse has the option to rollover the distribution from a deceased spouse's IRA into her or his own IRA. No other beneficiary is permitted to rollover an inherited retirement plan distribution.

Adding a Designated Beneficiary Can "Stretch-Out" Distributions

A participant can significantly reduce the amount of the minimum required distributions by adding a designated beneficiary who will continue receiving payments from the plan after his or her death. A "designated beneficiary" is any individual designated as a beneficiary by the participant. Over a person's lifetime the designated beneficiary's life expectancy can be incorporated into the calculation of minimum required distributions, subject to the "minimum distribution incidental benefit" rule (discussed below). Because the actuarial life expectancy of two or more individuals is always greater than one of the individuals alone, the addition of a designated beneficiary results in the extension of the payout period and a corresponding reduction in minimum required

distributions. After death, the payouts can be *stretched out* over the designated beneficiary's life expectancy rather than over just one or five years.

The "minimum distribution incidental benefit" rule ("MDIB") requires that, for purposes of calculating minimum required distributions, a non-spouse designated beneficiary cannot be treated as being more than ten years younger than the participant. Thus, even though a 20-year old granddaughter may be a designated beneficiary, if the grandmother is age 70, granddaughter will be considered 60 for purposes of calculating grandmother's minimum required distributions.

Designated beneficiaries can include a spouse, children, other individual, or a qualified trust (such as a credit shelter trust). If a qualified trust is named, the life expectancy of the trust's oldest beneficiary is used in the computation of minimum required distributions. The rules require that distributions to a successor beneficiary commence within one year of the participant's death.²¹

Minimum Required Distributions When Charity Named as Successor Beneficiary

It is critical to note that because an IRC §170(c) charitable organization and charitable remainder trust are not "individuals," they do not qualify as designated beneficiaries. In the case of a CRT, the IRS contends that the charitable remainderman is considered a beneficiary of a trust for these purposes even though the trust includes individuals as income recipients (any one of whom could qualify as a designated beneficiary).²² Thus, although a charity or a CRT can be named as a successor beneficiary, the life expectancy of such entities is considered zero. Therefore, naming either one as a successor beneficiary will be treated for minimum required distribution calculation purposes as though the participant is the sole income beneficiary of the plan.²³

Furthermore, when there are multiple beneficiaries, the law requires distributions to be made based on the beneficiary who has the shortest life expectancy. Thus, it is usually a mistake to name both a charity and a person as co-beneficiaries of the same IRA. Since a charity or CRT has no life expectancy, the entire amount would, depending on whether the participant dies prior to or after the RBD, have to be distributed to the charity and the child within one or five years.²⁴ The solution is usually to split the IRA into two IRAs and name the charity as the beneficiary of one and a family member as the beneficiary of the other.

Ltr. Rul. 9820021 offers another example of this limitation. In the request for ruling, a husband proposed to create a QTIP trust that would pay income to his wife for life with the remainder to a charity. The ruling held that if he names the QTIP trust as a successor beneficiary of a retirement plan, he cannot use a joint life expectancy with his wife to reduce minimum distributions over his life beginning at age 70^{1/2}; rather, he must withdraw amounts over his own single life

expectancy. The same rule would apply if he named a charitable remainder trust as the successor beneficiary.

These rules are particularly disconcerting to those who are charitably inclined because by the time a charity or charitable remainder trust is eligible to receive a distribution from the plan, there might be little or nothing left in the plan to distribute!

Example of Impact of Minimum Distribution Requirements

Ann T. Emm is a 70-year old childless widow with \$100,000 in an IRA. Upon her death she would like the assets remaining in her IRA to be transferred to a worthwhile charitable organization. Her only relative is a distant nephew who she has not seen in years.

She would like to take as little out of her \$100,000 IRA as possible since her family has a history of longevity and she may need the money for nursing home care later in life (e.g., at age 90). Assume that her IRA can earn a 9% annual return. If she names a worthwhile charity as the successor beneficiary of her IRA, then the maximum amount that the IRA can hold at age 90 will be \$57,525. If she names her nephew, her IRA can have \$184,080.

Age	Minimum Distributions if Charity Is the Beneficiary (Single Life Expectancy)		Minimum Distributions if Nephew Is the Beneficiary (MDIB* Combination of Lives)	
	Balance in Plan	Accumulated Distributions	Balance in Plan	Accumulated Distributions
70	\$100,000	\$6,250	\$100,000	\$3,817
75	112,158	45,092	132,590	28,608
80	109,595	98,200	159,636	66,200
85	90,446	163,852	179,934	121,789
90	57,525	231,861	184,080	200,132

Changing Designated Beneficiary After The RBD

A participant can always change the beneficiary of an IRA, even after the RBD. There is, however, a "one way" rule that penalizes a person who names either a charity or her or his estate after the RBD. If the new designated beneficiary is older than the original beneficiary, the new beneficiary's shorter life expectancy must be used to determine minimum required distributions. This will cause larger

payments every year. If the new beneficiary is younger than the original beneficiary, the original calculation with the older beneficiary remains in place. The minimum payments will not go down. Heads you lose, tails you tie.

Based on these rules, if a designated beneficiary is replaced with a charity or a charitable remainder trust after the RBD, the minimum required distributions must be recalculated based solely on the age of the participant. This results in the largest annual distributions that are required by law.

Naming a Charity as a Contingent Beneficiary Can Be a Good Strategy

Instead of naming a charity as the primary beneficiary, a good strategy is to name a charity as a *contingent beneficiary*. If a person is named as the primary designated beneficiary and a charity is named as a contingent beneficiary in the event of the primary beneficiary's death, then the charity is *not* considered to be a beneficiary for purposes of the minimum distributions rules.²⁵ Over the participant's lifetime, the required distributions ignore the charity and focus on the joint life expectancy of the participant and the primary beneficiary.

If the participant really wants the money to go to the charity upon the participant's death, one way to accomplish this is with a disclaimer. When the participant dies, the primary beneficiary can make a "qualified disclaimer" of all rights to the property so that the assets can be distributed to the contingent beneficiary: the charity.²⁶ This strategy is described in greater detail below.

Another curious result occurs if the primary beneficiary dies before the participant does. If the participant does not change the beneficiary forms, the charity then becomes the successor beneficiary that will indeed receive the assets. The tax regulations, however, provide that the death is ignored and the participant can receive distributions as if the original designated beneficiary were still alive.²⁷ Thus, the account owner can still receive smaller distributions over her or his remaining lifetime even though a charity will indeed receive the assets. By comparison, if the account owner changes the beneficiary forms—for example, to change the identity of the charity that will receive the assets—then the one-way rule kicks in and distributions must be accelerated.²⁸

Charitable Planning Options

There are several ways to plan testamentary charitable gifts of IRA assets with consideration to the minimum distribution rules. The main strategies are (1) qualified disclaimers and (2) separate IRAs for a charity and for family (to avoid having both a charity and a person named as co-beneficiaries of a single IRA).

Planning Prior to Age 70^{1/2}

Since there are no required distributions until a person attains age 70^{1/2}, an individual who is younger can name a charity as a successor beneficiary of a retirement plan without significant adverse consequences. In the event of a premature death, the charity will receive all of the assets in the retirement plan and the estate can claim a charitable estate tax deduction. As the donor approaches age 70^{1/2}, he or she can change the beneficiary if circumstances dictate.

Likewise, if the participant is in bad health and is not expected to live to actuarial life expectancy, naming charity as successor beneficiary may have little effect on the outcome.

Using a Qualified Disclaimer with Cooperative Family Member

One creative solution that will reduce minimum required distributions and still transfer assets to charity is to name a cooperative family member as a designated beneficiary and a charity as a *contingent* beneficiary in the event of the designated beneficiary's death.²⁹ By making the charity's interest contingent upon designated beneficiary's death, the charity will not be considered a beneficiary for purposes of the minimum distribution calculation.³⁰ Upon the participant's death, the designated beneficiary can make a "qualified disclaimer" of his or her interest in the plan so the property will pass to the charity.³¹ The estate can claim an estate tax charitable deduction for the amount that was transferred to the charity by way of the disclaimer.³² The family member will not recognize any IRD, nor will he or she be treated as having made a gift.

This solution should work, but it puts the charity at risk in case the individual chooses not to disclaim the interest or if there is a mistake (e.g., the disclaimer is not made within the applicable nine month period or it fails to meet some other requirement for a qualified disclaimer).

Planning for Multiple Beneficiaries

Suppose a participant's plan names his or her spouse, children, and one or more charities as successor beneficiaries. As mentioned earlier, because a charity cannot be a designated beneficiary, the entire IRA must be distributed over the participant's remaining single life expectancy.

This is no problem if the participant wants distribution to be at the same rate as required under the minimum distribution rules over a single life; but if the participant wants to stretch the payments out over the lifetimes of the individual successor beneficiaries, this can be accomplished by establishing separate accounts for each beneficiary. By doing so, the participant can take reduced distributions from the IRAs that name a person as the successor beneficiary, subject to special MDIB rules if the beneficiary is more than ten years younger than the owner.³³ Only the IRA that names the charity or a CRT as the successor

beneficiary will require the participant to compute distributions over his or her single life expectancy.

Special Break for Multiple IRAs: Although the participant will have to calculate the required minimum distributions separately for each IRA, IRS Notice 88-38 permits the participant to withdraw the entire amount from any single IRA to satisfy the distribution requirements. Therefore, the participant may, if desired, be able to leave the "charitable" IRA intact.

Planning After Age 70^{1/2}

If a participant has reached the RBD and has not selected a designated beneficiary, selecting one will not impact the participant's minimum required distributions. In those situations, naming a charity or charitable remainder trust as successor beneficiary may be beneficial.

Transferring Retirement Plan Assets to a Testamentary Charitable Remainder Trust

Some people advocate transferring IRA and retirement plan assets to a charitable remainder trust at death. However, another alternative should be considered. Both the family and the charity will usually have better results if the participant takes the retirement plan dollars and splits them into two IRAs before death: (1) a "stretch out" IRA for family members and (2) a separate IRA that will be paid outright to a charity at death. There are three situations where a charitable remainder trust might indeed be a good choice for retirement plan dollars:

- *The participant has a short life expectancy* (reason: naming a CRT as a beneficiary will cause faster distributions that significantly reduce account balances for older individuals, but have little effect on people under age 80) *or is already locked into a single life payout so naming a charity will not accelerate distributions* (as was explained above);
- *The assets will otherwise be fully taxed shortly after death* (that is, a stretch out IRA is not possible because the person had named an estate or a charity as a beneficiary after the RBD); and
- *No estate tax will be due* (either because the size of the estate is under the estate tax threshold or, for a large estate, the spouse is the only non-charitable beneficiary of the CRT so that there is a marital deduction to eliminate the estate tax for the non-charitable portion).³⁴

People who advocate transferring retirement assets to a charitable remainder trust point out two advantages: First, a charitable remainder trust is tax-exempt and will therefore pay no income tax when it receives a retirement plan distribution. Consequently, the entire amount transferred is available for

reinvestment and production of income undiminished by income taxes. Second, a partial estate tax charitable deduction reduces the trustor's taxable estate.

IRS Ruling Makes Testamentary Transfer of IRD Assets to CRT Generally Unattractive

The two disadvantages of naming a charitable remainder trust as the successor beneficiary of an IRA are (1) accelerated distributions over the account owner's remaining lifetime and (2) the inability of the beneficiary of the charitable remainder trust to claim an income tax deduction for the federal estate tax that was paid (the Section 691(c) deduction). These problems and the solution of separate IRAs are illustrated in the "Papa Ben" example near the end of this article.

Background on the IRS Position on Estate Tax and CRTs

As discussed earlier, IRC §691(c)(1)(A) provides that a person who receives IRD can deduct against his or her taxable income the federal estate tax attributable to IRD items paid by the decedent's estate. But what happens to the deduction when the recipient of the IRD asset is not an individual, but a testamentary charitable remainder trust? Can the noncharitable income recipient(s) of the trust use the §691(c) deduction attributable to the contributed assets against the income distributions they receive? The result may be surprising to some and disappointing to all.

In Ltr. Rul. 199901023, a parent executed a charitable remainder unitrust that will be funded upon his death with a lump-sum distribution from the parent's retirement plan. The parent's two children will be the income beneficiaries of the unitrust amount. Trust will terminate upon the earlier of (a) the date of death of the last income beneficiary, or (b) twenty years after the parent's death.

Distributions from the qualified plan would be ordinary income if received by the parent directly. Therefore, the distributions from the qualified plan to the trust will be IRD. Therefore, the plan proceeds will be "Tier 1" ordinary income in the trust.

The ruling held that under IRC §691(c)(1)(A), the trust would be entitled to a deduction for the estate tax attributable to the IRD. The deduction is determined by taking into account the estate tax charitable deduction attributable to the contribution of the IRD property. Thus, if for example, a \$100,000 transfer to the trust, that names the participant's children as income recipients, produces a \$20,000 estate tax charitable deduction, the estate tax attributable to the remaining \$80,000 will constitute the §691(c) deduction. Assuming a 55% marginal estate tax bracket, the tax and 691(c) income tax deduction would be approximately \$44,000.

Recall, if the children were to receive a direct lump-sum distribution of the plan proceeds rather than income from a CRT, the \$44,000 deduction would be available immediately to offset their ordinary income. In the case of a transfer to a CRT, however, the result is different. The deduction is not directly made available to the income beneficiaries; rather, it simply reduces the amount of Tier 1 ordinary income within the CRT.

In effect, if \$100,000 of IRD income is transferred to a CRT for which a \$44,000 §691(c) deduction is allowed, the trust will show \$56,000 of Tier 1 ordinary income. The \$44,000 deduction will, according to the ruling, be allocated to Tier 4 "corpus."

Because, under the four-tier system of taxation, the trust's ordinary income from current and prior years is considered distributed from a CRT first, the unitrust amounts will be taxable as ordinary income until all \$56,000 has been distributed from the trust. That would take many years; not to mention, the trust proceeds would be reinvested during that time, adding additional ordinary income and capital gains that would take priority over Tier 4 non-taxable distributions. In application, the income recipients would most likely never use up Tier 1 and 2 income in order to take advantage of any of the IRC §691(c) deduction. In essence, the deduction would be lost.

If the IRS sticks to its position in the ruling, there is a trade-off between the benefit of tax-deferral with the CRT (the rollover analogy) and the lower tax rate with giving the IRD assets directly to the beneficiary. When the numbers are run, it is possible for the CRT to produce greater after-tax dollars, but that usually occurs only when (1) the IRD would have been fully taxable within one year of death, and (2) the CRT has a duration of 20 years or more.

Criticism: The logic in the private letter ruling can be criticized. Because a charitable remainder trust is tax-exempt and all of its income retains its character until it is distributed to a tax-paying income recipient, one can argue that the proper treatment in the preceding example should be for the entire \$100,000 to be allocated as Tier 1 ordinary income. Then, as ordinary income is distributed from the trust in satisfaction of the unitrust or annuity amount, the income recipient would be able to claim the corresponding §691(c) income tax deduction.³⁵

Splitting the IRA as an Alternative to Naming a CRT as Successor Beneficiary

Papa Ben Example: Papa Ben, age 69, has a \$1,000,000 IRA. Upon his death he would like to see all of the IRA's assets transferred to a charitable remainder trust that will pay income to his daughter for her life with the remainder to his favorite charity. At the moment he expects the trust will generate the statutory minimum tax deduction of 10%.³⁶

The first problem is that if he names a CRT as the beneficiary and he lives until age 90, the maximum amount the CRT could receive is not \$1 million but just \$600,000 (please see the Ann T. Emm example above). Had he not named the CRT but had left his daughter as the beneficiary, the IRA could have grown to \$1.8 million!

The second problem concerns the ability of his daughter to deduct any estate tax. By way of background, had he given a \$1,000,000 IRA outright to his daughter upon his death, the federal estate tax would have been \$500,000 (oversimplified), which daughter might be required to pay. With a charitable deduction for the transfer to the CRT of 10%, the estate tax liability is reduced to \$450,000 (oversimplified). Since the daughter is the beneficiary, she might be required to pay this amount.

From the daughter's perspective, had she left the assets in the IRA, she would pay an effective income tax rate of just 24% as she receives each distribution of IRD from the IRA. However, every distribution from the CRT would be taxed at a 40% rate.

Solution: Ben should divide his IRA into two IRAs: One for \$100,000 (the "charitable IRA") and the other for \$900,000 (the "family IRA"). The \$100,000 amount represents the present value of the \$1,000,000 the charity would expect to receive upon the death of his daughter had the entire \$1,000,000 been transferred to a CRT.

The charitable IRA is left outright to charity. The charity should be happy to get the money sooner. The remaining \$900,000 IRA will go to the daughter, who can then claim income tax deductions for the \$450,000 of estate tax that she paid.

Ben can "stretch-out" his minimum distributions from the family IRA. Under IRS Notice 88-38 he can withdraw the minimum required distributions from both IRAs or just from the family IRA, if desired.

Testamentary Transfers of IRD Assets to a Pooled Income Fund or A Charitable Lead Trust Are Not Advised

A transfer of any IRD asset to a pooled income fund or a charitable lead trust could produce disastrous tax consequences and should be avoided under current law. Although charitable remainder trusts are tax-exempt, neither pooled income funds nor a charitable lead trusts are tax-exempt. A pooled income fund usually avoids paying income tax by distributing all of its net investment income (except for long-term capital gains permanently set aside for charitable purposes under IRC §642(c)(3)), so that there is no remaining income on which a tax can be assessed.

A contribution of income in respect of a decedent causes special problems because it will generally be treated as principal under the trust instrument and state law and as taxable income under tax law. This produces a "trapping distribution." A pooled income fund will then be required to pay income tax on the contribution of income in respect of a decedent and there could be a complicated apportionment of income and tax liabilities among the accounts in the fund.

Other Issues - Satisfying Specific Charitable Bequests with IRD Assets

Although an estate will not normally have any income if specific property is required to be distributed "in-kind," Reg. §1.661(a)-2(f)(1) provides that it can have taxable income if a distribution of property is made in satisfaction of a right to receive a distribution of a specific dollar amount (e.g., a specific bequest) or in specific property other than the property that was distributed. Thus, for example, if a will provides for a specific bequest of \$100,000 to a charity, the estate will have \$100,000 of taxable income if the bequest is paid by a distribution from a retirement plan.³⁷ There might, however, be an offsetting charitable income tax deduction to eliminate the pain.³⁸

The potential problems are worse if the transfer is to a CRT than outright to a charity:

Example: Assume that an estate receives a \$100,000 distribution from a Keogh retirement plan and that the estate is required to transfer the entire amount to a CRT that will pay income to the donor's brother. Assume the present value of remainder interest (i.e., the estate tax charitable deduction) is 30%. The estate tax return will report the entire \$100,000 as an asset of the estate and will claim a charitable estate tax deduction of \$30,000; the other \$70,000 will be subject to estate tax. On the estate's income tax return the entire \$100,000 would be reported as income. The estate could probably claim a \$30,000 charitable income tax deduction³⁹, but what are the income tax consequences for the \$70,000 non-charitable distribution? There is no legal authority to provide guidance. Compare the detail of IRC §2055(e) (estate tax) with the buried reference in IRC §4947 to IRC §642 (income tax).

The best way to deal with this problem is to keep the IRD off the estate's income tax return by having the assets transferred directly from the retirement plan to the charity or CRT rather than having amounts paid to the estate. This is accomplished by naming the testamentary CRT, rather than the probate estate, as the successor beneficiary on the beneficiary designation forms provided by the retirement plan.

The distributions will not be reported on the estate's income tax return because IRD is taxed directly to the beneficiary who receives the assets.⁴⁰ Of course, if the income is not reported on the estate's income tax return, there is no corresponding income tax charitable deduction either.

Footnotes

[1] IRC §§402(a) and 72(a)

[2] IRC §72(t)

[3] IRC §170(b)(1)(C)(iv)

[4] IRC §170(b)(1)(A) and (C) and Reg. §1.170A-9(e)(11)(ii)

[5] Notice 98-24, 1998-17 I.R.B. 5

[6] IRC §402(e)(4)(B)

[7] Ltr. Rul. 199919039

[8] IRC §170(e)(1)(A)

[9] See IRS Form 4972 to see if you qualify and how to compute the tax.

[10] IRC §§102 and 691

[11] See Ltr. Rul. 9723038 regarding transfers to public charities. Ltr. Ruls. 9901023 and 9634019 regarding transfers charitable remainder trusts.

[12] Ltr. Ruls. 9838028, 9818009, 9633006, and 9341008

[13] Ltr. Rul. 9826040

[14] Reg. §1.691(c)-1(a)

[15] IRC §67(b)(7)

[16] IRC §68

[17] IRC §§401(a)(9), 408(a)(6), 403(b)(10) and 4974.

[18] IRC §401(a)(9)(C)

[19] IRC §401(a)(9)(B)(ii)

[20] Prop. Reg. §1.401(a)(9)-1, Q&A- E-8(a)

[21] IRC §401(a)(9)(B)(iii)

[22] See Ltr. Rul. 9820021

[23] Prop. Reg. §1.401(a)(9)-Q&A, E-5 and E-8(a); §401(a)(9)(B)(ii).

[24] Reg. §1.401(a)(9)-E-5(e)

[25] IRC §2518

[26] Reg. §1.401(a)(9)-E-5(e)(2) and (3)

[27] Reg. §1.401(a)(9)-E-5(c)(2)

[28] The IRS has frequently approved disclaimers to transfer assets in qualified retirement plans. The usual situation involves a disclaimer by a spouse so that assets pass to the children. In each situation, the person who made the disclaimer was not liable for any income taxes attributable to the retirement plan assets but, rather, the new beneficiaries had to report the income in respect of a decedent. The clearest legal analysis of this issue is in GCM 39858 (Sept. 9, 1991). The IRS has approved disclaimers for interests in profit sharing plans (Ltr. Ruls. 9319029 (Feb. 12, 1993 and 9303027 (Oct. 27, 1992)), money purchase pension plans (Private Letter Ruling 9016026 (Jan. 18, 1990)) and IRAs (Private Letter Rulings 9226058 (March 31, 1992) and 9037048 (June 20, 1990)).

[29] Prop. Reg. §§1.401(a)(9)-1, Q & A E-5(e)(1) and 1.401(a)(9)-1, Q & A E-5(b) & (c)(2)

[30] IRC §2518(b)

[31] Reg. §20.2055-2(c)(1); See also Ltr. Ruls. 9141017 and 9527040. The estate may deduct value of remainder passing to a charitable remainder trust formed after qualifying disclaimers and reformation.

[32] IRC §401(a)(9)(A)(ii) and (G)

[33] Ltr. Ruls. 9634019, 9253038 and 9237020

[34] Ltr. Ruls. 9634019, 9253038 and 9237020

[35] Reg. §1.691(c)-1(d)

[36] IRC §664(d)(1)(D) & (2)(D)

[37] Keenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Ltr. Rul. 9507008

[38] Rev. Rul. 83-75, 1983-1 C.B. 114

[39] Reg. §1.642(c)-3(a) & (b)

[40] Reg. §1.691(a)-2(a)(2)

[41] Reg. §1.642(c)-3(b)