Charitable Giving with Retirement Benefits

Why, How, and When to Donate Retirement Benefits to Which Type of Charity

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Abbreviations and Symbols

¶ Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011); see www.ataxplan.com. Unless the section number begins with a "7," the referenced section is not reproduced in this seminar handout/Special Report.

§ Refers to a section of the Code unless otherwise indicated.

ADP	Applicable Distribution Period. See ¶ 7.2.02(B).
AGI	Adjusted gross income. § 62.
ATRA	American Taxpayer Relief Act of 2012. See ¶ 7.6.08.
Code	Internal Revenue Code of 1986, as amended through March 31, 2015.
DB	Designated Beneficiary. § 401(a)(9); see ¶ 7.2.02(A).
DNI	Distributable net income. See ¶ 7.4.01.
IRA	Individual retirement account or individual retirement trust under § 408 or § 408A.
IRD	Income in respect of a decedent. § 691; see ¶ 7.1.02(B).
IRS	Internal Revenue Service.
NII, NIIT	Net investment income, net investment income tax. § 1411. See next page.
NUA	Net unrealized appreciation of employer securities. See ¶ 7.7.04.
QCD	Qualified charitable distribution. See ¶ 7.6.
PLR	IRS private letter ruling.
Reg.	Treasury Regulation.
RMD	Required minimum distribution. See § 401(a)(9) and ¶ 7.6.02.
UBTI	Unrelated business taxable income. ¶ 8.2.

This Special Report discusses charitable gifts of retirement benefits under traditional IRAs, qualified retirement plans, and 403(b) plans. At-death gifts from traditional (non-Roth) retirement plans are discussed, as well as lifetime gifts from traditional and Roth IRAs.

The Affordable Care Act (2009) imposed a new 3.8 percent tax on net investment income (NII) of some individuals and trusts, effective beginning in 2013. For impact of the NII tax (or NIIT) on charitable giving with retirement benefits, see following sections of this Special Report:

✓ ¶ 7.4.01 regarding how the net investment income tax (NIIT) applies to a trust or estate that receives NII and makes distributions in the same year to one or more individuals.

✓ ¶ 7.4.02 regarding how a trust's distributions to a charitable beneficiary would or would not "carry out" NII to such charity for purposes of the NII.

✓ ¶ 7.5.50(B) regarding the effect of the NIIT on taxation of distributions from a charitable remainder trust.

Income and transfer tax rates, brackets, thresholds, and exemptions in this Special Report are as of 2013. All are subject to change due to legislative action, and many are subject to inflation adjustments for post-2013 years.

7.1 Three "Whys": Reasons to Leave Benefits to Charity

Leaving traditional retirement benefits to charity can be an ideal way to fulfill a client's charitable intent. Because the charity is income tax-exempt, it receives the benefits free of income tax. Thus the benefits may be worth more to the charity than to the client's other beneficiaries. This Special Report explains the pros, cons, and mechanics of donating retirement benefits to charity.

7.1.01 ***What practitioners must know***

Estate planning practitioners need to know:

✓ The reasons to leave retirement benefits to charity. ¶ 7.1.02.

✓ The seven ways to leave retirement plan death benefits to charity, and the advantages and pitfalls of each. ¶ 7.2.

✓ Minimum distribution problems that occur when benefits are paid to a charity under a trust that also has individual beneficiaries. ¶ 7.3.

✓ Income tax issues that arise when benefits pass through a trust or estate on their way to the charitable beneficiary. ¶ 7.4.

✓ Which types of charitable entities are suitable to be named as beneficiaries of retirement benefits. ¶ 7.5.

✓ Obstacles and planning opportunities in lifetime charitable giving with retirement benefits. ¶ 7.7.

This Special Report assumes the reader is generally familiar with the tax rules of charitable giving. For sources of information about charitable giving, see the Bibliography.

7.1.02 ***Reasons to leave retirement benefits to charity***

There are three reasons a client should consider leaving his retirement benefits to charity.

A. To benefit charity. The main reason to leave retirement benefits (or any other asset) to charity is to help the charitable organization achieve its goals. There is no advantage to giving retirement benefits to charity if the donor does not want to benefit that charity!

This Special Report explains how tax savings can reduce the cost of passing retirement benefits to charity, but the "cost" is never zero. In all the ideas discussed here, a substantial financial benefit is provided to the charity. Unfortunately, some promoters try to take advantage of the tax-exempt status of a charity to reap gains for private individuals. They devise schemes that provide only a token or speculative benefit to the charity, while profiting individuals who have no charitable intent. This Special Report does not discuss that type of "planning idea."

The ideas here are for *charitably-minded clients only*. If an individual's only estate planning goal is to maximize the value of his estate for his family (or other noncharitable beneficiaries), these ideas will not help that individual. If that is your situation, simply leaving your retirement benefits to your chosen individual beneficiaries is normally the best way to achieve your goal; though taxes will be higher, your family will end up with more money.

On the other hand, if you are interested in helping one or more charities, especially if you would like Uncle Sam to subsidize your charitable gift to the maximum extent possible, read on…

B. Most tax-efficient use of retirement plan dollars. If a client wishes to leave some of his estate to charity and some to noncharitable beneficiaries, the most tax-efficient allocation of his assets generally is to fund the charitable gifts with retirement benefits and leave other assets to the noncharitable beneficiaries. Generally, retirement plan assets are *worth more* to the charity than to individual beneficiaries, while other types of assets are *worth the same* to a charity as to an individual, for the following reason:

Retirement plan distributions to a beneficiary generally are "income in respect of a decedent" (IRD). § 691; Rev. Rul. 92-47, 1992-1 C.B. 198; Reg. § 1.663(c)-5, Example 9. IRD does not get a "stepped-up basis" at the donor's death, and accordingly will generally constitute taxable income to the beneficiary when received after the participant's death. § 1014; for more detail on IRD, see ¶ 4.6 of *Life and Death Planning for Retirement Benefits*. For a family member or other individual beneficiary, the income tax reduces the value of the inherited benefits. A charity is income tax-exempt, and thus does not lose any part of the inherited benefits to income taxes.

In contrast to retirement benefits and other "IRD" assets, other types of inherited assets generally do not come with an income tax bill, even for a noncharitable beneficiary, because of two tax rules:

- **An inheritance is not income.** An inheritance, as such, is not considered "income." Thus, when a beneficiary inherits cash, retirement benefits, or any other type of asset from a decedent, the beneficiary does not owe any income tax on the value of that inheritance. Income tax liability, if any, will arise only when the beneficiary sells the inherited asset, or (in the case of an inherited retirement plan) withdraws from, or transfers, the plan.

- **Stepped-up basis at death for non-IRD assets.** Most assets (such as a house, car, business, stocks, bonds, mutual funds, etc.) receive a new basis (for income tax purposes) when they pass from a decedent to an heir, equal to the date-of-death value. Because of this new-basis-at-death rule applicable to most inherited assets, the beneficiary (when he later sells the inherited asset) pays no income tax on any built-in capital gain that accumulated in the asset through the date of death. Compared with that treatment, a retirement plan is a less favorable asset for an individual beneficiary to inherit, because (as "IRD") it does not get a new basis at death.

See § 1014(c) for the new-basis-at-death rule (also called "stepped-up basis," on the assumption that assets always appreciate). (§ 1014(c) does not apply with respect to property inherited from certain decedents who died in the year 2010.)

Neil Example: Neil's mother dies, leaving Neil her house (worth $500,000) and her IRA (also worth $500,000). There is no estate tax, because the estate is under the $5.25 million federal estate tax exemption; Neil's mother had not used up any of her exemption through lifetime gifts. The house is transferred to Neil. The receipt of this asset is not an income-taxable event, because an inheritance is not considered income. The IRA is registered in Neil's name as beneficiary of his mother, but no money is taken out of it immediately; so far there is no tax he must pay on the IRA.

Now he sells the house for $500,000 and withdraws $500,000 from the IRA.

He pays no income tax on the house sale. His basis in the house is $500,000 (the date-of-death value), just as if he had paid $500,000 to buy the house, so there is no gain on the sale and thus nothing to pay income tax on—even though Neil's mother originally bought the house for just $100,000. The $400,000 of capital gain that built up in the house during Neil's mother's life is never taxed, because of the new-basis-at-death rule.

However, Neil does have taxable income as a result of cashing in the IRA. The $500,000 distribution is included in his gross income for the year of the distribution. The IRA, unlike the house, does not get a new basis upon the owner's death.

Suppose Neil's mother had wanted to leave only half her estate to Neil, and half to her favorite charity. She has a choice of assets. She could leave half of each asset to each beneficiary; she could leave the IRA to Neil and the house to the charity; or she could leave the house to Neil and the IRA to charity.

It makes no difference to the *charity* which asset it receives. Whether the charity receives the IRA, the house, or half of each, the charity will receive $500,000 of value from Neil's mother's estate, because it will not have to pay any income tax on either asset.

For Neil, however, it makes a substantial difference which asset he receives. If he receives the IRA, he will have to pay income tax of up to 39.6 percent, or $198,000 (2013 rates; plus state income tax, if applicable), on the $500,000 when he withdraws the money from the IRA. While his withdrawals could be deferred over a long period of time, and deferral reduces the impact of the income taxes, he might realistically conclude that the IRA is worth less than $500,000 to him. Thus he is probably better off receiving the house, from which he can immediately realize $500,000 of value, without a haircut for income taxes.

C. Accomplish other estate planning goals. Judicious use of charitable giving with retirement benefits can help the client accomplish other estate planning goals at the same time as he fulfills his charitable intentions. See ¶ 7.5.06.

D. Drawbacks, limitations. Leaving taxable retirement plan benefits to charity is not a "perfect" estate planning idea:

- For one thing, it is not *always* true that an individual beneficiary will have more money at the end of the line if he inherits after-tax assets rather than the same nominal amount of retirement plan assets. A young individual who inherits a retirement plan and makes maximum use of the life-expectancy-of-the-beneficiary payout method to "stretch" the distributions over his life expectancy may end up with more dollars than if he had inherited the same amount of after-tax assets, due to the power of income tax deferral. For explanation of the stretch payout of retirement benefits, see ¶ 1.1.03 of *Life and Death Planning for Retirement Benefits*.

- The minimum distribution rules make this planning idea self-limiting. If a participant who has named a charity as beneficiary of his retirement plan lives long enough, the minimum distribution rules (see Chapter 1 of *Life and Death Planning for Retirement Benefits*) will have forced out most of the plan's value, and there will be little left for the charitable beneficiary. A retirement plan's value tends to start shrinking significantly due to required distributions in the participant's mid-90s. A long-lived charitably inclined participant should consider giving his RMDs to charity each year (see ¶ 7.7.02), and/or revising his estate plan to leave other assets to the charity to make up for the diminished retirement plan.

*7.1.03 **Charitable pledges (and other debts)***

If the client names a creditor as beneficiary of his retirement benefits, so that the benefits will be used to satisfy the client's debt to that creditor, paying the benefits to the creditor would generate taxable income *to the client's estate*. Although generally retirement benefits are taxed to the person who receives them (§ 402(a); see ¶ 2.1.03 of *Life and Death Planning for Retirement Benefits*), the IRS would say that the estate "received" the IRD, because the estate's debt was canceled when the benefits passed to the creditor.

A charitable pledge that remains unfulfilled at death may, depending on applicable state law, constitute a debt enforceable against the estate. See, *e.g.*, *Robinson v. Nutt*, 185 Mass. 345, 70 N.E. 198 (1904) (unpaid written charitable subscription enforced as a debt against the estate due to charity's reliance), and *King v. Trustees of Boston University*, 420 Mass. 52, 647 N.E. 2d 1196 (1995). However, a charitable pledge is *not* considered a debt for federal income tax purposes. Rev. Rul. 64-240, 1964-2 C.B. 172. Therefore, leaving retirement benefits to a charity in fulfilment of the decedent's lifetime charitable pledge will not cause the estate to realize income when the charity collects the benefits, regardless of whether the pledge was enforceable as a debt against the participant's estate.

7.2 Seven "Hows": Ways to Leave Benefits to Charity

Here are the seven ways retirement benefits can pass, upon the participant's death, to a charitable beneficiary.

*7.2.01 **Name charity as sole plan beneficiary***

The method of leaving retirement plan benefits to charity that involves the fewest difficulties is simply to name the charity directly as the beneficiary of 100 percent of the death benefit payable under the particular retirement plan, as in the following example:

> "I name as my beneficiary, to receive 100% of the benefits payable under the above-named retirement plan on account of my death, the ABC Community Foundation."

Because the benefits are paid directly to the charity under the beneficiary designation form, income tax on the benefits is easily avoided. § 691(a) causes the benefits to be included directly in the income of the charitable recipient as named beneficiary, and the charity's income tax exemption (§ 501(c)) makes the distribution nontaxable. The estate tax charitable deduction (§ 2055(a)) is available for the full value of the charity's interest.

This format works equally well for gifts to multiple charitable beneficiaries: If all beneficiaries of the plan are charities, the problems discussed in ¶ 7.2.02–¶ 7.2.06 do not arise.

But no approach is problem-free. Based on anecdotal evidence, there can be problems with IRA providers and plan administrators when the participant seeks to name a charity as beneficiary. For example, the administrator may require documentation (such as articles of incorporation, corporate resolutions, etc.) before allowing the charity to collect the benefits it is entitled to. A small charity lacking staff may need professional help.

7.2.02 ***Leave benefits to charity, others, in fractional shares***

A charity can be named as one of several beneficiaries receiving fractional shares of the retirement plan, with other fractional shares passing to noncharitable beneficiaries, as in "I name as beneficiary of my IRA My Favorite Charity and my son Junior in equal shares."

A. **The problem: The IRS's multi-beneficiary rule.** The problem with this approach is that it risks losing the option of a "life expectancy payout" for the noncharitable beneficiary(ies). Under the "minimum distribution rules" (§ 401(a)(9) and regulations thereunder), a Designated Beneficiary can withdraw inherited retirement benefits in annual instalments over his life expectancy, thus achieving significant income tax deferral. See, generally, Chapter 1 of *Life and Death Planning for Retirement Benefits*. However, this favorable life expectancy or "stretch" payout option is available only to *individual beneficiaries* (and qualifying "see-through trusts"); a charity, as a nonindividual, cannot be a Designated Beneficiary. See ¶ 1.7.03 of *Life and Death Planning for Retirement Benefits* for more on this rule.

If there are multiple beneficiaries, the regulations' general rule is that all of them must be individuals or none of them can use the life expectancy payout method. Reg. § 1.401(a)(9)-4, A-3. Thus, if Junior and the charity are both named as beneficiary, the IRS's "opening bid" is that Junior cannot use the stretch payout method. There are two exceptions to this harsh rule. Because of these exceptions, it is still feasible to name both charities and humans as beneficiaries of the same account (though it may still not be *desirable*; see "D").

B. **First exception: separate accounts.** If there are multiple beneficiaries, but the respective beneficiaries' interests in the retirement plan constitute "separate accounts," each separate account is treated as a separate retirement plan for purposes of the minimum distribution rules. Thus, the Applicable Distribution Period for each individual beneficiary will be his life expectancy, and he can use the life expectancy payout method for his "separate account." He is considered the sole beneficiary of that separate account. Reg. § 1.401(a)(9)-8, A-2(a)(2).

Applicable Distribution Period

The Applicable Distribution Period (ADP) is the period of time over which retirement benefits may be drawn down under the minimum distribution rules of § 401(a)(9), such as (in the case of retirement plan death benefits payable to an individual "Designated Beneficiary") the life expectancy of the beneficiary. Required distributions from retirement plans under § 401(a)(9) are generally computed by dividing an annually-revalued account balance by an annually-declining life expectancy factor. This life expectancy factor is obtained from an IRS table and is called the **Applicable Distribution Period** (**ADP**) or **divisor**. Reg. § 1.401(a)(9)-5, A-1(a), A-4, A-5. For more detail see the regulations or see Chapter 1 of *Life and Death Planning for Retirement Benefits*.

The drawback of relying on this exception is that the beneficiaries may not meet the deadline for establishing separate accounts, which is December 31 of the year after the year of the participant's death. If they miss that deadline, the beneficiaries will be limited to taking benefits under whichever "no-Designated Beneficiary" (no-DB) rule applies: The benefits will have to be distributed by the end of the year that contains the fifth anniversary of the participant's death, if he died before his Required Beginning Date (RBD) (or *sixth* anniversary, if death occurred in 2004–2009). This is called the "5-year rule." If the participant died on or after his RBD, the applicable "no-DB rule" would require distribution of the benefits over what would have been the remaining life expectancy of the participant had he lived. See ¶ 1.5.06–¶ 1.5.08 of *Life and Death Planning for Retirement Benefits* for full explanation of these no-DB rules.

C. **Second exception: distribution or disclaimer by Sept. 30.** The other exception is that a beneficiary is "disregarded" (doesn't count as a beneficiary for purposes of determining the ADP) if such beneficiary ceases to have any interest in the benefits by September 30 of the year after the year of the participant's death (called the "Beneficiary Finalization Date" in this Special Report). Reg. § 1.401(a)(9)-4, A-4(a); see ¶ 1.8 of *Life and Death Planning for Retirement Benefits* for more on the Beneficiary Finalization Date. Thus, the charity's share can be paid out after the participant's death at any time up to the Beneficiary Finalization Date, and the remaining beneficiaries (assuming they are all individuals) will be entitled to use the life expectancy payout method. As of the magic date there is no nonindividual beneficiary on the account, so the plan complies with the "all-beneficiaries-must-be-individuals" rule.

Frank Example: Frank dies in Year 1. The beneficiary designation for his $1 million IRA provides that "$10,000 shall be paid to Charity X and the balance shall be paid to my son." Charity X takes full distribution of its $10,000 share of the account shortly after Frank's death. As of the Beneficiary Finalization Date (September 30, Year 2), the son is the sole remaining beneficiary of the IRA, because the charity's interest has been terminated by distribution. As an individual, the son is a Designated Beneficiary, and RMDs will be determined based on the son's life expectancy.

The drawback of relying on the distribute-by-the-Beneficiary Finalization Date exception is that time passes quickly and people miss deadlines. If for any reason the charity's interest is not entirely distributed (or disclaimed) by the deadline, the charity still "counts" as a beneficiary and the individuals would lose out on the life-expectancy-of-the-beneficiary payout method.

D. **When to rely (or not rely) on the exceptions.** As explained at "B" and "C," it is possible to name both individuals and charities as co-beneficiaries of one IRA, without necessarily losing the option for the individual beneficiaries to use the life-expectancy-of-the-beneficiary payout method, because of the two exceptions to the multiple-beneficiaries rule. The next question is whether it is advisable to rely on these exceptions, or to avoid the whole problem by not using this approach.

Relying on the exceptions makes sense in some cases but not others. If use of the life-expectancy-of-the-beneficiary payout method would be extremely desirable and advantageous for the individual beneficiaries, it may not be wise to rely on the exceptions. Instead, consider establishing separate IRAs during the participant's life, one payable to the charitable beneficiary(ies) and one payable to the individual beneficiary(ies), rather than putting both types of beneficiaries on the same account and risking loss of the life-expectancy-of-the-beneficiary payout method through the beneficiaries' failure to meet the deadlines for establishing separate accounts (or paying out the charities' share). That way there is no pressure on the beneficiaries to get something accomplished by a particular deadline. See the "Rita" Example.

On the other hand, if establishing separate IRAs prior to death would be disproportionately burdensome compared to the benefits gained thereby, it makes sense to rely on the exceptions. See the "Matt" and "Lonnie" Examples.

Rita Example: Rita wants to leave half of her $2 million IRA to her favorite charity and the other half (along with the rest of her estate) to her son James. James, now age 44, is counting on using the life expectancy payout method for his share of the IRA. He would have ample assets from the rest of the estate to pay all estate taxes and provide for other immediate needs, and sees the required minimum distributions from his half of the inherited IRA as eventually being a major source of retirement income for him. Rather than leave it up to James and the charity to make sure, after her death, that the IRA is divided into separate accounts by a certain deadline, or that the charity's share is entirely paid out to it by an even earlier deadline, Rita divides her IRA into two separate IRAs during her life, one payable to James and one to the charity. She will have to keep an eye on the two accounts during her life, transferring assets from one to the other (or taking distributions from them in certain proportions) to keep them approximately equal in value. Her durable power of attorney directs her attorney to make reasonable efforts to keep the accounts equal in value if she becomes disabled.

Matt Example: Matt has a $1,000,000 IRA. On his death, he wants half of it to go to his favorite charity, and the other half to go to his wife, if living, otherwise his sister. Matt is 75, his wife is 72, and his sister is 76. He understands that, by naming a charitable and an individual beneficiary on the same account, he is taking a risk that, after his death, the individual beneficiary would not qualify for the life-expectancy-of-the-beneficiary payout method unless the charity's share is paid out to it, or established as a separate account, by certain deadlines. However, he is not concerned about this risk. His wife can roll over her share of the IRA; even if she and the charity miss the 9/30 and 12/31 deadlines, his wife would *still* be entitled to roll over her share to her own IRA and get a fresh start (after taking any required distributions from the inherited IRA). If his wife does not survive him, so the individual beneficiary is his sister (who cannot roll over her share of the IRA benefits to her own IRA), he still doesn't care whether her interest qualifies for the life-expectancy-of-the-beneficiary payout method. Matt is past his RBD, so the no-DB ADP for the IRA is Matt's remaining life expectancy. Since Matt is younger than his sister, Matt's life expectancy gives the sister a longer payout period than her own life expectancy would provide. Thus, there is no tax reason to split up the IRA into two IRAs (which would make life more complicated for Matt). See ¶ 3.2 of *Life and*

Death Planning for Retirement Benefits for details on the spousal rollover, and ¶ 1.5.04(C) regarding the "no-DB rule" in case of death after the RBD.

Lonnie Example: Lonnie is leaving his $300,000 IRA in equal shares to his favorite charity, his son, and his daughter. Though he realizes the son and daughter will not be able to use the life-expectancy-of-the-beneficiary payout method if they fail to establish separate accounts (or pay out the charity's share) within a certain time after his death, he feels they will have ample time to take care of this, and they are well aware of the requirement, as are the charity and Lonnie's professional advisors. Furthermore, in the unlikely event the job does not get done on time, the loss of the life expectancy payout on $200,000 would not be a major economic catastrophe, whereas dividing up his IRA now into separate IRAs for the charity and the children would create an annoyance and extra chores that Lonnie does not want. He decides to take his chances.

E. If the spouse is the only noncharitable beneficiary. The concern about multiple beneficiaries does not arise if the only beneficiaries are the participant's spouse and one or more charities, if *the spouse in fact survives the participant*, because the spouse does not need to take an installment payout of the benefits over her life expectancy in order to defer income taxes; she can simply roll over her share of the benefits to her own retirement plan. See ¶ 3.2 of *Life and Death Planning for Retirement Benefits* regarding the "spousal rollover."

However, even when the spouse is named as the sole noncharitable primary beneficiary, consider the possibility of the spouse's disclaimer, simultaneous death, or predeceasing the participant *if* the contingent beneficiary in that case would be another individual, because in that case you are right back in the situation of having both individual and nonindividual beneficiaries.

7.2.03 ***Leave pecuniary gift to charity, residue to individuals***

Another way to leave part of the benefits to charity is to name the charity as beneficiary of a pecuniary (fixed-dollar amount) portion of the account, with the balance (residue) going to individual beneficiaries.

Nora Example: Nora's beneficiary designation for her $1 million IRA reads as follows: "Pay $100,000 to the Topeka Maritime Museum and pay the balance to my daughter Diana."

According to anecdotal evidence, some IRA providers will not accept pecuniary gifts in a beneficiary designation form. Assuming the IRA provider will accept it, the pecuniary gift presents some of the same problems as leaving benefits to charitable and individual beneficiaries in fractional shares (see ¶ 7.2.02), and some additional problems:

A. Pecuniary gift may not qualify as a "separate account." Under one approach to funding a pecuniary gift, the IRA provider would create two shares as of the date of death, one with $100,000 and the other containing the rest of the account's assets. Then both shares would share pro rata in gains and losses occurring after the date of death. This treatment could be required by the beneficiary designation form, or (if the beneficiary designation form does not address this question) this treatment might be required as part of the IRA provider's standard procedures.

On the other hand, the beneficiary designation form, or the IRA provider's documents, might indicate that the charity is to receive a flat $100,000, regardless of what appreciation or depreciation occurs in the IRA after the date of death. The planner needs to determine what the client's wishes are and spell out the desired result in the beneficiary designation form.

The interpretation of the pecuniary gift will affect not only how much each beneficiary receives, but also what options will be available for preserving the availability of the life expectancy payout option for Diana. If the beneficiary designation creates two separate shares as of the date of death, with the Museum's portion sharing pro rata in gains and losses that occur after Nora's death, then the same options will be available as discussed under ¶ 7.2.02(B) and (C) above (establish separate accounts by 12/31 of the year after the year of Nora's death, or pay out the charity's share in full by 9/30 of the year after the year of Nora's death).

If the Museum is to receive a flat $100,000, regardless of any post-death fluctuations in the account value, then the option of establishing separate accounts will not be available. See ¶ 1.7.06(A) of *Life and Death Planning for Retirement Benefits*. However, the option of paying out the charity's entire share by 9/30 of the year after the year of Nora's death is available either way. If the Museum receives its full share of the account by that date, the Museum does not count as a beneficiary of the account for required minimum distribution (RMD) purposes, and Diana can use the life expectancy payout method for her share of the IRA.

B. **Consider separate IRAs for large pecuniary bequests.** For example, Nora might divide her IRA into two separate IRAs while she is still living, one containing something more than $100,000 (perhaps $200,000?) of which the beneficiary is "$100,000 to the Topeka Maritime Museum, residue to Diana," and the other containing the balance of the IRA ($800,000?) payable solely to Diana. That way, she can have her pecuniary bequest to the charity just as she wants it in the smaller IRA. Meanwhile, the bulk of the assets are in a separate IRA payable solely to the individual beneficiary, and *this* IRA is not subject to any risk of losing the life expectancy payout method due to failure to meet the post-death deadlines.

C. **Put small pecuniary bequest in will?** If the pecuniary bequest to charity is modest, consider putting the charitable bequest in the will. Though it is more tax-advantageous to fund the charitable bequest from the retirement plan, the advantage (if the bequest is very small) may not be worth incurring the risk of jeopardizing the life expectancy payout for the individual beneficiaries.

Richard Example: Richard has a $1 million IRA and many other assets. He wants to leave $10,000 to a charity that cares for abandoned emus, and the rest of his estate to his children. Richard's lawyer suggests that it does not make sense to jeopardize the children's ability to use the life expectancy payout method for their share of the IRA by putting this small charitable bequest in the beneficiary designation, nor is it worth creating a separate IRA for this amount. Accordingly, Richard's lawyer recommends putting the bequest into Richard's will, rather than in the beneficiary designation, despite the fact that it would be more tax-efficient to fund it from the IRA.

D. Make charity's gift conditional on payment by 9/30? Richard in the preceding example tells his lawyer that she's too chicken. Richard wants to put the $10,000 charitable bequest in the beneficiary designation form for his $1 million IRA; he is confident his children are sufficiently competent that they would pay out the charity's share before the Beneficiary Finalization Date (¶ 7.2.02(C)).

However, just to be on the safe side, he makes the charity's IRA gift *conditional* on the charity's taking its entire $10,000 share of the IRA prior to the Beneficiary Finalization Date. The beneficiary designation form says, "Pay to Charity X the sum of $10,000 before September 30 of the year after the year of my death; and pay the balance (including any portion or all of said $10,000 that Charity X has failed to withdraw from the account by September 30 of the year after the year of my death) to my issue surviving me by right of representation." Thus, he has guaranteed that the life expectancy payout method will be available for his children, because (as of the Beneficiary Finalization Date) they are the only beneficiaries of the IRA (because the charity has either received or forfeited its share).

Now Richard has one more concern: This conditional IRA gift to charity may not entitle his estate to an estate tax charitable deduction. To cover that gap, he puts the following bequest in his Will: "I bequeath to Charity X the sum of $10,000, reduced by any amounts paid to the said Charity from my IRA." Thus, the estate tax deduction is assured, because the charity is guaranteed to receive the $10,000 either from the IRA or from the probate estate. This is a complicated way to deal with the problem, but every method has its drawbacks.

E. Can payment of the pecuniary gift fulfill the RMD?

Marlene Example: Marlene dies in Year 1, after her RBD, leaving her $500,000 IRA as follows: $25,000 is to be paid to her church, and the balance is left to her child A. Marlene had not yet taken her RMD for Year 1 ($22,000) at the time of her death. Under the minimum distribution rules, the RMD for the year of the participant's death must be distributed to the beneficiary(ies) before the end of such year. Reg. § 1.401(a)(9)-5, A-4(a). Before the end of Year 1, $25,000 is distributed to the church in fulfilment of its bequest. Does that distribution fulfill the RMD requirement for Year 1? The answer to this appears to be yes; see Reg. § 1.401(a)(9)-8, A-2(a)(2), and Reg. § 1.401(a)(9)-5, A-4(a), and Rev. Rul. 2005-36. For detailed discussion of this question, see ¶ 1.5.04(F) and ¶ 1.7.06 of *Life and Death Planning for Retirement Benefits*.

Now suppose that Marlene had already taken her Year 1 RMD prior to her death, and that no distribution is made to any beneficiary in Year 1. In Year 2, prior to September 30, $25,000 is distributed to the charity in fulfilment of its bequest. Because the charity has been "removed" as a beneficiary prior to the Beneficiary Finalization Date (see ¶ 7.2.02(C)), the child is considered to be the only beneficiary of the account for Year 2 and later years. Assume based on the child's life expectancy the RMD for Year 2 would be $18,000. Did the $25,000 distribution to the church in Year 2 fulfill the RMD requirement for Year 2, so the child does not have to take anything else out in Year 2?

Under § 401(a)(9), the portion of the account payable to a Designated Beneficiary must be distributed over the life expectancy of that beneficiary; this suggests that each beneficiary has a personal obligation to take an annual distribution from his share. However, arguably the IRS has "overruled" this Code provision in its separate account regulations, by providing that: "Except as otherwise provided…[under Reg. § 1.401(a)(9)-8, A-2(a)(2), the separate accounts rule discussed at ¶ 7.2.02(B)], if an employee's benefit under a defined contribution plan is divided into separate accounts under the plan, the separate accounts *will be aggregated* for purposes of satisfying the rules in section 401(a)(9). Thus, except as otherwise provided in this A-2, all separate accounts...*will be aggregated* for purposes of section 401(a)(9)." Reg. § 1.401(a)(9)-8, A-2(a)(1). Emphasis added. If, as this regulation states, the plan is treated as a single account, then a distribution to *any* of the beneficiaries would satisfy the distribution requirement.

7.2.04 ***Formula bequest in beneficiary designation***

Often, the amount a client wants to leave to charity is neither a fixed dollar amount nor a fractional share of the retirement plan, but rather is derived from a formula based on the size of the client's estate and/or adjustments for other amounts passing to the charity.

Corey Example: Corey wants to leave 10 percent of his estate to his church and the balance to his issue. His assets are a $2 million IRA, a home worth $1 million, and other investments worth $3 million. Thus, based on present values, he would expect the church to receive about $600,000. One way to accomplish that goal is to leave the charity 10 percent of the IRA and 10 percent of the rest of the estate. That approach exactly carries out Corey's intent of leaving 10 percent of all his assets to the church. However, that is not the most tax-efficient way to fund the church's share. As explained at ¶ 7.1.02(B), without reducing the amount the church receives, Corey could leave more to his children by funding the church's share entirely from the IRA. His lawyer drafts a beneficiary designation formula leaving the church a fractional share of the IRA equal to 10 percent of Corey's total estate, and leaving the balance of the IRA (if any) to Corey's issue.

The first problem with a formula beneficiary designation is that the IRA provider may not accept it. The IRA provider normally does not have the information needed to apply the formula. For example, Corey's IRA provider it has no way to determine what assets are in his estate; all it knows is what is in the IRA. Also, the IRA provider typically charges a nominal fee for providing custodial duties, and its services do not include calculating elaborate formula amounts.

Both these problems can be overcome, with some IRA providers, by specifying that the participant's executor or some other fiduciary will provide the formula amount to the IRA provider, and that the IRA provider has no responsibility for verifying that the fiduciary's figures are correct. For example, one IRA provider requires any IRA holder who files a "customized beneficiary designation" to supply, along with the beneficiary designation, an authorization that allows the IRA provider to rely on representations by the participant's executor.

If using this approach, make sure that the related trust document or will specifies that this task is part of the duties the fiduciary undertakes by agreeing to be executor or trustee.

7.2.05 ***Leave benefits to charity through a trust***

In many cases it is not feasible to name the intended charitable recipient directly as beneficiary of the retirement benefits. The most common reason for this is that some additional actions must be taken, after the client's death, to carry out the charitable gift. For example:

❑ The intended charitable recipient may be a charitable foundation that has not been created yet; or

❑ The amount going to the charity may be based on a formula that depends on facts that cannot be determined until after the client's death; or

❑ The client may want the charitable recipients to be selected after his death, with a designation such as "The benefits shall be distributed to such one or more educational institutions located in Indiana as my executor shall select from among those that are exempt from federal income taxes under § 501, and gifts to which qualify for the federal estate tax charitable deduction under § 2055."

In all of these cases, the plan administrator may not be willing to accept a beneficiary designation under which the administrator would not be able to tell, at the participant's death, who is entitled to the benefits.

If the only problem is that the actual charitable recipients are to be selected after the participant's death, consider leaving the retirement benefits to a "donor-advised fund" (¶ 7.5.03). The participant should create the fund prior to death, name it as beneficiary, designate who will be responsible for allocating the fund's assets to charities after his death, and provide the allocators with the guidelines they are to follow. Because the donor-advised fund is itself tax-exempt, the problems discussed in the rest of this section do not arise—and the plan administrator is happy because it knows to whom it must make the check payable.

In some situations, however, the benefits may have to be made payable to the participant's estate (or trust) as beneficiary of the retirement plan, with the Will (or trust instrument) specifying that the benefits are to be paid to the not-yet-created (or not-yet-selected) charitable beneficiaries. The executor or trustee is then responsible for carrying out the post-death actions (such as forming the charitable foundation, calculating the formula distributions, or selecting the charities), and the plan administrator can then simply follow the instructions of the executor (or trustee) in distributing or transferring the benefits.

Unfortunately, this approach involves substantial additional complexity with respect to required minimum distributions (see ¶ 7.3) and fiduciary income taxes (see ¶ 7.4).

7.2.06 ***Leave benefits to charity through an estate***

When it is not feasible to name a charity directly as beneficiary, there is an advantage to leaving the benefits to the charity through the participant's estate, rather than through a trust. An estate is entitled to an income tax deduction for amounts either paid to or "set aside" for charity, whereas generally a trust is entitled to an income tax deduction only for amounts "paid" to charity. See ¶ 7.4.04(B), (C). Thus, an estate may have a slight edge; but otherwise the income tax complications of passing retirement benefits through an estate on their way to the charity are the same as for a trust, and require expert knowledge, both at the drafting and administration stages. See ¶ 7.4.

7.2.07 ***Disclaimer-activated gift***

This approach may appeal to a client who would like to encourage his individual beneficiary to be philanthropic. The participant names an individual (such as a son or daughter) as primary beneficiary of the plan, and names a charity as contingent beneficiary, specifying that the charity is to receive any benefits disclaimed by the primary beneficiary. See PLR 2001-49015 for an example of this type of planning. For discussion of disclaimers of retirement benefits, including more detail on the rules referred to in this section, see ¶ 4.4 of *Life and Death Planning for Retirement Benefits*.

Sample "disclaim-to-charity" form

I name as Primary Beneficiaries of my IRA my two sons, Cain and Abel, in equal shares; provided, that if either of my said sons predeceases me, or disclaims all or a portion of his share of this my IRA, that son's share (or the portion thereof so disclaimed, as the case may be) shall be paid, instead, to the Nature Conservancy, for its general charitable purposes.

The participant might express a wish (preferably in a separate letter, to avoid the necessity of getting the plan administrator to deal with a nonstandard beneficiary designation form) that the child disclaim all or part of the benefits.

Why not just leave the benefits to the child, along with a letter expressing the parent's wish that the child give the funds to charity? The disclaimer route is preferable because of the income tax consequences. If the child is the beneficiary of the account and does not disclaim it, the child cannot later assign the benefits to a charity without first paying income tax on them. The child may not be able to eliminate the income tax on the distribution through the charitable deduction; see ¶ 7.7.01. In contrast, if the charity receives the benefits as the result of the child's qualified disclaimer, the income associated with the benefits is shifted to the tax-exempt charity. GCM 39858.

The contingent beneficiary that will receive the benefits upon the primary beneficiary's disclaimer can be any type of charity that is suitable to receive retirement benefits (see ¶ 7.5.01–¶ 7.5.08), EXCEPT that it CANNOT be:

1. A private foundation (¶ 7.5.02) of which the disclaimant is a trustee or manager having power to choose recipients of the foundation's funds, unless the foundation is legally required to hold the disclaimed assets in a separate fund over which the disclaimant does not

have such powers. This is because of the requirement that disclaimed assets must pass "without any direction on the part of" the disclaimant. § 2518(b)(4).

According to PLR 2005-18012, a disclaimer in favor of a donor-advised fund (DAF; ¶ 7.5.03) does not violate requirement #2, even if the disclaimant is an "advisor" to the DAF, because the advisor merely advises; he cannot "direct" distribution of the DAF's funds.

2. A charitable remainder trust (¶ 7.5.04) or gift annuity (¶ 7.5.08) of which the disclaimant is an income beneficiary (unless the disclaimant is the participant's surviving spouse), because of the requirement that disclaimed property must pass, as a result of the disclaimer, either to the participant's surviving spouse or to someone other than the disclaimant. § 2518(b)(4). See *Christiansen*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009), in which a disclaimer was held not to be qualified under § 2518 for this reason (the disclaimed asset passed to a charitable lead trust (¶ 7.5.09) of which the disclaimant was a remainder beneficiary).

Donna Example: Donna, named as primary beneficiary of her late brother's IRA, disclaims the IRA. As a result of her disclaimer, the IRA passes to the contingent beneficiary, a charitable remainder trust (CRT; ¶ 7.5.04) of which Donna is the life beneficiary. Because of her life interest in the CRT, the IRA is not passing to "someone other than the disclaimant." Since Donna is not the spouse of the IRA owner, her disclaimer is therefore not a qualified disclaimer (unless she first disclaims all interests in the CRT). Although her nonqualified disclaimer is treated as a gift for gift tax purposes, there are no adverse *gift tax* consequences, because the "donee" is a CRT of which the only beneficiaries are herself and a charity. Gifts to yourself or to charity are not subject to gift tax. However, her nonqualified disclaimer is not within the safe harbor of GCM 39858 for *income tax* purposes. If the disclaimer is treated as an assignment of the right to receive income in respect of a decedent, Donna would be liable for income taxes on the full value of the IRA, and the IRA would lose its qualification. § 691(a)(2); see ¶ 2.1.03(C) and ¶ 4.6.03 of *Life and Death Planning for Retirement Benefits*.

7.3 RMDs and Charitable Gifts Under Trusts

This ¶ 7.3 explains how the minimum distribution rules work with respect to a trust that is named as beneficiary of a retirement plan, when one or more charities are beneficiaries of the trust. For explanation of the minimum distribution rules applicable under § 401(a)(9) to IRAs and other defined contribution retirement plans, see Chapter 1 of *Life and Death Planning for Retirement Benefits*. For details regarding the minimum distribution rules as they apply to trusts, also called the "RMD trust rules," see ¶ 6.2–¶ 6.3 of *Life and Death Planning for Retirement Benefits*.

7.3.01 ***Trust with charitable and human beneficiaries***

Suppose a client wants to name a trust as beneficiary of his retirement plan. His children are intended to be the primary beneficiaries of the trust, but the trust also has one or more charitable beneficiaries. He wants the plan benefits that pass to this trust to be paid out in installments over the life expectancy of his oldest child. To achieve the desired result, the "RMD trust rules" must be complied with, so that the trust qualifies as a "see-through trust" for minimum distribution purposes.

One of these rules is that all trust beneficiaries must be individuals. § 401(a)(9)(E); Reg. § 1.401(a)(9)-4, A-1, A-2. This rule creates two problems in common estate planning situations involving charities:

- First, *any* charitable gift to be paid from the trust at the participant's death, no matter how small, would cause the trust to flunk this requirement. The only *possible* exception to this rule would be if the trustee is forbidden to use the retirement benefits to fund the charitable bequest. Even the normally innocuous statement "this trust shall pay any bequests under my will, if my estate is not adequate to pay the same," could make the trust "flunk" if the will contains charitable bequests. However, the problem of such payable-at-death charitable gifts can be cured by distributing the charitable bequests prior to the Beneficiary Finalization Date. See ¶ 7.3.02.

- The second problem is that, generally, remainder beneficiaries of the trust are considered "beneficiaries" for this purpose. See PLR 9820021. Thus, if a trust is the beneficiary of the retirement plan, and any part of the remainder interest in the trust passes to charity (or could be appointed to charity under a power of appointment), the trust will flunk (unless the charitable remainder beneficiary can be disregarded under the IRS's RMD trust rules). This is not a problem with a true "charitable remainder trust" (¶ 7.5.04), because such trusts are income tax-exempt. The problem is with a trust that is primarily a family trust but which definitely or even possibly has charitable gifts that will be made after the family members' deaths; see ¶ 7.3.03.

Thus, when drafting a trust that is to make charitable gifts, or that may be used to fund charitable bequests under the client's will, it is important to determine whether any retirement benefits may be payable to that trust, and, if so, to either:

A. In the beneficiary designation form and in the trust, make the benefits payable directly to the trust shares that benefit only individuals (see ¶ 6.3.01(B) of *Life and Death Planning for Retirement Benefits* for discussion of this technique), if qualifying for the life expectancy payout is an important goal (see ¶ 6.2.01 of *Life and Death Planning for Retirement Benefits* for discussion of when this may not be an important goal); or

B. Match the retirement benefits to the charitable gifts, if the goal is to have the benefits pass to the charity free of income taxes (see ¶ 7.4). Under this approach you are giving up on using the life expectancy payout method for the benefits.

*7.3.02 **If charitable gift occurs at the participant's death***

Russ Example: Russ leaves his $3 million IRA to a trust. The trust provides that, upon Russ's death, the trustee is to pay $10,000 to Russ's favorite charity, and hold the rest of the funds in trust for the life of Russ's wife with remainder to Russ's issue.

The trustee can "eliminate" the charitable beneficiary by paying to the charity its $10,000 bequest before the Beneficiary Finalization Date; see ¶ 7.2.02(C). If the charity is paid in full prior to the Beneficiary Finalization Date, then it is no longer a "beneficiary" of the trust as of the Beneficiary Finalization Date, and (assuming the $10,000 bequest to charity was the only defect of the trust under the minimum distribution trust rules) the trust has only individual beneficiaries and qualifies as a "see-through trust." See PLR 2006-08032, in which shares of the decedent's IRA were transferred (from the trust named as beneficiary) to the trust's charitable beneficiaries, prior to the Beneficiary Finalization Date, in fulfilment of their pre-residuary bequests, and the trust was thereby enabled to qualify as a see-through trust.

If the trust does not contain a prohibition against paying retirement benefits to charity, and the trustee has authority to pay any asset to any beneficiary, the trustee could choose whether to use the IRA proceeds or other assets to pay the $10,000 bequest. It would make no difference, under the minimum distribution rules, which assets were used, as long as the charity has no further interest in the benefits after the Beneficiary Finalization Date. See ¶ 7.4 regarding income tax treatment of the trust's distribution to the charity.

*7.3.03 **If charitable gift occurs later***

If the charitable gift(s) will not occur until after the death(s) of one or more individual beneficiary(ies), the problem of "fixing" the trust so that the retirement benefits can be paid out over the life expectancy of the oldest individual trust beneficiary becomes much more complex.

Heather Example: Heather's trust provides that, upon Heather's death, the trust is divided into equal shares for her four children. Each child receives income for life from his or her share, plus principal in the trustee's discretion for the child's health, education and support. At death, each child can appoint the principal of such child's share among Heather's issue and any charity. If the child fails to exercise this power of appointment, such child's share is paid to such child's issue if any, otherwise to the other children. The assets coming to this trust at Heather's death are Heather's $1 million IRA and $1 million of other assets. The existence of potential charitable remainder beneficiaries (as appointees under the children's powers of appointment) would mean that, under the multiple beneficiary rule, this trust would flunk the IRS's minimum distribution trust rules. The trust would not be able to use the life expectancy of the oldest child to measure RMDs from the IRA to the trust after Heather's death. It would be stuck with the applicable "no-DB rule" (see ¶ 7.2.02). Adding a blanket prohibition against paying retirement benefits to charity is *not* the best way to solve the problem in Heather's trust. For one thing, it is not clear that such prohibitions "work" under the RMD trust rules; see ¶ 6.3.01(D) of *Life and Death Planning for Retirement Benefits*.

For another, because the potential charitable gifts do not occur until each child dies, the trustee, in order to carry out a blanket prohibition against using retirement benefits to fund any charitable gift, would have to segregate the IRA (and all distributions from the IRA) from the other assets of the trust immediately upon Heather's death and keep them segregated for the duration of the trust. So instead of administering four trusts (one for each child) the trustee would end up administering eight trusts (one trust for each child's share of the IRA and IRA distributions, which could not be appointed to charity on the child's death, plus a separate trust for each child's share of the non-IRA assets, which *could* be appointed to charity on the child's death). That is the only way the trustee will be able to tell, when the child dies many years from now, which assets can be appointed to charity and which assets cannot be. If the trust instrument or local law does not clearly give the trustee authority to establish two separate trusts for each beneficiary, the trustee might have to go to court to get such authority.

Suppose the trustee sets up the eight separate trust shares. Now Child A needs a discretionary distribution of principal. Does it come out of the retirement assets trust for Child A? or the nonretirement assets trust for Child A? Again, this is a question that must be covered in the trust instrument (or, if it is not, the trustee might have to go to court for authority to pay out of one share or the other).

If there may be charitable remainder interests in a trust that is being created primarily for individual beneficiaries, and the trust may receive retirement benefits, here are options to consider instead of a catchall clause prohibiting payment of retirement benefits to nonindividuals:

A. **Jettison the less important goal.** Determine which is a more important goal to the client, the charitable remainders or the life expectancy payout for the retirement benefits, then give up whichever one is less important. If the charitable gifts are high priority, consider giving up the life expectancy payout. In the Heather Example, if the total value of Heather's retirement plan had been $100,000 out of her total estate of $2 million, she might decide the life expectancy payout was not of significant value, and therefore not bother taking steps to try to preserve it.

B. **Create separate trusts.** Consider creating separate trusts to receive the retirement benefits and the nonretirement assets. If Heather places high priority on *both* the deferred payout of her $1 million IRA over the life expectancy of her children, *and* on allowing the children to appoint their shares of the other $1 million of assets to charity, she could direct the trustee to establish two separate trusts for each child, one for the child's share of the IRA and one for the child's share of the other assets. The power to appoint to charity would apply only to the trusts that held no retirement benefits. The drawback of this approach is the administrative inconvenience and cost of extra trust bookkeeping.

C. **Use a Charitable Remainder Trust.** Consider whether an income tax-exempt Charitable Remainder Trust (CRT; ¶ 7.5.04–¶ 7.5.07) would be a better choice of beneficiary than the client's "regular" trust.

D. **Use a Conduit Trust.** Under a Conduit Trust, each time the trust receives a distribution from the retirement plan, the trustee must immediately pass that distribution out to the life beneficiary. For RMD purposes, the remainder beneficiary of a Conduit Trust does not "count" as a beneficiary; thus, having a charity as remainder beneficiary of a Conduit Trust does not violate the "all trust beneficiaries must be individuals" rule. See Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2, and ¶ 6.3.05 of *Life and Death Planning for Retirement Benefits*.

Luigi Example: Luigi wants his daughter Lee, age 41, to receive a stream of income from his $3 million IRA. A stream of minimum required IRA distributions over her life expectancy would be just right. However, he does not want her to have outright control of the entire IRA after his death. Although a stream of RMD payments from the IRA would not be guaranteed to last for Lee's entire life (it would last only until the end of her IRS-defined life expectancy), he thinks a stream of RMD payments probably *would* last for her lifetime because she has a below-average life expectancy due to her medical condition. If she does die prematurely, he wants any money left in the IRA to go to the charity that funds research into Lee's illness. He could leave the benefits to a Conduit Trust for Lee with remainder to the charity. There would be no estate tax charitable deduction (because this is not a Charitable Remainder Trust; ¶ 7.5.04), but, as a Conduit Trust, the trust would be able to use Lee's life expectancy as the ADP (because the charitable beneficiary can be disregarded).

E. **Use disclaimer to fix the problem after the fact.** Another way to eliminate a nonindividual beneficiary is to have it disclaim the benefits by means of a qualified disclaimer. See ¶ 4.4 of *Life and Death Planning for Retirement Benefits* regarding disclaimers of retirement benefits. This approach is not for the planning stage, but may help "clean up" a trust if the participant has already died. It would be unusual for a charity to consider disclaiming benefits left to it under a trust, but it's possible to imagine a case where it might work.

Caleb Example: Caleb dies at age 60, leaving his $1 million IRA and other assets to a trust to pay income to David for life, plus principal in the discretion of the trustee for David's health, support and happiness. On David's death, the trust is to distribute $25,000 to Harvard College, and the balance of the remaining principal to Rosemary and Gilbert (who are younger than David). Because of the bequest to a nonindividual beneficiary (Harvard), the trust "flunks" the minimum distribution trust rules, and benefits will have to be distributed under the 5-year rule. If this bequest did not exist, the benefits could be distributed over the life expectancy of the oldest trust beneficiary, David, who is only 45. David, Rosemary and Gilbert have always been generous supporters of Harvard, and have named Harvard as beneficiary of substantial bequests in their own estate plans. They meet with Chuck from Harvard's Planned Giving Office and ask Chuck whether Harvard would like to disclaim the $25,000 remainder bequest under Caleb's trust. They do not compensate, or offer to compensate, Harvard for making the disclaimer, or make any threat or promise about what they will do or not do if Harvard does or doesn't disclaim. They simply point out a few facts. First, Harvard wouldn't be losing much by disclaiming (maximum $25,000, after life of a 45 year-old; the present value of this is much less than $25,000). Second, they remind Chuck that, if the life expectancy payout is not available to the trust, the trust will have less money in it overall, which will mean lower income for David, and less principal available for David, Gilbert and Rosemary. They point out that the less money these individuals have, the less they personally can afford to give to Harvard. Finally, they point out that Harvard's refusal to disclaim would leave them with a bad taste in their mouths as they see the IRS raid the IRA, and no longer would the name "Harvard" conjure only sweetness and light in their minds. Harvard disclaims the bequest. The trust uses the life expectancy payout method. David becomes Class Gift Chairman for his Harvard 25th Reunion and raises a record amount.

F. Trust reformation to make it qualify as a see-through. This is another one to consider if the participant has already died. With proper proceedings in the Court having jurisdiction of the trust, it *may* be possible to have a noncomplying trust reformed, settled, divided into separate trusts, or otherwise re-engineered so that it complies with the trust rules. While post-death actions to modify a trust are not necessarily effective to cure all "tax defects" in a trust, the IRS has occasionally ruled favorably on see-through status for a trust that was reformed after the participant's death; see CCA 2008-48020 (discussed at ¶ 7.4.03(B)), in which the IRS apparently viewed with favor a post-death reformation designed to make a trust qualify as a see-through. More recent rulings, however, show strong IRS hostility towards post-death reformations. See PLRs 2007-42026, 2010-21038.

Here is an example of how a reformation could be used to make a trust qualify as a see-through, if the IRS attitude should thaw:

Dolly Example: Dolly left her $1 million IRA and other assets to a trust that provided life income to Brinley, and on Brinley's death provided a gift of $50,000 to charity and the balance to John or John's descendants. By an agreement of all beneficiaries and the trustee, including a guardian to represent the unborn descendants, approved by the Probate Court, the charity is paid a reduced sum immediately (equal to the present value of its remainder) and in exchange gives up its $50,000 remainder. In effect, the trust is reformed so that the charitable beneficiary is paid its share in full before September 30 of the year after the year of the participant's death. A beneficiary who ceases to be a beneficiary prior to that date (due to distribution or disclaimer of its share of the benefits) is not counted as a beneficiary in applying the minimum distribution rules. Reg. § 1.401(a)(9)-4, A-4(a). The reformation might persuade the IRS (assuming the trust meets all the other trust rules) that the trust qualifies as a see-through. Whether it is effective to provide Dolly's estate with an estate tax deduction for this charitable gift is a totally separate question, since as of the date of death, that gift was in the form of a non-qualifying split interest.

7.4 Income Tax Treatment of Charitable Gifts From a Trust or Estate

This ¶ 7.4 discusses certain income tax issues involved when retirement plan death benefits are paid to a trust (other than an income tax-exempt trust) or estate, especially whether and how an estate or trust can avoid income taxes on benefits payable to it that are used to fund charitable gifts under the instrument. It does not seek to explain all the rules of trust income taxation. For complete explanation of trust income tax rules, see the four treatises recommended in the Bibliography, which are cited in this Special Report as "*Abbin*," "*Blattmachr*," "*Ferguson/Freeman/Ascher*," and "*Zaritsky*," respectively.

¶ 7.4.01–¶ 7.4.03 assume that the fiduciary receives a distribution from the retirement plan and, in the same year, funds a gift to a "public" charity (¶ 7.5.01) or private foundation (¶ 7.5.02). If the charitable gift is not funded in the same year the distribution is received from the retirement plan, see ¶ 7.4.04. If, instead of taking a distribution from the plan and passing the distributed property out to the charity, the fiduciary transfers the retirement plan itself to the charity, see ¶ 7.4.05.

For ease of reading, this ¶ 7.4 will sometimes refer only to trusts; the same rules apply to estates unless otherwise specified.

7.4.01 ***Introduction to trust income tax rules, "DNI," and the NIIT***

Trusts and estates get a unique deduction on the way from "gross income" to "taxable income": The trust or estate can deduct certain distributions made to the trust's or estate's beneficiaries. § 651, § 661. The beneficiaries then pay the income tax on these distributions. § 652, § 662. The amount the trust or estate can deduct is limited to the amount of its "distributable net income" or "DNI." § 651, § 661. Because of this limitation, the deduction is often called the "DNI deduction." See ¶ 7.4.02 of *Life and Death Planning for Retirement Benefits* for more discussion. Here are the DNI rules that particularly affect retirement benefits payable to a trust with one or more charitable beneficiaries:

- There is no DNI deduction allowed for a distribution from an estate or trust *to a charity*, although a distribution to a *charitable remainder trust* may be eligible for the DNI deduction. See ¶ 7.4.02.

- A distribution to a charity (but not to a charitable remainder trust) from an estate or trust is deductible, if at all, only as a charitable deduction. See ¶ 7.4.03.

- Under the "separate share" rule of § 663(c), the gross income that results when a trust receives a distribution from a retirement plan might have to be allocated among all of the trust's residuary beneficiaries, even if the trust instrument gives the trustee the power to pick and choose which beneficiary receives which asset. See ¶ 7.4.05.

Another tax the trust must contend with is the 3.8 percent additional income tax on the trust's undistributed net investment income (NII), sometimes called the net investment income tax (NIIT). The tax is imposed on the recipient's income of a certain type, namely "investment income" (interest, dividends, gains, etc.) if the recipient's income exceeds certain thresholds. Retirement plan distributions are exempt from the tax, but taxable distributions from retirement plans (because they go into the recipient's gross income) do count for purposes of determining whether the recipient's adjusted gross income exceeds the applicable threshold.

The threshold for individuals ($200,000 for single, $250,000 if married filing jointly) is much higher than the threshold for trusts and estates ($12,300 as of 2015). However, a trust is liable for the tax only on its *undistributed* NII, while for individuals, the tax applies to the lesser of the individual's NII or the individual's adjusted gross income in excess of a certain threshold, with no option to reduce the tax by somehow "distributing" the NII to another taxpayer.

Since the trust pays NIIT only on its *undistributed* NII (a term not defined in the Code), the IRS had to create a system for determining which distributions from the trust would "carry out" NII. In Reg. § 1.1411-3(e)(3), the IRS provides that a distribution to noncharitable beneficiaries would carry out NII using a proportionate rule. Whatever percentage of the trust's DNI consisted of investment income or exempt income (e.g., a retirement plan distribution) that percentage would apply for purposes of determining the NIIT consequences also.

Using that principle, one would conclude that if a nongrantor trust received (for example) a $10,000 taxable IRA distribution (NIIT-exempt) and $10,000 of ordinary dividends (subject to NIIT) as its only gross income for the year, and the trust distributed (say) $10,000 to its only beneficiary, the distribution would be deemed to consist equally of NII and NIIT-exempt income. The beneficiary would therefore have to report $5,000 of NII attributable to this distribution, leaving the trust with the other $5,000 of NII to report on its fiduciary income tax return.

For how distributions to *charity* do or do not carry out the trust's NII, see the next Section.

7.4.02 ***DNI deduction, retirement benefits, and charity***

A retirement plan distribution received by a trust becomes part of the trust's "distributable net income" (DNI) to the extent the distribution is includible in the trust's gross income. See Reg. § 1.663(c)-5, Examples 6 and 9. If the trust has more than one beneficiary, the extent, if any, to which the trustee can allocate this DNI to the beneficiary(ies) of the trustee's choice may be determined under the separate share regulations; see § 663 and ¶ 6.5.05–¶ 6.5.06 of *Life and Death Planning for Retirement Benefits* regarding these rules.

There is no DNI deduction allowed for a distribution from an estate or trust *to a charity*. § 651(a)(2), § 663(a)(2). Although the Code could be interpreted to mean that a trust can take a DNI deduction for distributions to charity that do not qualify for the charitable deduction, the IRS has not interpreted it that way. See Rev. Rul. 68-667, 1968-2 C.B. 289. The courts have supported the IRS; see *Blattmachr*, § 3:2.1[J], Note 174; *Ferguson/Freeman/Ascher* § 6.10, in which the authors argue that the IRS regulation may be invalid, as the potential abuse it sought to prevent has been obviated by the statutory change that made the separate share rule (see ¶ 7.4.05) applicable to estates as well as to trusts; and *Zaritsky,* ¶ 2.04[6]. Accordingly, if the distribution to charity does not qualify for the charitable deduction under § 642(c) *it will not be deductible at all*.

A distribution to a *charitable remainder trust* (¶ 7.5.04) is eligible for the DNI deduction, to the extent it meets the other requirements of that deduction. Reg. § 1.664-1(a)(5)(iii).

Addition of the 3.8 percent NIIT on the trust's undistributed net investment income (see discussion in previous section) adds a further complication. The IRS, in Prop. Reg. § 1.1411-3(e)(4) provides essentially that we know that kind of income the trust is distributing (based on the DNI-pass-out principles explained above); and if the distribution is carrying out NII, and the distribution otherwise qualifies for the fiduciary income tax charitable deduction (see the following complicated rules), it will also carry out the NII to the income-tax exempt charity.

7.4.03 ***Charitable deduction under § 642(c)***

Since a distribution to a charity is not eligible for the DNI deduction (¶ 7.4.02), a distribution to a charity from an estate or trust is deductible, if at all, only as a charitable deduction under § 642(c). § 642(c) allows an estate or trust "a deduction in computing its taxable income…[for] any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a" charitable purpose (as defined in § 170(c)).

A distribution from an estate or trust to a Charitable Remainder Trust is *not* eligible for the income tax charitable deduction; it is deductible, if at all, only as DNI (¶ 7.4.02). Reg. § 1.642(c)-2(d); § 1.664-1(a)(5)(iii).

A. Introduction to § 642(c): the fiduciary charitable deduction. Like an individual taxpayer, a trust is entitled to an income tax deduction for certain payments to charity. However, there are many differences between the *individual* income tax charitable deduction under § 170 and the *fiduciary* income tax deduction under § 642(c); for example, the fiduciary income tax charitable deduction is unlimited in amount. Also, none of the requirements discussed in sections B–F below that apply to the fiduciary income tax charitable deduction apply to the individual version. For discussion of all the differences between the individual and the fiduciary income tax charitable deductions, see *Ferguson/Freeman/Ascher* § 6.01 or *Zaritsky* ¶ 2.04[1].)

Suppose a trustee receives a $10,000 distribution from an IRA that is payable to the trust, and then distributes $10,000 from the trust to a charity. To determine whether the trust can take a charitable deduction for the $10,000 payment to the charity, the trustee must answer the following five questions:

First, the trustee must determine whether the "separate share" rule applies, and if so what its effect is. If the separate share rule applies, the trustee may not be entitled to allocate all the gross income resulting from the retirement plan distribution to the charity—even if he paid the entire plan distribution to that charity. See § 663 and ¶ 6.5.06 of *Life and Death Planning for Retirement Benefits*.

Second, there is the matter of timing. In what taxable year was the plan distribution received by the trust, and in what taxable year did the trust make a distribution out to the charity? There is some limited flexibility regarding the year in which the deduction can be taken relative to these two events; see ¶ 7.4.04.

Third, was the payment to the charity made "pursuant to the governing instrument?" See "B." If it was not, there is no deduction. If the answer is yes, then:

Fourth, was the payment paid out of "income?" See "C," "D," and "E." If not, there is no deduction. If the answer is yes, then:

Finally, out of what *class* of income was the payment made? The deduction will be allowable to the extent the payment was made out of gross income that is neither tax-exempt income nor unrelated business taxable income (UBTI). See "F," "G," and ¶ 7.4.05.

As this list of requirements shows, taking a charitable deduction for a retirement plan distribution that is paid to a charity through a trust or estate is not a simple matter. A trustee can sometimes avoid having to meet all these technical requirements by transferring the retirement plan account, itself, intact, to the charity, rather than taking a distribution from the plan and then paying funds to the charity; see ¶ 7.4.05.

B. **"Pursuant to the governing instrument."** A trust is entitled to an income tax deduction for amounts that are paid to charity out of its gross income "pursuant to the governing instrument." § 642(c).

A treatise could be written about the meaning of the phrase "pursuant to the governing instrument," starting with the question of which document is "the governing instrument." For example, if a trust instrument grants a beneficiary a testamentary power of appointment, and the beneficiary appoints the property to charity, the beneficiary's will exercising the power is not "the governing instrument," according to *Brownstone v. U.S.*, 465 F. 3rd 525 (2d Cir. 2006), which disallowed the charitable deduction in these circumstances.

In CCA 2008-48020, a trust (of which the only asset was an IRA payable to the trust as beneficiary) provided for ongoing distributions to individuals and charities. The trust was reformed by court order, after the participant's death, to provide for (among other changes) immediate distributions to the charities, so that the ongoing trust would be solely for the benefit of individuals and qualify as a see-through trust. The IRS Chief Counsel advised that the immediate payments made to the charities under the reformed trust were not made "pursuant to the governing instrument," because the trust reformation was done to achieve a tax goal (acquire see-through trust status) rather than to compromise a dispute, and accordingly were not income tax-deductible! Compare PLR 2006-52028 (discussed at ¶ 7.4.05).

For our purposes, suffice it to say that "pursuant to the governing instrument" means that the trustee is explicitly authorized or required by the trust instrument to make the payment to the charity. *If there is more than one instrument involved, or if there is any other ambiguity regarding whether this requirement is met, please refer to the treatises cited in the Bibliography, not this Special Report*.

Janet Example: Janet dies in Year 1, leaving her $1 million IRA to her living trust, which already holds $3 million of other assets at her death. The entire trust is to be paid to three charities in equal shares, as soon as Janet's estate is settled. In the meantime, the governing instrument gives the trustee discretion to pay income and/or principal to the three charities in equal shares. In Year 1, the trustee cashes out the $1 million IRA and distributes the cash to the three charities equally. This is a payment to the charities made from the gross income of the trust pursuant to the governing instrument, and accordingly is deductible under § 642(c). See PLR 2003-36020.

C. **Out of gross income, Part I: Tracing.** The Code requires that the payment to charity must come from the trust's *gross income* in order to be deductible. This requires tracing the origin of the item that is distributed to the charity. Rev. Rul. 2003-123, 2003-50 I.R.B. 1200. Note that this is in contrast to the "DNI" system for deducting distributions to noncharitable beneficiaries (¶ 7.4.01), which was explicitly designed to eliminate the need for tracing, according to *Ferguson/Freeman/Ascher*, § 6.09, Note 1.1.

Lou Example: Lou dies leaving his $1 million bank account to his trust. The trust authorizes the trustee to pay income and/or principal to charity and/or to Lou's daughter. The day after Lou dies, the trustee distributes $10,000 to the charity and $30,000 to Lou's daughter, reducing the bank account to $960,000. Over the remaining months of the trust's taxable year, $40,000 of interest is credited to the bank account. One might think the trust's income tax return for the year would show $40,000 of gross income, with a charitable deduction of $10,000 and a $30,000 DNI deduction, producing taxable income of zero. However, the trust is not entitled to deduct the $10,000 payment to the charity because it was not paid out of "gross income"; the payment to the charity was made before the trust had even received any income, so it could not have been paid out of income. The payment to Lou's daughter is deductible because the DNI deduction does not require a showing that the funds actually came out of the trust's gross income.

"Income in respect of a decedent" (IRD; see ¶ 7.1.02(B)) that is includible in the gross income of a trust is "gross income" for purposes of the charitable deduction. Reg. § 1.642(c)-3(a). Why does the regulation go to the trouble of spelling this out? Because IRD, being an asset owned by the decedent at death and includible in the decedent's gross estate for federal estate tax purposes, would typically be considered part of the trust's "principal" for *trust accounting* purposes (see ¶ 6.1.02 of *Life and Death Planning for Retirement Benefits*). The regulation clarifies that even though this asset is "principal" for trust accounting purposes it is "gross income" for income tax purposes, including for purposes of the trust income tax deduction under § 642(c).

Retirement plan death benefits are IRD to the extent they are includible in the recipient's gross income. Rev. Rul. 92-47, 1992-1 C.B. 198; Reg. § 1.663(c)-5, Example 9. Retirement plan death benefits generally are wholly includible in gross income when received by the beneficiary, but there are exceptions (see ¶ 2.1.06 of *Life and Death Planning for Retirement Benefits*).

Ben Example: Ben dies leaving his $1 million IRA (all of which is pre-tax money, includible in gross income as ordinary income when distributed) and no other assets to his trust. The trust authorizes the trustee to pay income and/or principal to charity and/or to Ben's daughter. Under applicable state law, the $1 million date-of-death balance of the IRA is considered principal for trust accounting purposes. The day after Ben dies, the trustee withdraws $40,000 from the IRA, and distributes $10,000 of it to the charity and $30,000 to Ben's daughter, reducing the IRA value to $960,000. Over the remaining months of the trust's taxable year, the trust takes no other IRA distributions and receives no other income. The trust's income tax return for the year will show $40,000 of gross income (the IRA distribution), with a charitable deduction of $10,000 and a $30,000 DNI deduction, producing taxable income of zero. The trust is entitled to deduct the $10,000 payment to the charity because it was paid out of "gross income."

D. Out of gross income, Part II: Authorization. Suppose the trust instrument directs the trustee to pay $x to charity (so the payment is "pursuant to the governing instrument"), and the trustee actually makes the payment out of the trust's gross income (so the "tracing requirement" is met), but nothing in the governing instrument specifically indicates that the payment to the charity is to come *out of the trust's gross income*. Can the trust take the deduction? This one is a bit murky. The IRS will look to applicable state law to determine whether the payment is deemed to come from the trust's "income."

In Rev. Rul. 68-667, 1968-2 C.B. 289, the decedent's will left a formula pecuniary bequest to a charity and left the residue of the estate to a noncharitable trust. The will was "silent as to the disposition of income of the estate during the period of administration." The estate made distributions to the charity and to the trust during the year. The IRS held that the payments to the charity were not deductible under § 642(c) because applicable state law required that "all income earned by an estate during the period of administration be distributed to the residuary legatee." Thus, the estate's "income" belonged to the noncharitable residuary trust, and the estate could not under applicable law have used such "income" as the source of the payments to the charity.

Thus, it is not enough that the actual distribution to the charity can be traced to the trust's gross income as its source. Either the governing instrument or applicable state law must indicate that the gross income *can be* (or must be) the source of such payment.

In Rev. Rul. 71-285, 1971-2 CB 248, a trust was required to make an annual annuity payment to charity. On termination, the trust would pass to daughter. The trust was silent regarding the source of the charitable annuity payments. Applicable local law indicated that, absent a contrary provision in the trust, payments would be made first from the trust's income. Accordingly, the IRS allowed the charitable deduction for the charitable annuity payments in this case, unlike in Rev. Rul. 68-667.

E. Out of gross income, Part III: Governing instrument provision. If the governing instrument (or applicable state law, in the absence of a governing instrument provision) specifies that the payment to charity shall be made first from income, that provision will be honored for purposes of § 642(c), regardless of whether it has any economic effect independent of its income tax consequences. Rev. Rul. 71-285, *op. cit.*

Nongrantor charitable lead trusts, for example, are allowed an income tax charitable deduction for charitable annuity payments paid out of gross income, even though there is no "economic effect" of designating income as the first source for such payments—the charity is entitled to the same annuity amount regardless of whether the trust even has any income. Rev. Proc. 2007-45, 2007-28 I.R.B. 87, Section 5.01(3); see PLRs 2003-39018, 2005-16005, 2005-36013.

This conclusion is consistent with the rules for the allocation of DNI, where a governing instrument provision that a particular beneficiary's "separate share" is to be funded "first" with retirement benefit proceeds will be respected for purposes of allocation of DNI among beneficiaries' shares even though the provision has no economic effect independent of income taxes. Reg. § 1.663(c)-5, Example 9. See ¶ 7.4.05.

Ivan Example: Ivan dies, leaving his $1 million IRA (all distributions from which are includible in the trust's gross income) and $2 million of other assets to his revocable trust. The trust instrument directs the trustee to pay a flat fixed-dollar amount of $100,000 to each of three charities and two aunts immediately upon Ivan's death, and to fund these $500,000 total gifts from the IRA proceeds. To carry out this provision, the trustee withdraws $500,000 from the IRA and distributes $100,000 to each of these five beneficiaries. There is no DNI deduction for the distributions to the aunts (because there is generally no DNI deduction for a pecuniary bequest; see § 663(a)(1), Reg. § 1.663(a)-1, and ¶ 6.5.02(C)), or for the distributions to the charities (see ¶ 7.4.02). However, the distributions to the charities are deductible under § 642(c) since the trust instrument mandates that these charitable gifts be paid out of the 401(k) proceeds, i.e., out of gross income. A pecuniary gift is eligible for the income tax charitable deduction to the extent it is paid out of gross income pursuant to the governing instrument; see Reg. § 1.642(c)-(3)(c), Example 2.

F. Out of WHICH income? The charitable deduction under § 642(c) is limited to amounts paid out of gross income *other than tax-exempt income and unrelated business taxable income* (UBTI). § 681(a); Reg. § 1.642(c)-3(b)(1), (d).

If a trustee has received both ordinary taxable income and tax-exempt income in a particular year, and then makes a distribution to charity out of the trust's income account (pursuant to the governing instrument of course), how does the trustee know whether what he paid the charity was taxable income (deductible) or tax-exempt income (nondeductible)?

That should be easy to answer—look at the governing instrument! After all, Reg. § 1.642(c)-(3)(b)(2) provides that "if the governing instrument specifically provides as to the source out of which amounts are to be paid…" for a charitable purpose, "the specific provision controls." Reg. § 1.643(a)-5(b) says the same thing. Accordingly, to minimize taxes, the drafter of a nongrantor charitable lead annuity trust (for example) might specify that the annual "lead interest" payments to charity would be made, first, out of ordinary taxable income that was not UBTI, secondarily from long-term capital gain, and only lastly from tax-exempt income or UBTI.

Unfortunately, despite its own clear unqualified statement in two regulations that a specific governing instrument provision "controls," the IRS has long maintained that such a specific provision in the governing instrument does *not* control, and a payment to charity from gross income will be *deemed to come proportionately from all classes of the trust's income*, unless the "specific provision" has *economic effect independent of income tax consequences*. See *Ferguson/Freeman/Ascher* § 6.09, Note 16. The Treasury has now codified this "hidden rule" in Regs. § 1.643(a)-5(b) and § 1.642(c)-3(b), but the Preamble to these regulations when issued in proposed form claimed that the economic effect requirement was not new—it was there all along if you read a chain of regulations cited in the Preamble. Vol. 73 F.R. 118, p. 34670 (6/18/08).

For the meaning of "economic effect independent of income tax consequences," the proposed regulation cross-references Reg. § 1.652(b)-2(b), which deals with the allocation of classes of DNI among beneficiaries.

G. Example: directing payment to charity out of retirement benefits. We know that retirement plan death benefits, to the extent includible in gross income, are "IRD," and that IRD is includible in DNI. We know that IRD is considered "gross income" for purposes of the requirement that, in order to be eligible for a charitable deduction, a payment to charity must be made from "gross income." Now let's put this all together and see what happens when a governing instrument directs that a charitable bequest must be satisfied out of retirement benefits that are payable to the trust.

Steve Example: Steve dies on January 1, Year 1, leaving his $100,000 IRA to a trust as beneficiary, along with $900,000 of other assets. The IRA is 100 percent pre-tax money. Under applicable local law, the $100,000 date-of-death balance of the IRA is considered principal for trust accounting purposes. The trust provides that, upon Steve's death, the trustee shall pay $100,000 to Charity Y, and shall hold the balance of the assets in trust for Steve's daughter. The daughter is to receive income and principal of the trust for life in amounts determined annually in the trustee's discretion. The trust provides that the charitable bequest shall be funded, to the maximum extent possible, from the IRA. In Year 1, the trustee receives the following amounts of gross income: $100,000 IRA proceeds; $25,000 of tax-exempt income (municipal bond interest); and $10,000 of bank interest. The trustee distributes $35,000 to the daughter and $100,000 to Charity Y. Here's how Steve's trustee will report these transactions on the trust's tax return for Year 1:

Gross income: $100,000 IRA distribution plus $10,000 taxable interest =	$110,000
DNI: $100,000 IRA distribution plus $10,000 taxable interest plus $25,000 municipal bond interest =	$135,000

The trustee would *like* to allocate the $100,000 of taxable IRD to the charity and allocate to the daughter $25,000 of tax-exempt interest and $10,000 of taxable interest. That way, the trustee hopes, the trustee would get a $100,000 charitable deduction for the distribution to Charity Y and a $35,000 DNI deduction for the distribution to the daughter, and the daughter would pay tax on only $10,000 because $25,000 of her distribution would be tax-exempt interest. But the trustee will find it doesn't work that way.

The governing instrument's requirement that the Charity Y's bequest be paid out of "income" (namely, the IRA distribution) is respected. Thus, the charity is deemed to have received its $100,000 from the trust's income, and that requirement of § 642(c) is met.

However, the governing instrument's requirement that the charity be paid "first" out of the IRA proceeds means that the allocation of a *particular class of income* (in this case IRD) to the charity does not have any economic effect independent of income tax consequences. The charity is to receive no more or less than $100,000 from the trust, regardless of the IRA value and regardless of how much gross income the trust has. Accordingly, the IRD, along with all other classes of the trust's income, must be allocated pro rata to both of the beneficiaries.

The proportion of tax-exempt income to the trust's total income is $25,000/$135,000. Thus, $18,518 of the $100,000 distributed to Charity Y is deemed to come from the trust's tax-exempt income and the trust does not get a charitable deduction for that portion. The trust's charitable deduction is limited to the $81,481 that is deemed to have been distributed to the charity out of "income" that is includible in "gross income" for federal income tax purposes.

The daughter is deemed to have received $6,481 of tax-exempt income and $28,519 of taxable income, some of which is IRD. So the trust's DNI deduction is only $28,519.

Thus the trust's taxable income is:

Gross income	$110,000
Less:	

Charitable deduction	81,481
DNI deduction	28,519
Taxable income	Zero

Can the trustee avoid this effect (and shift a higher proportion of tax-exempt income to the daughter) by transferring the IRA, intact, to Charity Y in fulfilment of its bequest (see ¶ 7.4.05)? Probably not. The IRS would deem the transfer of an IRA to a beneficiary in fulfilment of a pecuniary bequest as a taxable transfer of a right-to-receive-IRD under § 691(a)(2). See CCM 2006-44020 (discussed at ¶ 6.5.08 of *Life and Death Planning for Retirement Benefits*). Accordingly, the transfer would generate $100,000 of gross income (IRD) and the allocation of the trust's income and distribution deductions would be the same as if the trustee had cashed out the IRA and paid Charity Y from the proceeds.

Could these effects have been avoided at the planning stage? There are alternative ways the charitable bequest could have been written that would have produced a little better income tax result for the daughter, but not without producing other "side effects."

One approach would have been to name the charity directly as beneficiary of the IRA up to the amount of $100,000. That would have avoided the hazards and complications of the trust income tax charitable deduction, but it would have created other hazards and complications; see ¶ 7.2.03.

Another way would be to have drafted the charitable bequest of retirement benefits in a way that has "economic effect." For example, the trust could have said that the charity would receive "the first $100,000 of distributions from the IRA," and nothing else. If the total IRA was $1 million, the donor would be fairly confident that there would be more than enough money in the IRA to cover the charity's bequest, so there would be little risk that the charity would actually not get its full $100,000. Unfortunately, by creating "economic effect," you create the real risk that the economic effects will in fact occur. For example, if the IRA were to be cashed out by the owner on his deathbed, there would be no more IRA payable to the trust, so the charity's bequest would lapse.

The moral is: When retirement benefits are to be paid to charity through a trust or estate, draft the documents to carry out the donor's intent exactly. If you can accomplish the donor's objectives and also reduce taxes, do so. However, don't make changes in the documents for the purpose of reducing taxes if such changes will jeopardize achievement of the donor's primary goal.

7.4.04 ***Timing of charitable deduction for trust or estate***

This ¶ 7.4.04 deals with when (in what year) a trust or estate may take an income tax charitable deduction under § 642(c) relative to the timing of (1) receipt of a distribution from a retirement plan and (2) the estate's or trusts' payment to the charity of the income resulting from that plan distribution. The rules for an estate are slightly different from the trust rules.

¶ 7.4.03 dealt with retirement plan distributions that are paid to a trust and distributed by the trustee to the trust beneficiaries, where the plan-to-trust distribution and the trust-to-beneficiary distribution both occur *in the same taxable year of the trust*. The exact same rules apply when a retirement plan distribution is paid to an estate, and is then in turn distributed by the executor to the estate beneficiaries, where the plan-to-estate distribution and the estate-to-beneficiary distribution occur *in the same taxable year of the estate.*

If the plan distribution is received in one year, but not distributed to the charity until a later year, then different rules apply (and the results may differ depending on whether the plan distribution was received by a trust or by an estate). The following subparagraphs A–C assume that the distribution to the charity meets the other applicable requirements of the income tax charitable deduction (see ¶ 7.4.03).

A. **Distribution to charity in the next year.** If the amount is distributed to the charity in the year (Year 2) *following* the year the income was received (Year 1), the fiduciary can elect to treat the payment to the charity as if it had been made in Year 1 (and so can deduct it in Year 1). § 642(c)(1). This rule applies to both estates and trusts.

B. **Estate gets a set-aside deduction.** If the distribution to the charity does not occur until even later than that, things get tougher. An *estate* can take a charitable deduction for amounts "permanently set aside for" charity as well as for amounts "paid to" charity. § 642(c)(2). Note: There is no set-aside deduction, even for an estate, for amounts set aside for future distribution to a Charitable Remainder Trust. Reg. § 1.642(c)-2(d).

C. **Trust may or may not get set-aside deduction.** Trusts, unlike estates, generally *cannot* take a deduction for amounts that are merely "set aside for" charity; a trust generally gets a deduction only for amounts *paid* to charity. There are two exceptions to this general rule: A trust may take a set-aside deduction if the trust is treated as part of the estate pursuant to a § 645 election (see Reg. § 1.645-1(e)(2)(i)), or if the trust is eligible for a grandfather exception for certain pre-10/9/69 instruments (see § 642(c)(2)). PLR 2004-18040.

*7.4.05 **Transfer benefits to charity to avoid "separate share" and other rules***

This ¶ 7.4.05 discusses transferring a retirement plan benefit (for example, an IRA), intact, from an estate or trust to one or more charitable beneficiaries of the estate or trust. This is discussed primarily in the context of avoiding negative results under the "separate share rule," but the technique can also help the fiduciary sidestep some technical requirements of § 642(c). For example, in PLR 2006-52028, a beneficiary designation form was reformed, after the participant's death, to name a trust rather than the participant's estate, as beneficiary of an IRA; all or part of the trust's residue passed to charities, and the IRS ruled favorably on the transfer of the IRA to the charities as a nontaxable event. Compare CCA 2008-48020, discussed at ¶ 7.4.03(B).

For how to do these transfers, see ¶ 6.1.05 of *Life and Death Planning for Retirement Benefits*. For the income tax treatment of such transfers, see ¶ 6.5.07–¶ 6.5.08.

Transferring part of a retirement plan to a charitable beneficiary prior to the Beneficiary Finalization Date may enable the trust to qualify as a see-through trust for minimum distribution purposes with respect to the rest of the plan (or other retirement benefits); see ¶ 7.4.05. Other than this minimum distribution deadline, there is no particular date by which the transfer must occur in order to "work" for the income tax purposes discussed here.

The"separate share" rule of § 663(c) provides that, "For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts." A similar rule is provided for estates. § 663(c). When the separate share rule of § 663(c) applies, if a fiduciary distributes money to a beneficiary, that distribution will carry out DNI only to the extent there is DNI that is properly allocable to that particular beneficiary's "separate share"; see ¶ 6.5.05–¶ 6.5.06 of *Life and Death Planning for Retirement Benefits*.

Although § 663(c) states that it applies for the *sole* purpose of determining the amount of DNI "in the application of sections 661 and 662," it appears that the separate share rules also apply to determine allocation of DNI to the share of a *charitable* beneficiary, even though, after all the allocating is done, there will be no DNI deduction for distributions to charity, because:

✓ The separate share rules apply if a trust or estate "has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares...." Reg. § 1.663(c)-1(a). The regulation does not say the rules apply only if the entity has more than one non-charitable beneficiary.

✓ The IRS has not provided any other system for deciding how much of the trust's income is allocated to charitable shares.

✓ One of the examples in the separate share regulations includes allocation of DNI among both charitable and non-charitable beneficiaries, though noting that the "payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662." Reg. § 1.663(c)-5, Example 11.

See also *Ferguson/Freeman/Ascher,* § 6.10, where the authors assume this result.

If the participant has already died, leaving retirement benefits to a trust that has "separate shares" within the meaning of § 663; and the beneficiary(ies) of one or more shares is (are) charities, while one or more other shares have noncharitable beneficiaries; and the trust does not include a provision mandating allocation of the retirement benefits to the share(s) of the charitable beneficiary(ies); the deemed allocation to noncharitable beneficiaries' shares of gross income arising from retirement plan distributions can still be avoided, in the trust administration phase, if:

1. The trust instrument (or applicable state law) gives the trustee authority to distribute assets in kind to beneficiaries in satisfaction of their shares; and

2. The trust instrument (or applicable state law) gives the trustee authority to pick and choose which asset will be used to fund the charity's share; and

3. The trustee, instead of taking distribution of the retirement benefits, assigns (transfers) the retirement plan itself to the charity.

Following the assignment, the charity can take distributions directly from the retirement plan. The distributions do not have to be included in the gross income *of the trust* because the benefits are never paid to the trust. The problem of Reg. § 1.663(c)-2(b)(3) is avoided. This approach also sidesteps a requirement of getting a charitable deduction that applies if the trustee takes a plan distribution, namely, that the instrument must specify that the payment to charity must come out of gross income (¶ 7.4.03(D)).

Here is the reasoning behind this approach. Retirement plan death benefits, when paid to a beneficiary, are taxable to the beneficiary as income in respect of a decedent (IRD) under § 691 (except to the extent such benefits are nontaxable as return of basis or under some special provision of the Tax Code, such as that for net unrealized appreciation of employer securities). Rev. Rul. 92-47,1992-1 C.B. 198; Reg. § 1.663(c)-5, Example 9.

The retirement plan itself (i.e., once inherited by the beneficiary, but prior to distribution of the benefits out of the plan) is a "right to receive IRD." PLRs 2002-34019, 2005-20004, 2005-26010, 2006-17020, 2006-20025, 2006-44020, 2006-52028, and 2013-30011. Generally, the transfer of a right to receive IRD, whether by gift or by sale, triggers immediate taxation of the IRD to the transferor. § 691(a)(2). However, this general rule does not apply to a "transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." § 691(a)(2). Instead, in the case of such a transfer, the transferee is taxable on the IRD as and when it is paid to such transferee (or upon a further transfer of the right to receive the IRD by such transferee, if such further transfer is not itself excepted). § 691(a)(1)(C).

Thus, for example, when an estate transfers, to a residuary beneficiary of the estate, an IRA that is payable to the estate, the transfer is not a taxable assignment because it qualifies for the exception under §691(a)(2). In PLR 2002-34019, IRAs were payable to a deceased participant's estate. The residuary beneficiaries of the estate were charities and individuals. The executor (pursuant to power granted in the will to make disproportionate distributions in kind) distributed cash to the individual beneficiaries in satisfaction of their shares, and proposed to transfer the IRA to the charities in payment of their shares. The IRS ruled that transfer of the IRAs to the charities would not be a taxable assignment of IRD under § 691, or create taxable income to the estate or the individual beneficiaries. For other similar rulings, see PLRs 2004-52004 [which, however, does not mention §691], 2005-20004, 2006-17020, 2006-18023, 2006-33009, 2008-26028, 2008-50004, and 2010-13033. More recent rulings include PLRs 2011-28036, 2012-10047, 2012-10045, 2012-08039, and 2013-30011.

For an IRS-blessed transfer of an IRA to a charity from an estate where the will was reformed after the decedent's death to specify that the IRAs would be the source of funding the charitable gifts, see PLR 2008-50004.

There are two limitations in connection with this type of transfer:

- **Plan administrator problems:** Not all retirement plan administrators and IRA providers permit such post-death transfers by the trustee or executor of a trust or estate that is named as beneficiary of the plan or IRA. If possible, ascertain the policy of your client's plan administrator or IRA provider in advance. If confronted post-death with a refusal on this point, determine whether the problem can be solved by providing a legal opinion or (less attractive in view of the expense and delay) a private letter ruling from the IRS. If the benefits are in an IRA, an IRA provider's refusal can be dealt with by moving the account, via plan-to-plan transfer, to a different IRA provider that will allow the transfer. See ¶ 2.6.01(E) of *Life and Death Planning for Retirement Benefits* for discussion of plan-to-plan transfers. If the benefits are in a qualified plan, the option to have the benefits transferred to a cooperative IRA provider is *not* available after the participant's death; if the problem is discovered while the client is still living, urge the client to roll over the money to an IRA to avert the problem.

- **Pecuniary bequests:** The foregoing rationale applies to the transfer of retirement benefits, intact, from a trust (or estate) to the residuary beneficiary(ies) of the trust (or estate). This approach is recommended *only* with respect to a sole residuary beneficiary or (if there are multiple residuary beneficiaries) to any of multiple residuary beneficiaries whose shares are fractional or percentage portions of the residue. It may not work with respect to a pecuniary (fixed-dollar) gift or bequest. The IRS Chief Counsel has opined that a trustee's transfer of retirement benefits in fulfillment of a *pecuniary* gift (in contrast to a fractional or percentage gift) is treated as a "sale" of such benefits, triggering immediate realization of income to the funding trust under § 691(a)(2). See Chief Counsel Advice (CCA) 2006-44020, discussed at ¶ 6.5.08 of *Life and Death Planning for Retirement Benefits*.

7.4.06 ***How to name a charity as beneficiary through a trust***

Here are guidelines to follow if retirement benefits are to be paid to a trust at the client's death, and the trust is to make distributions to charities, and you want the gross income resulting from the retirement plan distributions not to be taxable to the trust, and you also want the maximum estate tax benefit for making the charitable gifts.

These guidelines assume that all or most of the retirement benefits will pass to charity, so that there is no need to be concerned about preserving a "life expectancy of the oldest trust beneficiary" payout for the trust. Preserving a life expectancy payout for noncharitable beneficiaries under a trust when part of the retirement benefits are to be paid to charity is addressed at ¶ 7.3.

✓ **Specify that no estate taxes are to be charged against or paid out of the charity's share.** This is required IF you do not want the estate tax charitable deduction to be reduced by the amount of the estate taxes paid out of the charity's share. Since reducing the charitable deduction would further increase the estate taxes, paying estate taxes out of the charity's share requires a circular calculation to determine the deduction.

✓ **Specify that the retirement plan benefits must be used first to fund the charitable bequests**, and that nonretirement assets are to be used for this purpose only if there are no other assets available. This assures that the trustee will not be required (by state law equitable apportionment principles, the "separate share rule" of § 663, or otherwise) to assign proportionate shares of the retirement benefits and other assets to all beneficiaries; see ¶ 7.4.05.

✓ **Specify that the trustee has authority to distribute assets in kind.** This will assure that the trustee can transfer the retirement plans directly to the charities to fulfill their shares, rather than being compelled to withdraw funds from the retirement plans and then distribute funds to the charities. See ¶ 7.4.05.

✓ **Use fractional rather than pecuniary formulas to define the charitable gifts**, if possible. This allows the fiduciary to fulfill the gift by transferring the retirement benefits intact to the charity, as described in ¶ 7.4.05.

7.5 Seven "Whiches": Types of Charitable Entities

The Tax Code recognizes various types of charities and "split-interest" partially-charitable entities, not all of which are income tax-exempt. This ¶ 7.5 explains which charitable entities are and are not suitable to be named as beneficiaries of traditional (taxable) retirement plan death benefits.

7.5.01 ***Suitable: Public charity***

§ 501 provides an income tax exemption for a lengthy list of organizations, including clubs, burial societies, employee benefit plans and, in § 501(c)(3), the type of organization people usually mean when they refer to "charities": "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve [sic] the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual," and which does not engage in certain proscribed political activities. The definition is similar, though not identical, for § 2055(a)(2) (estate tax deduction for bequests to charity). These organizations are referred to in this Special Report as "public charities," meaning 501(c)(3) organizations that are not private foundations (¶ 7.5.02).

A public charity is exempt from income tax (except for the tax on "unrelated business income" or "UBTI"). § 501(a), (b). Bequests to public charities qualify for the estate tax deduction, up to the value of such property included in the gross estate. § 2055(a).

Lifetime gifts to such charities are deductible for gift tax purposes (§ 2522(a)). Lifetime gifts to *domestic* charities qualify for the income tax charitable deduction. § 170(a). Gifts to some charities qualify for a larger deduction (as a percentage of the donor's gross income) than others, but this distinction is irrelevant to at-death gifts.

Making a bequest of retirement plan death benefits directly to a public charity presents the fewest problems. The planner needs to verify that the organization is an exempt organization under § 501(c)(3) and for a major gift the planner should review each of the Code sections under which a deduction will be claimed, to make sure that the organization in question meets the requirements. This is not generally a problem in the case of gift by a U.S. citizen to typical charities.

7.5.02 ***Suitable: Private foundation***

In general, a private foundation is a "501(c)(3) organization" (¶ 7.5.01) that is primarily supported by contributions of one donor or family. However, the definition of a private foundation is notoriously convoluted (see § 509), especially since there are several different types and not all are subject to the same restrictions. Untangling the various definitions and subsets of private foundations is beyond the scope of this Special Report.

Certain private foundations, although exempt from "regular" income taxes (except the tax on UBTI), are subject to a two percent excise tax on net investment income. § 4940. The § 4940 tax "is a limited excise tax that applies only to the specific types of income listed in that section. Amounts from retirement accounts are deferred compensation income," not part of "the gross investment income" of a foundation, and therefore are *not* subject to the tax, according to PLRs 9838028 and 2000-03055.

These PLRs evidently supercede the earlier PLR 9633006, which ruled that a distribution from a Keogh plan to a foundation was subject to the two percent tax to the extent it represented investment income and gains accumulated inside the retirement plan, but not to the extent it represented contributions to the plan by the decedent or his employer—despite the IRS's contrary even *earlier* PLR 9341008, holding that the tax does not apply to any property a foundation receives as a gift, including IRA death benefits. See Timothy W. Mulcahy, CPA (criticizing PLR 9633006), "Is a Bequest of a Retirement Account to a Private Foundation Subject to Excise Tax?," 85 *Journal of Taxation* 2 (August 1996), p. 108.

7.5.03 ***Suitable: Donor-advised fund***

A donor-advised fund (DAF) is a "public" (501(c)(3)) charity that receives contributions from many individual donors, invests those contributions as separate accounts (one per donor), and distributes the account funds at a later time to "real" charities such as schools, museums, and aid organizations. The donor of the gift (or other individual appointed by the donor) "advises" the DAF which charities to distribute the funds to. The DAF is not obligated to follow the advisor's suggestions but normally does so.

Originally offered by community foundations, DAFs are now run also by mutual fund firms and (unfortunately) some questionable organizations as well. Some problems led Congress to impose more regulations and penalties on DAF abuses; see § 4966 and § 4977. However, most use of DAFs is entirely benign and DAFs are very useful for donors, so hopefully they will continue to exist, and donors will avoid the abusive transactions.

One legitimate use of the DAF is to involve family members (the donor's children, typically) in philanthropy. By leaving assets to a DAF where his children are the advisors, the donor provides a philanthropic role for them. Because a DAF is an income tax-exempt 501(c)(3) charity, funding it with retirement plan death benefits is highly suitable. However, individuals leaving retirement plan death benefits to a DAF should take precautions to make sure the chosen DAF meets any applicable requirements. Gifts may have to be made conditional on the DAF's meeting such requirements, in order to assure the desired tax-free and deductible nature of the contribution, with a contingent gift over to a more typical "public" charity if the chosen DAF does not meet the applicable requirements.

Regarding disclaimers to a DAF, see ¶ 7..2.07, #1.

7.5.04 ***Suitable: Charitable remainder trust***

A Charitable Remainder Trust (CRT), as that term is used here, means a charitable remainder trust that meets the requirements of § 664 and accordingly is income tax-exempt. § 664(c)(1). The general idea of a CRT is that the trust pays out an annual income to one or more noncharitable beneficiaries (such as the donor's spouse or children) either for life or for a term of not more than 20 years. At the end of the life (or term) interest, the remaining trust assets are paid to charity.

A CRT must meet rigid requirements set forth in § 664 and its related regulations: The annual payout to the noncharitable beneficiary is specified in the trust instrument and must be either a fixed dollar amount, in which case the trust is a "charitable remainder annuity trust" or CRAT, or a fixed percentage of the annually-determined value of the trust, in which case the trust is a "charitable remainder unitrust" or CRUT. The annual payout rate of a CRUT must be at least five percent (but not more than 50%). A CRUT is more flexible than a CRAT because it can provide that the annual payout to the noncharitable beneficiary is the unitrust percentage or the net income of the trust if less, and can even provide for "makeup" distributions to the noncharitable beneficiary if in later years the trust's income exceeds the unitrust percentage. However, neither type of CRT can permit the noncharitable beneficiary to receive anything other than the unitrust or annuity payout amount.

The attraction of leaving retirement plan death benefits to a CRT is that the benefits are paid to the CRT with no income tax. Thus, the client's human beneficiaries can receive a life income from reinvestment of the *entire amount* of the retirement benefit. In contrast, if the individuals inherited the benefits as named beneficiaries under the plan, they would have to pay income taxes on the benefits as those were distributed to them, meaning that (once distribution of the benefits is complete) the amount left over for the beneficiaries to invest is substantially reduced. Thus they could expect a larger annual income from the CRT than they would receive by investing the after-tax value of any retirement benefits distributed to them directly.

Another attraction is that the decedent's estate is entitled to an estate tax charitable deduction for the value of the charitable remainder gift. This value is determined using IRS-prescribed actuarial tables and interest rates, and must be at least 10 percent of the date-of-death value of the trust. § 664(d)(1)(D); § 7520.

This is not to suggest that the client's human beneficiaries will receive more money as life beneficiaries of a CRT than they would receive if they were named directly as beneficiaries of the plan. Normally the opposite is true, because an individual named directly as beneficiary of a retirement plan receives the *entire* benefit, not just the income from the benefit. The income beneficiary of a CRT receives only the income from the reinvested plan proceeds; the proceeds themselves (the principal of the CRT) eventually go to the charity. Also, the economic advantage of deferral of distributions over the life expectancy of the beneficiary, if the life expectancy payout method is available, reduces the negative effects of the fact that the distributions are taxable income to the beneficiary; see ¶ 1.1.03 of *Life and Death Planning for Retirement Benefits*.

On the other hand, the payout from a CRT may be more attractive than naming the individual beneficiaries directly as beneficiaries of the retirement plan if long-term deferral is not available—for example, if the proposal (originally made by Senator Max Baucus, and then incorporated into

President Obama's 2014 Budget Proposal) to require a 5-year payout for almost all retirement plan death benefits becomes law—especially when the estate tax benefits of the charitable deduction are taken into account; see ¶ 7.5.06(A), (D). See also ¶ 7.7.04 regarding gifts of NUA stock to a CRT.

7.5.05 ***Income tax rules for CRTs; IRD deduction***

A CRT generally pays no income tax itself (see ¶ 7.5.04), but:

A. Retirement benefits and UBTI. In years prior to 2007, a CRT that received unrelated business taxable income (UBTI) lost its income tax exemption for the year of such receipt. In post-2007 years, there is a 100 percent tax on the UBTI of a CRT (but its other income for the year is tax-exempt). § 664(c)(2). PLRs 9237020 and 9253038 involved CRTs that were to be named as beneficiaries of retirement benefits. The IRS ruled that the trusts in question qualified as CRTs (and thus were tax-exempt as long as they did not have UBTI), and that retirement plan death benefits payable to the trusts would be IRD and have the same character as the income would have had if it had been paid to the deceased participant. These rulings thus imply that retirement plan distributions are *not* UBTI.

B. The multi-tier CRT accounting system. A CRT has a unique internal accounting system, under which every dollar that the CRT receives is allocated to one of several "tiers" based on its federal income tax character (such as ordinary income, capital gain, tax-exempt income, or principal). § 664(b).

In effect, the CRT "remembers" what types of income it has received. Then, when the CRT makes a distribution to the human beneficiary, the distribution is deemed to come out of one of these tiers, and the federal income tax character of the amount is revived. If the distribution to the noncharitable beneficiary is deemed to come out of the ordinary income tier, the beneficiary will have to include that distribution in his gross income as ordinary income.

Distributions to the noncharitable beneficiary are generally assigned to tiers on a "worst-first" basis, so (for example) the noncharitable beneficiary cannot receive any capital gain income from the CRT until the CRT has distributed everything it held in its ordinary income tier.

Some people mistakenly believe that, if they leave a retirement plan to a CRT, the CRT could take a distribution of the entire plan tax-free (correct so far), reinvest the proceeds in municipal bonds (that's ok too), and then pay the tax-exempt municipal bond interest annually to the human beneficiary. This maneuver does not work, because the retirement plan distribution to the CRT (to the extent it is ordinary income) all goes into the "ordinary income" tier. Most retirement plan distributions are ordinary income. Even if the trustee *did* invest the proceeds in municipal bonds, no distribution to the human beneficiary would be treated as coming from the tax-exempt bond interest "tier" until the ordinary income "tier" had been used up.

So, although the CRT pays no income tax when it receives a distribution from a retirement plan, the beneficiary of the CRT will have to pay income tax on the distributions *from* the CRT, to the extent those are deemed to represent the CRT's regurgitation of the retirement plan benefit (or other taxable income) under the tier system.

The 3.8 percent additional tax on "net investment income" (§ 1411; see ¶ 7.4.01) further complicates life for CRTs and their beneficiaries. Beginning in 2013, the tax-exempt CRT must keep track of an additional category of income, "net investment income" (NII). NII includes interest (other than municipal bond interest), dividends, and capital gains, but does not include retirement plan distributions. Thus the CRT must keep track of a new category of ordinary income, namely taxable retirement plan distributions, as distinguished from investment-income-type ordinary income like interest and dividends.

Here's the real new headache: Post-2012 investment income received by the CRT is NII (subject to the NIIT, if and when distributed to the beneficiary), whereas pre-2013 investment income is not subject to NIIT. Is this income regurgitated to beneficiaries on a LIFO or FIFO basis? The IRS's proposed regulations indicate that distributions from a CRT to the individual beneficiary(ies) will be deemed to "carry out" net investment income first and to carry out other types of income only after all the NII has been distributed. See Prop. Reg. § 1.1411-3(c)(2)(i).

But that ordering of distributions contradicts the Code in cases where the CRT has received both capital gains (which are net investment income for purposes of the NIIT, if received after 2012) and one or more retirement plan distributions (which are ordinary income and exempt from the NIIT regardless of when received). The Code provides that all ordinary income is distributed from the CRT before any capital gain is distributed. § 664(b)(1), (2). But the IRS regulation seems to state that capital gain that is post-2012 NII is deemed to be distributed before either retirement plan distributions or pre-2013 ordinary investment income (both of which are not NII), which directly contradicts the Code. Under the Code retirement plan distributions would be deemed distributed prior to distribution of any capital gain, regardless of whether that gain is 0re-2013 or post-2012..

C. **CRTs and the IRD deduction.** Generally, when the beneficiary of a retirement plan receives a distribution from the plan, he must include it in his gross income as income in respect of a decedent (IRD), but he is entitled to an income tax deduction for the federal estate taxes that were paid on those benefits. § 691(c); see ¶ 4.6.04 of *Life and Death Planning for Retirement Benefits* for details. If retirement benefits are paid to a Charitable Remainder Trust, that deduction for practical purposes disappears—nobody gets to use it. There is no mechanism by which a CRT can pass out the IRD deduction to the CRT's human beneficiaries.

The § 691(c) deduction reduces the taxable income of the CRT (i.e., income assigned to the trust's "first tier") in the year the distribution is received from the plan. Reg. § 1.664-1(d)(2). Distributions to the individual beneficiary would be deemed to come out of the "net taxable income" of the CRT (first tier) until it had all been used up. The income of the CRT that was sheltered by the 691(c) deduction would become "principal" that could eventually be distributed to the individual beneficiary tax-free as part of the last tier. However, the tax-free principal of the CRT is not deemed distributed until after all net *taxable* income has been distributed. *This point would never be reached in most CRTs funded with retirement benefits.* Accordingly, under this interpretation, the § 691(c) deduction is essentially "wasted" when retirement benefits are left to a CRT.

The IRS confirmed this interpretation in PLR 1999-01023. Some practitioners disagree with the result in this ruling and argue that the unitrust distributions to the noncharitable beneficiary from the CRT should retain their character as IRD and therefore carry out the IRD deduction to the noncharitable beneficiary along with the taxable income, citing Reg. § 1.691(c)-1(d).

7.5.06 ***Solving planning problems with a CRT***

For a client with any charitable inclination, naming a charitable remainder trust as beneficiary of retirement benefits can help solve estate planning problems in addition to satisfying the charitable intent. For example, it can be a good way to benefit charity while also benefitting an older individual (see "**A**"), multiple adults ("**B**"), the surviving spouse ("**C**"), or a disabled individual ("**D**"), or to dispose of a lump-sum-only plan ("**E**"). But caution is required: See ¶ 7.5.07 for drawbacks, risks, and other reasons NOT to leave benefits to a CRT.

A. **To benefit an older individual.** Naming an older nonspouse individual outright as beneficiary of retirement benefits has the effect of dumping the benefits out of the plan and into the beneficiary's gross income rapidly (over the beneficiary's short life expectancy), so the income taxes get paid up front and the elderly person will have less money available in his later years. In contrast, if the benefits are left to a CRT for the life benefit of that person, he will enjoy a more-or-less steady income from the CRT that will last for his entire life (not run out at the end of some artificial life expectancy from an IRS table).

In addition, the participant's estate will get an estate tax charitable deduction which may free up some other funds that can be given to the same or other beneficiaries. A charitable gift annuity could also be used in this situation; ¶ 7.5.08. The downside is that the individual beneficiary cannot take out more than the pre-set income stream from the CRT (or gift annuity) regardless of need.

Hilda Example: Hilda, age 68, has a $3 million IRA. Her goal is to provide a life income to her sister Justine (age 71) and remainder to a charitable foundation. Leaving the benefits to a trust that provided life income to Justine and remainder to charity would require a rapid fully income-taxable distribution of the account after Hilda's death. Such a trust would not qualify as a see-through trust (because of its nonindividual remainder beneficiary, the charity), so the IRA would have to be entirely distributed within five years after Hilda's death. Even if the trust were a conduit trust (so it qualified as a see-through despite the charitable remainder beneficiary), the benefits would have to be entirely distributed (and taxed) over Justine's relatively short life expectancy (16 years). Assuming the income stream from a CRT would provide sufficient funds for Justine, Hilda should leave her IRA to a CRT for Justine's life benefit. There would be no income tax on distribution of the benefits from the IRA to the CRT, and Hilda's estate would get an estate tax deduction for the value of the charitable remainder. This solution assumes there are other assets available to pay any applicable estate expenses and taxes (see ¶ 7.5.07(A)).

B. **Provide life income for multiple adults.** Naming a noncharitable trust for multiple adult beneficiaries of varying ages produces a nightmare from the point of view of required minimum distributions (RMDs): Either the trust must use the oldest beneficiary's life expectancy to measure RMDs, or the participant must name multiple separate trusts, one for each beneficiary, which could have the effect of chopping up the assets into too many too-small pots. See ¶ 6.2.01 and ¶ 6.3.02 of *Life and Death Planning for Retirement Benefits* for background of that conclusion.

By naming as beneficiary, instead, one CRT that pays a unitrust payout for life to several adult beneficiaries, the participant avoids all RMD problems (because the tax-exempt CRT can cash out the plan benefits immediately upon the participant's death, with no income taxes). The trust produces a more-or-less steady income which can be split among the human beneficiaries. When any of the individual beneficiaries dies, his income share passes to the surviving members of the group, thus providing a crude form of inflation protection. Because the value of the charity's remainder interest (determined actuarially using IRS tables) must exceed 10 percent of the total trust value as of the date of the participant's death, this approach will only work with a small group of adult beneficiaries (*e.g.*, a group of 50-something siblings or friends and 80-something parents); see ¶ 7.5.07(B). § 664(d(1)(D).

Ogden Example: Ogden is single, age 45. He has worked for several companies and as a result he has money in several different qualified plans, 403(b)s, and IRAs. His estate planning goals are: to provide for his parent's needs, if they survive him and need additional funds; to provide something for his siblings; and to benefit charity. He creates a CRT which will pay a five percent unitrust payout in equal shares to the living members of the group consisting of his parents (who are in their 70s) and two siblings (ages 42 and 48). His estate has other assets to pay the estate taxes applicable to his other assets and to the noncharitable interests under the CRT (see ¶ 7.5.07(A) for why this is a concern).

C. For spouse, as a QTIP alternative. For a charitably inclined participant, leaving retirement benefits to a CRT for the life benefit of his surviving spouse can sidestep the drawbacks and risks involved in leaving such benefits outright to the spouse or to a noncharitable trust for her benefit (but see ¶ 7.5.07(C) regarding spousal consent).

Leaving benefits outright to the spouse has major tax advantages (primarily the spousal rollover), but only if the spouse rolls the benefits over to her own retirement plan after the participant's death, and there is no way to guarantee that she will actually do that. Also, the spouse might blow money left to her outright on expenditures the participant wouldn't approve of, and/or leave what's left of it at her death to a beneficiary the participant wouldn't approve of. If the participant leaves the benefit to a QTIP trust to head off these outcomes, there are major income tax drawbacks; see ¶ 3.3.02 of *Life and Death Planning for Retirement Benefits* for details.

In contrast, if benefits are left to a CRT for the spouse's life benefit, the spouse will get an income stream for life, without the drawbacks of leaving benefits to a QTIP trust. There will be no need for the spouse to roll benefits over on the participant's death. The participant can choose the ultimate beneficiary (which has to be a charity of course). If the spouse is the only noncharitable beneficiary (strongly recommended), there will be no estate tax on the benefits either at the participant's death or at the spouse's death (due to the combination of the charitable and marital deductions). § 2056(b)(8).

D. **Disabled beneficiary.** If an individual is receiving means-tested government disability benefits, naming that individual as outright beneficiary of a retirement plan would typically cause the individual to lose his or her government benefits until the inherited retirement plan had been spent down. One alternative is to name a charitable remainder trust for the life benefit of the disabled individual as beneficiary of the retirement plan, and then provide (in the CRT) that the CRT's annuity or unitrust payments will be made to a special needs trust for the benefit of the disabled beneficiary (see ¶ 6.3.11) rather than outright to the disabled beneficiary, as permitted by Rev. Rul. 2002-20, 2002-1 I.R.B. 794.

E. **Lump sum distribution-only plan.** Many qualified retirement plans offer a lump sum distribution as the only permitted form of death benefit. A CRT is a good choice of beneficiary for a lump sum distribution-only plan. By receiving the lump sum distribution tax-free, then paying a unitrust payout for life to, *e.g.*, the participant's adult children, the CRT approximates the life expectancy payout that is not available under the retirement plan.

A "Designated Beneficiary" of a lump-sum-distribution-only plan (including a "see-through trust" named as beneficiary) can instruct the plan to transfer the lump sum, by direct rollover, to an "inherited IRA" (created for the purpose of receiving the distribution) in the name of the deceased participant and payable to the same beneficiary, thus enabling the beneficiary to receive a life expectancy payout (from the "inherited" IRA) even though that is not an option offered by the plan he actually inherited. § 402(c)(11); see ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* for full details on such "nonspouse beneficiary rollovers." Despite the existence of this option, there are still factors that make the CRT an attractive alternative compared with naming a see-through trust as beneficiary of a lump-sum-only plan and expecting that trust to have the benefits transferred to an inherited IRA:

✓ Drafting a see-through trust is a complicated and perilous undertaking, in view of the IRS's problematic "minimum distribution trust rule" regulations. See ¶ 6.2–¶ 6.3 of *Life and Death Planning for Retirement Benefits*. If the trust for some reason does not qualify as a see-through (for example, because the trustee forgets to send required documentation to the plan administrator by October 31 of the year after the year of the participant's death) the nonspouse beneficiary rollover to an inherited IRA is not available (it's available only to "Designated Beneficiaries").

✓ There is the risk that the lump sum benefits, instead of being transferred by direct rollover to an inherited IRA as instructed by the Designated Beneficiary after the participant's death, will by mistake (either of the plan trustee or the IRA provider) be transferred to a taxable account, causing immediate income taxation of the entire lump sum, with no ability to correct the mistake by rolling the money back into the plan or into an IRA. Transferring intended rollover distributions into a taxable account is one of the most common mistakes made in the retirement benefits area. See, *e.g.*, PLRs 2007-03036, 2007-04038, 2007-27027, 2007-09068, 2007-17027, 2007-22030, 2007-27022, 2007-27025, and 2007-32025. When this mistake happens after the participant's death it cannot be corrected (unless the beneficiary happens to be the participant's surviving spouse).

✓ A recent proposal by Senator Max Baucus and President Obama would seek to raise revenue and "simplify" the retirement rules by abolishing the life expectancy payout method and requiring all (almost all) retirement plans to pay out all benefits within five years after the participant's death—with exceptions for surviving spouses, minor beneficiaries, disabled beneficiaries, and beneficiaries the same age as or older than the participant. Should such a drastic change become law, the CRT would become the only tax-advantaged way retirement benefits could be used to provide a life income to the participant's adult nondisabled children.

7.5.07 ***Reasons NOT to leave benefits to a CRT***

Though it is a great planning tool, there are limitations on leaving retirement benefits to a CRT. Beware of leaving too much money to a CRT with individual beneficiaries other than the surviving spouse (see "**A**"), or with individual beneficiaries who are "too young" ("**B**"), or for a nonconsenting surviving spouse ("**C**").

A. Do not overfund CRT with nonspouse beneficiary. When retirement benefits are left to a CRT, the entire value of the benefit is included in the decedent's gross estate for estate tax purposes. The estate tax charitable deduction for a bequest to a CRT will not shelter the entire value from estate taxes. Rather, only the actuarial value of the charitable remainder is allowed as a charitable deduction.

Accordingly, unless the surviving spouse is the sole noncharitable beneficiary of the CRT (in which case her interest is nontaxable because it qualifies for the marital deduction; § 2056(b)(8)), the noncharitable beneficiary's interest in the CRT will in effect be subject to estate tax. The question of who is going to pay that tax and with what funds needs to be settled as part of the estate plan. Leaving too much money to a CRT could cause a tax meltdown.

Ted Example: Ted dies in 2013, leaving his $10 million IRA to a five percent CRUT for the life benefit of his 50-year-old son Todd. There are no other assets in the family. Ted's gross estate is $10 million for federal estate tax purposes. From this amount, the estate is entitled to an estate tax charitable deduction for the value of the charitable remainder under the CRT. This deduction reduces the taxable estate to $7.2 million, still substantially in excess of the federal estate tax exemption amount ($5.25 million for deaths in 2013). There is no money to pay the estate taxes, except in the IRA. Paying the tax from the IRA will cause a cascade effect: The IRA distribution will be subject to income tax, so the IRA needs to distribute substantially more than the amount of the estate taxes just to get the estate tax paid…but using the IRA money for this purposes reduces the bequest to the CRT, which in turn reduces the charitable deduction, which increases the estate tax…

B. **CRT does not work if beneficiaries are too young**. In order to be a qualifying charitable remainder trust, the value of the charitable remainder (as of the date of the gift to the trust, or, in the case of a CRT funded at death, as of the date of death) must be at least 10 percent of the total value of the trust. § 664(d)(1)(D), (d)(2)(D). If the CRT beneficiaries are "too young," and have a life interest, the trust will not meet the 10 percent requirement and it will not qualify as a CRT.

Gerald Example: Gerald, age 75, dies leaving his $1 million IRA to a trust that is to pay a five percent "unitrust" payout to his two grandchildren, ages 14 and 16, for life, with remainder to Gerald's alma mater, Cornell University. The actuarial value of the remainder interest, after the lives of two individuals aged 14 and 16, is only 3.523 percent. Because this is less than 10 percent, the trust "flunks" § 664(d), and it is not a qualified charitable remainder trust. Gerald's estate will not get any charitable deduction for estate tax purposes, and the trust will not be income tax-exempt, so it will have to pay income tax and estate tax on the entire $1 million IRA. Gerald could, instead, leave the benefits to a CRT that would last only for a fixed term of 20 years (thereby passing the 10 percent rule), to make the IRA-to-trust distribution income tax-free.

C. **Spousal consent may be required.** Qualified plan benefits are subject to certain federal-law rights held by the spouse of the worker; accordingly, as to either all or part of a married client's benefit under a qualified plan, it will not be possible to leave it to a CRT without the spouse's consent. See ¶ 3.4 of *Life and Death Planning for Retirement Benefits* for explanation of these requirements. State law marital property rights may affect the participant's ability to freely choose a beneficiary for an IRA.

Connie Example: Connie, age 64, works at Acme Corp. where she has substantial funds in a qualified profit sharing plan. She and her husband are quite wealthy. Her husband, age 69, suffers from mental impairment. It would not be advisable to leave substantial funds to him outright. Connie would like to leave the 401(k) plan to a CRT that would pay a life income to her husband with remainder to a charity. She cannot do this without his consent. Obtaining his consent will require legal guardianship proceedings since he is mentally incompetent.

7.5.08 ***Suitable: Charitable gift annuity***

Under a charitable gift annuity, a sum is left to a charity and the charity agrees to pay a fixed income to a human beneficiary for life. Leaving a retirement plan to a charity subject to the obligation to pay an annuity to the participant's chosen human beneficiary could be a good way to provide an income for an older beneficiary. The participant's estate gets an estate tax deduction for the value of the retirement benefits left to the charity minus the value of the annuity (determined using IRS tables). The benefits are paid to the charity free of income tax. See PLR 2002-30018.

This approach has several advantages compared with the charitable remainder trust (¶ 7.5.06(A)) or a life expectancy payout directly from the retirement plan: The human beneficiary would receive a fixed predictable income (which many beneficiaries prefer to the fluctuating income provided by a charitable remainder unitrust or a life expectancy payout from a retirement plan).

There is no need to draft a CRT. The income is guaranteed to last for the beneficiary's life, not run out at the end of her IRS-defined life expectancy.

For an excellent explanation of charitable gift annuities, including what is known about funding them with retirement benefits, see "Charitable Gift Annuities" by William Finestone, 29 *ACTEC Journal* 37 (Vol. 29, No. 1), Summer 2003.

Edith Example: Edith, age 64, wants to use her $300,000 IRA to provide a secure life income, after her death, to her brother Jeremy, who is four years younger than she, and to fulfill her charitable intentions. The amount is too small to justify creating a charitable remainder trust. A pooled income fund is not suitable (see ¶ 7.5.10). She leaves the IRA to Combined Jewish Philanthropies of Greater Boston subject to the requirement that it pay Jeremy a life income computed at the charitable gift annuity rate in effect on the date of her death.

7.5.09 ***Usually unsuitable: Charitable lead trust***

A charitable lead trust (CLT) is the mirror image of a charitable remainder trust: A "unitrust" or "annuity" income stream is paid to a charity for a term of years, then the underlying property passes to the donor's individual beneficiaries at the end of the term. § 170(f)(2)(B).

Unlike a CRT, however, the CLT is not exempt from income taxes. Thus a CLT named as beneficiary must pay income tax on the benefits as they are distributed from the retirement plan. Because of this, leaving traditional retirement benefits to a CLT appears generally to be a disadvantageous way to fund such a trust.

Generally, the planning advantage of a CLT funded at death is that, in addition to satisfying the donor's charitable intentions, it may allow funds to pass to the donor's descendants free of gift or estate taxes. This phenomenon occurs if the investment performance of the trust "beats" the IRS's § 7520 rate. When the initial bequest is made to the CLT, the IRS § 7520 tables are used to value the charity's and family's respective interests in the trust. The decedent's estate then pays estate tax on the value of the interest passing to the family. If the trust's investments outperform the § 7520 rate, the amount by which the investments outperform the § 7520 rate eventually passes to the family beneficiaries. Since the IRS rates did not predict that this value would exist, the excess value is never subjected to estate tax.

If the CLT is funded with traditional retirement benefits, however, the CLT will generally start out at a disadvantage, since some of the principal that the IRS assumed the trust would have has been used up paying income taxes. This makes it *less* likely that the trust will "beat" the IRS's § 7520 rate, because in effect the trust starts out with a loss. The client may well end up paying estate tax on *more* than the family beneficiaries eventually receive. The CLT thus appears generally an unattractive choice as beneficiary of traditional retirement benefits, though there could be some unique circumstances in which it would work.

Is there any advantage to naming a CLT as beneficiary of a "Roth" IRA, distributions from which are generally income tax-free? Again, probably not. A CLT cannot qualify as a "see-through trust" under the IRS's minimum distribution trust rules, because it has a nonindividual beneficiary (the charity that is the lead beneficiary). Thus, to comply with the minimum distribution rules, all funds would have to be distributed out of the Roth IRA within five years after the participant's death (see ¶ 1.5.03(E) of *Life and Death Planning for Retirement Benefits*). This disposition would waste the potential long-term deferred tax-free payout that is allowed if the Roth IRA is payable to an individual beneficiary or a see-through trust.

7.5.10 ***Unsuitable: Pooled income fund***

With a pooled income fund (§ 642(c)(5)), the donor makes his gift to a fund maintained by the charitable organization that will ultimately receive the gift. The fund invests the gift collectively with gifts from other donors, and pays back to the donor (or to another beneficiary named by the donor) a share of the fund's income corresponding to the relative value of the donor's gift. When the donor (and/or the beneficiary he nominated) dies, the share of the fund attributable to that donor's gift is removed from the fund and transferred to the charitable organization.

The pooled income fund has been called "a poor man's charitable remainder trust," because it provides approximately the same benefits as a CRT (irrevocable gift of remainder interest to charity generates an estate tax charitable deduction, while providing a life income to the donor's human beneficiaries), without the expense of creating and operating a stand-alone CRT. Unlike CRTs, however, pooled income funds are not exempt from income tax. Reg. § 1.642(c)-5(a)(2); compare § 664(c). Therefore, generally retirement plan death benefits paid to a pooled income fund will be subject to income tax in the year received by the fund to the same extent they would be taxable to an individual beneficiary. Accordingly a pooled income fund is not an attractive choice as beneficiary of traditional retirement benefits.

Nor is it an optimal choice as beneficiary for a Roth IRA, because it cannot qualify as a see-through trust; see discussion at end of ¶ 7.5.09.

7.6 Qualified Charitable Distributions

The preceding sections have discussed leaving retirement benefits to charity *at death*, a very tax-favored form of estate planning for traditional retirement benefits. This and the following section discuss ways to transfer retirement benefits to charity *during life*.

Generally, lifetime gifts of retirement benefits are not a tax-favored way to deal with such benefits; see discussion at ¶ 7.7.01. One minor but very popular exception is the "qualified charitable distribution" (QCD)—the ability of *some people* to transfer *a limited amount* of funds directly from *certain types of IRA* to *certain types of charities*. Specifically, an over-age-70½ IRA owner or beneficiary (see ¶ 7.6.02) can instruct the administrator of the IRA (see ¶ 7.6.03) to transfer up to $100,000 in any calendar year (see ¶ 7.6.04) to one or more eligible charities (see ¶ 7.6.05). The amount(s) so transferred is not includible in the gross income of the IRA owner-donor (see ¶ 7.6.06), even though it is a distribution from his or her IRA, and even though it may be used to satisfy the required minimum distribution (se ¶ 7.6.08(A)).

This ¶ 7.6 explains QCDs—the requirements, mechanics, limitations, and benefits.

7.6.01 ***Where to find the law***

The QCD is created by § 408(d)(8), which has in effect been part of the Tax Code since 2006—"in effect" because it was enacted several times on a temporary and often retroactive basis before being made a permanent part of the Code in December 2015.

QCDs were first permitted in calendar year 2006. § 408(d)(8) Originally enacted as a temporary measure (good for IRA distributions in 2006 and 2007 only), § 408(d)(8) was extended in late 2008 for two more taxable years (2008 and 2009). In December 2010, § 408(d)(8) was extended for two more years (2010–2011). The American Taxpayer Relief Act of 2012 (ATRA) extended them *again*, but only through 2013. (All the rest of ATRA's provisions were permanent). They were again allowed by late-in-the-year legislation for 2014, but again as a temporary provision: Subsection (F) of § 408(d)(8) stated that the section would not apply to distributions after 2014. QCDs were re-authorized retroactively for 2015 *and made permanent* for 2015 and later years by the "Protecting Americans from Tax Hikes (PATH) Act of 2015" enacted December 18, 2015, which struck subsection (F). See PATH, section 112. So finally § 408(d)(8) does not have an expiration date!

The Treasury's only authoritative pronouncement on QCDs was and so far remains IRS Notice 2007-7 (Part IX), 2007-5 I.R.B. 395, Q & A 34 through 44.

7.6.02 ***Who can make QCDs: Individuals over age 70½***

Only individuals who are age 70½ or older can make QCDs. § 408(d)(8)(B)(ii).

The QCD donor can be either an IRA participant donating from his own IRA or a beneficiary donating from an inherited IRA. IRS Notice 2007-7, A-37. The only requirement is that the donor (whether owner or beneficiary) must be age 70½ or older.

This is the only tax code provision to make the age 70½ "birthday" itself a significant event. Required minimum distributions are based on the YEAR the participant reaches age 70½, not the DAY he reaches that age. Someone who reaches age 70½ on (say) December 30 could have a tough time getting his IRA provider to make the QCD on the last day of the year. It would have been easier for all concerned to allow QCDs to occur anytime during or after the calendar year the individual reaches age 70½—but that's not what the law says.

Example: In 2014, Jonathan inherited an IRA from his mother. He also has an IRA of his own. Jonathan's 70th birthday was April 1, 2015. He turned 70½ on October 1, 2015. He can make QCDs from either his own IRA or the inherited IRA he holds as beneficiary of his mother (or both) any time on or after October 1, 2015.

7.6.03 ***From IRAs only (but not ongoing SEPs or SIMPLEs)***

QCDs may be made *only* from IRAs. § 408(d)(8)B). So, a QCD can not be made from a "qualified retirement plan," i.e., a plan qualified under § 401(a) of the Code, such as a pension, profit-sharing, Keogh, or 401(k) plan); or from a 403(b) plan; or from a 457 plan.

A QCD can be made from *any type of IRA* (including a Roth IRA) subject to the following exceptions/limitations:

✓ A QCD may **not** be made from an "ongoing" SEP-IRA or SIMPLE IRA. SEPs and SIMPLEs are IRAs funded directly by contributions from the individual's employer. See § 408(k) and § 408(p). An "ongoing" SEP or SIMPLE in any particular year is one that receives an employer contribution in such year. IRS Notice 2007-7, A-36.

✓ A QCD can come from a Roth IRA (to the extent the amount distributed would be included in the owner's gross income if distributed to him or her; see ¶ 7.6.06). § 408(d)(8)(B). But generally a person would not make a QCD from a Roth IRA. For one thing, most Roth IRA distributions are income tax-free, and so not eligible to be the subject of a QCD; see ¶ 5.2.03 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). Even if an over-age 70½ person holds a Roth IRA distributions from which could be partly includible in his/her income (because he/she had not held a Roth IRA for the required 5-year holding period of § 408A(d)(2)(B); see ¶ 5.2.05 of *Life and Death Planning for Retirement Benefits*), the Roth IRA owner can expect that these funds eventually will qualify for income-tax free treatment and it would not be advantageous to throw away that future tax benefit just to make a QCD.

Example: Carl is age 76 and still working at Acme Widget. In 2016, he holds an IRA he inherited from his father, a Roth IRA he had owned for 10 years, a SEP-IRA to which Acme Widget is contributing in 2016, and a 401(k) plan account in the plan of his prior employer, Bacchus Detective Agency. He can make a QCD in 2016 from the inherited IRA. He cannot make a QCD from the Roth IRA because anything distributable to him from that account would be excludible from his income and thus not QCD-eligible. He cannot make a QCD from the SEP-IRA this year because it is "ongoing" (receiving an employer contribution) in 2016. He cannot make a contribution from the 401(k) plan because it is not an IRA.

7.6.04 ***How much? $100,000 per year per IRA owner***

The QCD income exclusion is limited to $100,000 per year. § 408(d)(8)(A). The limit is per IRA owner, not per IRA. "For married individuals filing a joint return, the limit is $100,000 per individual IRA owner." IRS Notice 2007-7, A-34. So, a husband and wife who are both over age 70½ and who both have IRAs can each transfer up to $100,000 to charity from their respective IRAs in the same year. But if (for example) wife has an IRA and husband does not, wife cannot "borrow" husband's limit and give $200,000 from her IRA.

The donor does not have to give that much. $100,000 per IRA owner per year is the maximum and there is no minimum (other than what the IRA provider may impose administratively).

Example: Jody, age 83, gives $5,000 per year to her church and does not make any other charitable gifts. Since 2006 she has made these annual gifts directly from her IRA as QCDs. Her sister Agatha, age 81, gives $200,000 a year to charity. She makes half her annual gift in the form of a QCD and the rest using appreciated stock held in her taxable account.

7.6.05 ***Requirements applicable to charity and donation***

A QCD can be made to any charity EXCEPT a donor-advised fund (§ 4966(d)(2)) or a supporting organization (§ 509(a)(3)). § 408(d)(8)(B)(i).

Also, the QCD must be a contribution that would be 100 percent deductible if paid from the owner's nonIRA assets, so a split-interest gift will NOT qualify. Thus, QCDs can NOT be made to a charitable remainder trust (¶ 7.5.04), pooled income fund (¶ 7.5.10), or charitable gift annuity (¶ 7.5.08), or in exchange for any consideration. Note however that in determining whether the gift would be 100 percent deductible if made with nonIRA assets the percentage-of-income limits in § 170(b) are ignored. § 408(d)(8)(C).

The gift must meet all other requirements applicable to the income tax charitable deduction under § 170, such as the substantiation requirement. IRS Notice 2007-7, A-39.

7.6.06 ***Income tax aspects; effect on basis***

The QCD is excluded from the individual's gross income for all purposes. § 408(d)(8)(A). Thus it cannot be counted as part of the individual's gross income for purposes of applying the percentage-of-income limits in § 170(b) with respect to his other charitable gifts. Of course, there is no income tax charitable deduction for the QCD. IRS Notice 2007-7, A-39.

The QCD must be a distribution that would otherwise be includible in the donor's gross income. § 408(d)(8)(B). Here is the effect of this rule on:

✓ Distributions from Roth IRAs: A qualified distribution from a Roth IRA (see ¶ 5.2.01 of *Life and Death Planning for Retirement Benefits*) cannot be a QCD because a qualified Roth IRA distribution is nontaxable. Thus, QCDs could be made from a Roth IRA only if the Roth IRA had not yet met the requirements for a "qualified distribution." But even then it would normally not be good planning to make a QCD from a Roth IRA; see ¶ 7.6.03.

✓ IRAs where the IRA owner has no after-tax money in any IRA: If the traditional-IRA owner does not have any after-tax money in any of this IRAs, this rule is "no problem" since all distributions from any of his IRAs will consist 100 percent of pretax money (includible in gross income).

✓ If the IRA owner has any "basis" (after-tax money; also called "investment in the contract") in any of his IRA accounts, then the requirement that QCDs must be all pretax money would pose a problem. Under the rule nicknamed the "cream-in-the-coffee rule" of § 72 (explained at ¶ 2.2.08 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011)), any distribution from an IRA carries out proportionate amounts of the "pretax" and "after-tax" money in the individual's IRAs (with all of his traditional IRAs being treated as single account for purposes of determining the proportions).

To accommodate this requirement, there is a special "basis recovery rule" in the Tax Code for QCDs: QCDs are deemed to come out of the IRA's pretax money first. § 408(d)(8)(D).

Burton Example. Burton is a charitably-inclined individual age 71 who does not like to pay taxes. He owns a $70,000 IRA with a $20,000 basis resulting from nondeductible contributions in prior years. He owns no other IRAs. He directs the IRA provider to transfer $50,000 from his IRA directly to the Red Cross. This is a QCD, so the $50,000 is deemed to come from the IRA's pretax money "first." Now he is left with a $20,000 IRA which is 100 percent after-tax money. He can then convert this small "stub" IRA to a Roth IRA tax-free, or cash it out tax-free.

Note that this federal rule does not necessarily have any effect on state tax treatment of the distribution. For example, a particular state's "basis recovery rule" for IRA distributions may or may not accommodate this special federal rule for QCDs. The client and preparer must determine the client's income tax basis (investment in the contract) both before and after the QCD occurs, for both federal and (if applicable) state purposes.

7.6.07 ***How to do it; how to report it***

To effect a QCD, the IRA owner directs the IRA provider/administrator to transfer funds from the IRA to the charity. The donor-IRA owner should communicate with her IRA provider regarding its policies and preferred procedures for carrying out these transfers. One acceptable procedure is for the IRA provider to cut a check payable to the charity and have the donor physically deliver the check to the charity. IRS Notice 2007-7, A-41.

The IRA custodian is supposed to report the QCD on Form 1099-R, just as if it had paid the distribution to the individual donor rather than to a charity. There is no special code or other indication on Form 1099-R signaling that the distribution is a QCD. Thus, nothing in the 1099-R will reveal that the distribution is nontaxable! As the IRS put it in the instructions for Form 1099-R (2013), p. 1, "There's no special reporting" that IRA providers have to do for qualified charitable distributions.

Instead, it's up to the IRA owner-donor to report the nontaxable status, in the following manner: First, he enters the total distribution (as shown on Form 1099-R) on Line 15a of his personal income tax return, Form 1040. Then he enters the taxable portion of the distribution (zero, if the QCD was the only distribution for the year) on Line 15b. See instructions for IRS Form 1040, 2014, p. 24, Lines 15a and 15b, Exception 3. Then the donor is supposed to "Enter 'QCD' next to line 15b," apparently by hand in the margin of the tax form.

This method of reporting QCDs presumably means that some QCD-donors will not get the benefit of the income tax exclusion. This will happen if the IRA owner-donor simply turns over all his 1099-Rs to his tax preparer without alerting the preparer to the fact that there was a QCD. The preparer will then presumably simply report the entire distribution as taxable, and if the client doesn't notice that discrepancy but simply signs and files the return, the U.S. Treasury will collect a bit more money than it's entitled to.

*7.6.08 **Using QCDs for the RMD; other planning uses and pitfalls of QCDs***

The QCD will not save anyone millions of dollars of taxes, but it is nevertheless a safe legal tax-favored way for an over-age-70½ client to use his IRA to benefit charity. Despite a few kinks and pitfalls, the QCD is a low-tax way to fulfill the minimum distribution requirement for the charitably inclined client.

A. **Use QCD to fulfill RMD.** A QCD will count as a distribution for purposes of determining whether an individual has fulfilled the RMD requirement. IRS Notice 2007-7, A-42. This is consistent with Regs. § 1.401(a)(9)-5, A-9(a), and § 1.408-8, A-11(a), which state that, except as otherwise provided in A-9(b) or A-11(b) of such regulations, or as may later be otherwise provided by other IRS pronouncements, "all amounts distributed" from a plan or IRA "are taken into account in determining whether section 401(a)(9) is satisfied…." The charitable IRA rollover is an ideal way for a charitably-inclined individual over age 70½ to fulfill the RMD requirement.

B. **Mixing up QCDs and RMDs.** Someone who has already taken his RMD for a particular year cannot use a QCD later in the year to fulfill his RMD requirement for that year; he cannot roll the already-taken RMD back into the IRA (to enable him to use a QCD instead) because RMDs are not eligible rollover distributions. See ¶ 2.6.03 of *Life and Death Planning for Retirement Benefits*. He can still make a QCD from his IRA; it just will not be his RMD. People will get confused about the RMD/QCD relationship. The two things have nothing to do with each other (other than the fact that a QCD counts towards the RMD, to the extent the RMD has not already been taken). A person can make QCDs of up to but not more than $100,000 (in any year QCDS are permitted), *regardless* of: whether his RMD for the year is more or less than $100,000; *regardless* of whether he has already taken the RMD; and *regardless* of what other distributions he has taken or later takes from the IRA.

C. **Advantages of the QCD.** The QCD eliminates *some* of the problems that arise when making lifetime charitable gifts from an IRA (see ¶ 7.7.01). A QCD does not increase AGI and therefore does not: increase the individual's adjusted gross income for purposes of determining the extent to which his "net investment income" will be taxed (§ 1411); decrease the deductibility of medical expenses (§ 213(a)) or miscellaneous itemized deductions (§ 67(a)); increase the reduction of itemized deductions (§ 68(a)); increase the taxability of Social Security benefits (§ 86); increase Medicare premiums (42 U.S. Code §1395r(i)); or increase state income taxes (in a state that uses federal AGI as the basis for computing state income tax but does not allow a charitable deduction). Since there is no itemized charitable deduction for the QCD gift, the gift does not "count" for purposes of the percentage-of-income limits on charitable deductions in § 170(b); does not get reduced by § 68(a); and is in effect "deductible" even for someone who does not itemize deductions.

D. **Fulfilment of pledge.** A QCD is considered a payment "to" the participant for purposes of the prohibited transaction rules. Thus, it is not a prohibited transaction even if it is used to fulfill a pledge to the charity. IRS Notice 2007-7, A-44.

E. **Drawbacks, problems, and what will go wrong.** QCDs are allowed only for direct transfers from the IRA to one of the permitted types of charitable recipients. If the money is first distributed to the individual, then donated to charity, it is not a QCD, and all the usual limits and drawbacks described at ¶ 7.7.01 will apply (there was an exception to this for certain charitable transfers in January 2013). While it might appear desirable for an over-age 70½ individual to use QCDs to fund all of his charitable contributions, there will be practical limits on this: Presumably, IRA providers will start charging "distribution fees" or setting minimum distribution amounts if they are asked to issue dozens of tiny QCDs. Finally, for an IRA owner who wants to give more to charity than just the amount of his/her RMD, the donor-owner should determine whether another form of charitable gift would be more advantageous for such additional gifting (such as gifts of appreciated stock from a taxable account).

7.7 Other Lifetime Gifts of Retirement Benefits

This ¶ 7.7 discusses charitable giving options for individuals who have money in IRAs and other retirement plans. Most of the considerations discussed here apply to both living participants and beneficiaries (with respect to inherited benefits they hold).

7.7.01 ***Lifetime gifts from distributions***

A client who has more money in his retirement plan than he expects to need may wish to give some of it to charity. Generally, the only way he can do this is to first withdraw funds from the plan and then give the funds to the charity. For one minor but popular technique that is an exception to this general rule, see "Qualified Charitable Distributions" (¶ 7.6).

Withdrawing funds or other assets from a retirement plan generally causes the value of the withdrawn property to be included in the recipient's income. If the recipient then donates the withdrawn amounts to charity in the same year that he took the distribution, the income tax charitable deduction *theoretically* should eliminate the tax on the distribution. Unfortunately the following obstacles often prevent the income tax charitable deduction from wiping out the tax cost of the distribution:

A. **Percent-of-income limit.** The income tax deduction for charitable contributions is limited to a certain percentage (30% or 50%, depending on the type of property given and the type of recipient charity) of the individual's gross income. § 170(b). If the individual's donations exceed the deduction limit, the excess can be carried forward for a limited number of years.

B. **Deduction-reduction for high-income taxpayers.** Charitable deductions are an itemized deduction, subject to the "reduction of itemized deductions" that applies to high-income individual taxpayers in years before 2009 or after 2012. § 68. The *amount* of the reduction is a percentage of the donor's AGI—so the potential reduction is increased by the plan distribution, which increases AGI. The phaseout begins at $250,000 of AGI for single taxpayers ($300,000 for married filing jointly).

C. PEP for high-income taxpayers. The personal exemption deduction is phased out under a different Code section (§ 151(d)) and schedule, again beginning at $250,000 of AGI for single taxpayers ($300,000 for married filing jointly). A retirement plan distribution, by increasing AGI, may cause loss of some or all of the taxpayer's personal exemption. The charitable contribution does not offset this.

D. Deduction decreases taxable income but not AGI. Because the distribution is included in the individual's gross income, it may increase his taxes in other indirect ways that are not offset by the charitable deduction, because the distribution increases his adjusted gross income (AGI) and the charitable deduction does not decrease AGI. For example, the plan distribution could decrease his medical expense deduction (limited to expenses in excess of 7.5% or 10% of AGI; see § 213) and miscellaneous itemized deductions (limited to expenses in excess of 2% of AGI; see § 67); increase his Medicare premiums; decrease his eligibility to contribute to a Roth IRA (see ¶ 5.3.04 of *Life and Death Planning for Retirement Benefits*); and/or increase the taxability of his Social Security benefits (see § 86).

E. Split-interest gifts are only partially deductible. If the gift is made to a charitable remainder or lead trust, to a pooled income fund, or in the form of a charitable gift annuity, the amount of the deduction is only part of the total gift (since a portion of the gift is benefitting individuals), even though all of the plan distribution was includible in income.

F. Penalty for pre-age 59½ distributions. If the participant is under age 59½ at the time of the distribution, there is a 10 percent penalty on the distribution unless an exception applies. § 72(t); see Chapter 9 of *Life and Death Planning for Retirement Benefits.* The charitable deduction has no effect on this penalty. See ¶ 7.7.03 for a lifetime charitable giving strategy for under-age-59½ individuals. This penalty does not apply to beneficiaries. § 72(t)(2)(A)(ii).

G. State income taxes. In a state that allows no charitable deduction in computing its income tax, the participant would pay state tax on the distribution but get no offsetting deduction.

H. Nonitemizers. An individual who uses the "standard deduction" rather than itemizing his deductions would see no income tax benefit from the charitable contribution.

I. Extra tax on net investment income. An additional 3.8% tax applies to the investment income in excess of a certain threshold amount of taxpayers whose adjusted gross income exceeds $250,000. § 1411. An IRA distribution will normally increase the recipient's gross income for purposes of determining how much of his investment income is subject to the 3.8% tax, but an itemized charitable deduction will not reduce it.

Some drawbacks can be minimized by using smaller distributions and smaller gifts (see ¶ 7.7.02–¶ 7.7.03). Also, certain forms of retirement plan distributions (see ¶ 7.7.04–¶ 7.7.06) are not subject to full normal income tax, and so may offer an opportunity for tax-effective charitable giving.

7.7.02 ***Give your RMD to charity***

A retirement plan participant generally must start taking required minimum distributions (RMDs) annually (except in 2009) from his IRAs and other plans after age 70½ (or after retirement in some cases). See Chapter 1 of *Life and Death Planning for Retirement Benefits*. If the participant does not need his RMDs for other purposes, this would be an appropriate source of charitable gifts. The drawbacks listed at ¶ 7.7.01 still apply, but since he has to take the unneeded RMD anyway, he might as well give it to charity; and in most cases he will receive *some* income tax benefit from the charitable gift. A pledge to "give my RMDs to charity" would especially make sense for someone who is planning to leave the balance of the account to charity at his death.

A beneficiary who has inherited a retirement plan is also generally required to take annual RMDs from the plan. If a beneficiary does not need the distributions from an inherited retirement plan, he might consider giving them to charity. Ideally, the participant should have left the benefits directly to charity in the first place, rather than leaving them to a rich beneficiary who does not want them. However, if that did not happen, and the beneficiary is receiving a stream of unneeded RMDs, the beneficiary could reduce his income tax liability by giving the distributions to his favorite charity as he receives them. This approach is especially appropriate for a younger wealthy donor, who generally cannot take distributions from his *own* retirement plan without paying a 10 percent penalty (see ¶ 7.7.03); the penalty does not apply to distributions from an inherited plan. § 72(t)(2)(A)(ii).

If the participant's estate was subject to federal estate taxes, the beneficiary is entitled to an income tax deduction (the "IRD deduction") as he takes distributions from the inherited plan, for the estate taxes attributable to that plan. See § 691(c). By giving the distribution to charity, he gets both deductions.

A Qualified Charitable Distribution can be used to satisfy the distribution requirement in any year when QCDs are permitted; see ¶ 7.6.08.

7.7.03 ***Gifts from a pre-age 59½ "SOSEPP"***

A 10 percent additional tax generally applies to retirement plan distributions taken before reaching age 59½. § 72(t); see Chapter 9 of *Life and Death Planning for Retirement Benefits* for details regarding this penalty and its exceptions. A young individual who wanted to give some of his retirement benefits to charity would be discouraged from doing so by this penalty. This penalty does not apply to death benefits (§ 72(t)(2)(A)(ii)), so it affects only participants, not beneficiaries.

One of the more than a dozen exceptions to this penalty is well suited for fulfilling a pledge of annual gifts to a charity. It is called the "series of substantially equal periodic payments" (SOSEPP). § 72(t)(2)(A)(iv). The series must meet extensive IRS requirements; see ¶ 9.2–¶ 9.3 of *Life and Death Planning for Retirement Benefits*.

Cornelia Example: Cornelia, age 52, has $3 million in a rollover IRA, and $10 million outside of the IRA, of which more than $9 million is in real estate. She has pledged $100,000 a year for 10 years to her favorite charity. She would like to take this money out of her IRA rather than diminish the smaller pool of liquid funds she has outside her retirement plans. Working with her accountant, she determines that an IRA of $1.6 million would support a "SOSEPP" of approximately $100,000 a year for someone her age, based on the IRS-prescribed methods, interest rates, and actuarial assumptions. She divides her $3 million IRA into two separate IRAs, one holding $1.6 million and the other $1.4 million. She starts taking annual distributions of $100,000 from the $1.6 million IRA, penalty-free, and uses those distributions to fund her charitable pledge.

7.7.04 ***Gift of NUA stock***

The Code gives special favorable treatment to distributions of employer stock from a qualified plan. Any increase in value of such stock, occurring while the stock is in the plan, over the plan's "cost basis" in the stock is called "net unrealized appreciation" (NUA). Under certain circumstances, NUA is not taxed at the time of the distribution; rather, taxation is postponed until the stock is later sold. See ¶ 2.5 of *Life and Death Planning for Retirement Benefits*.

A retired employee who holds stock with not-yet-taxed NUA apparently has the same options that other individuals owning appreciated stock have when they wish to diversify their investments and/or increase the income from their portfolios: Either sell the stock, pay the capital gain tax, and reinvest the net proceeds; or, contribute the stock to a Charitable Remainder Trust (¶ 7.5.04) reserving a life income, thus avoiding the capital gain tax and generating an income tax deduction besides. It is advisable to obtain an IRS ruling if using this technique; see PLRs 1999-19039, 2000-38050, and 2002-15032 for examples of use of this technique.

7.7.05 ***Gift of other low-tax lump sum distribution***

"NUA" is not the only special tax deal available for qualifying lump sum distributions (LSDs). An LSD to a participant who was born before January 2, 1936 (or to the beneficiaries of such a participant) qualifies for a special tax treatment under which the distribution is excluded from the recipient's gross income and taxed under a separate rate schedule. This schedule would typically produce a lower-than-normal tax on LSDs up to a few hundred thousand dollars. See ¶ 2.4.06 of *Life and Death Planning for Retirement Benefits*.

The special tax treatment for LSDs has a mixed effect on charitable giving. The effect may be favorable: Since the LSD is excluded from the recipient's gross income, the recipient may be able to pay the low LSD rate on the distribution, give the distribution to charity, and deduct the gift from his other income, thus saving taxes at his regular income tax rate. Or the effect may be unfavorable: If the distribution is large enough, excluding it from gross income may cause a large charitable gift to exceed the percentage-of-AGI limits on charitable deductions (¶ 7.7.01(A)).

7.7.06 ***Give ESOP qualified replacement property to CRT***

The Code allows a business owner, if various requirements are met, to sell stock of his company to an "employee stock ownership plan" (ESOP), then reinvest the proceeds in marketable securities ("qualified replacement property"), without paying income tax on the sale. § 1042. The untaxed gain carries over to the qualified replacement property and the capital gain tax thus deferred will be paid when the taxpayer "disposes of" the qualified replacement property.

A disposition of the qualified replacement property "by gift" does not trigger this recapture provision, but since the Code doesn't define "gift," there is some question whether transferring qualified replacement property to a Charitable Remainder Trust (which is not totally a gift if the donor retains an income interest) is considered a gift for this purpose. PLR 9732023 answered this question favorably to the taxpayer involved in that ruling, concluding that "the contribution of the qualified replacement property to the charitable remainder unitrust will not cause a recapture of the gain deferred by the Taxpayers under section 1042(a)...."

Unfortunately, even aside from the fact that a private letter ruling cannot be relied on as precedent, the language of the ruling is ambiguous and limited. It says: "In the present case, the transfer of the [qualified replacement property] to the charitable remainder unitrust constitutes a disposition of such property within the meaning of section 1042(e) of the Code. However under the facts of the present case, no gain is realized by the Taxpayers on the transfer...," with no indication of *why* no gain is realized. Presumably the rationale is that the transfer is a gift, and therefore excepted from the recognition of gain.

7.8 Putting it All Together

Here are planning principles that emerge from the discussion in this Special Report:

1. If a client wants to make charitable gifts as part of his estate plan, consider using retirement benefits as a tax-efficient way to fund such gifts. ¶ 7.1.02(B).

2. If part of the client's IRA is to be paid to individuals and part to charity, and use of the life expectancy payout is an important goal for the individual beneficiaries, consider establishing separate IRAs, one payable to the charity and one to the individuals. ¶ 7.2.02(C).

3. If benefits are left to a trust with individual and charitable beneficiaries, determine which is more important, the life expectancy payout or the charitable gift. It may be necessary to sacrifice one goal to achieve the other, or establish separate trusts to achieve both. ¶ 7.3.03.

4. If benefits are to be left to a charity through a noncharitable trust or an estate, take care, both at the drafting and the administrative stages, to assure that the trust or estate does not become liable for income taxes on the benefits intended to go to the charity. ¶ 7.4.

5. Consider leaving retirement benefits to a public charity, a private foundation, a charitable remainder trust, a gift annuity, or a donor-advised fund; generally do not name a charitable lead trust or pooled income fund as beneficiary of a retirement plan. ¶ 7.5.

6. Consider lifetime gifts to charity using NUA or ESOP stock, required distributions, or a series of substantially equal payments; if over 70½, use Qualified Charitable Distributions (in years when QCDs are permitted) to satisfy all or part of your IRA minimum distributions.

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Charitable giving law: Conrad Teitell, Esq., is one of the country's top experts in the tax law of charitable giving, and fortunately for the rest of us he is also a prolific author and superb public speaker. For access to his books, newsletters, and seminars, visit http://www.taxwisegiving.com/.

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