GIFTS FROM RETIREMENT PLANS: LAWS, OPPORTUNITIES AND PITFALLS

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I. Tax Planning Ground-Rules For Charitable Gifts

1. **Lifetime Gifts** -- The best asset to use for a major lifetime outright or deferred charitable gift is appreciated stock, appreciated mutual funds or appreciated real estate. In the case of museums and universities, gifts of appreciated charitable assets (paintings, historic artifacts, etc.) can also be advantageous. The advantage is that the donor can usually deduct the appreciated value without having to recognize any taxable income from the growth in value.

By comparison, a lifetime gift from a retirement account does not produce favorable tax treatment for an outright charitable gift and it produces horrible tax consequences (with one exception) for a lifetime deferred gift. If "Charitable IRA Rollover" is enacted, the tax treatment for outright gifts will be somewhat improved and for deferred gifts will be dramatically improved. Still, even if "Charitable IRA Rollover" is enacted, most donors will still have greater tax savings by contributing highly appreciated stock, mutual funds or real estate than by contributing amounts from their IRA.

2. **Bequests** -- The best asset to use for a charitable bequest is any asset that produces income in respect of a decedent ("IRD"). Whereas most inheritances are exempt from the income tax, a person who inherits IRD must pay income tax in the year it is received. Usually the largest source of IRD in people's estates will be a retirement account. Other such assets may include savings bonds and installment sale notes.

It is better to leave the taxable IRD in retirement accounts to a tax-exempt charity, thereby freeing up other tax-free assets in the estate (including stock, mutual funds and real estate) to be distributed to tax-paying family members and friends. Thus, retirement accounts are great sources for charitable bequests.

II. Different Types of Qualified Retirement Plans -- Rules That Make Charitable Gifts from Some Types of Plans Harder than Others.

A. Different types of plans

1. **Section 401(a) Plans (Company plans and "Keogh" plans)**

Account Plans

Money purchase pensions — Stock bonus plans
Profit sharing plans — ESOPs
Section 401(k) plans

Annuity Plans (payments stop when retiree dies)
Defined benefit plans
Annuity plans

2. **Individual Retirement Accounts (Section 408 Plans)**
Individual Retirement Accounts
Individual Retirement Annuities
Simplified Employee Pension"SEP" (usually IRA accounts)
SIMPLE Plans (also accounts in IRAs)

3. **Charities and Government Employers (Sections 403(b) & 457(b))**
Tax-sheltered custodial accounts; Tax-sheltered annuities

4. **Roth IRA (and in 2006: Roth 401(k) and Roth 403(b))**
With a Roth account, there is no tax deduction when amounts are deposited into the account. After 5 years all distributions from the account are exempt from income tax if paid to the Roth owner after age 59 ½ or if paid to a beneficiary after death. For income tax purposes, these are the best assets that a person can inherit. Charitable gift planners should recognize this principle and suggest that beneficiaries of Roth accounts be family and friends and that other assets be used for a charitable bequest.

B. Restrictions on lifetime charitable distributions

1. **Restrictions imposed by law** - Retirement plan assets are designed to provide retirement income to an employee when he or she leaves the work force. Thus, there are laws that prohibit distributions to employees while they are still employed. For example, a 401(k) plan is prohibited from making a distribution to an individual before age 59 ½ or until the employee separates from service, whichever is earlier. §401(k)(2)(B).

2. **Restrictions imposed by the employer** -- An employer may impose additional restrictions. For example, although the law may permit distributions from 401(k) plans when an employee attains age 59 ½, most plans will prohibit such distributions and will not allow distributions until the employee quits.

3. **Restrictions imposed by an IRA administrator** - Whereas an employee can only withdraw amounts from a company retirement account in accordance with the terms of the retirement plan, a person can withdraw money from an IRA at any time. If done before age 59 ½, there is generally a 10% penalty. §72(t).

The problem for charitable giving is that IRA administrators will insist that every withdrawal from an IRA consist of a distribution to the IRA owner. In other words, an IRA administrator will not normally issue a check to a charity or to some other individual.

Thus, there is no way under current law or administrative practices for someone to contribute their retirement account to charity during his or her lifetime in the same manner as a person can contribute stock or real estate. If the source of a charitable contribution will be a retirement account, the donor must generally go through the 2-step process of (1) receiving a taxable distribution from the retirement account and then (2) making a charitable gift from the proceeds of the distribution. If Charitable IRA Rollover is enacted, IRA administrators will have to change their computer programs to allow lifetime checks to a charity from a retirement account in order for the IRA Owner to avoid recognizing taxable income from the charitable distribution.

III. MINIMUM DISTRIBUTIONS AND THE 50% PENALTY TAX

A. Tax Planning Objective – Keep Large Balance During Lifetime and After Death, Too! The tax planning strategy that most advisors follow is to structure IRA and QRP accounts in such a way that only the smallest amounts will be required to be distributed. Smaller distributions permit greater amounts to remain in the QRP or IRA account, thereby producing greater income.

EXAMPLE: By leaving amounts in the plan, a person can have over 50% more investment income each year (e.g., $10,000 per year rather than $6,000 assuming a 10% yield, or $5,000 rather than $3,000 assuming a 5% yield, etc. etc.).

	Principal	10% Yield		5% Yield	
Amount in IRA	$100,000	10%	$ 10,000	5%	$ 5,000
Income Tax on Distribution (40%)	40,000				
Amount Left to Invest	$ 60,000	10%	$ 6,000	5%	$ 3,000

In order to force QRP and IRA accounts to be used to provide retirement income, Congress enacted two significant penalties on account beneficiaries for non-retirement uses of these assets. First, there is a 10% penalty tax for most distributions before age 59 ½.. Sec 72(t). Second, there is a 50% penalty tax imposed on the account owner for not receiving sufficiently large distributions after attaining the age of 70 ½ or retiring, whichever occurs later. Sec. 4974; Reg. Sec. 54.4974-2. The 50% penalty tax also applies after the account owner's death to beneficiaries who fail to receive the post-death minimum amounts. Distributions from any of the qualified retirement plans, IRAs and 403(b) plans described above are potentially subject to the 50% penalty tax.

B. Basic Planning Strategy If a Charity Is a Beneficiary

1. Lifetime distributions – Over the account owner's lifetime the minimum distributions are generally the same whether a charity is named as a beneficiary or not. During a person's lifetime, there is no problem naming a charity as a beneficiary of part or all of the account.

2. After the account owner's death. The administrator will generally want to "cash out" the charity's share of the account before the "determination date" (September 30 of the year that follows the year that the account owner died). If the remaining beneficiaries are all "designated beneficiaries" (e.g., human beings), then the decedent's IRA can be a "stretch IRA."

C. REQUIRED LIFETIME DISTRIBUTIONS AFTER AGE 70 ½

GENERAL RULES – Unless you are married to someone who is more than ten years younger than you, there is one -- and only one -- table of numbers that tells you the portion of your IRA, 403(b) plan or qualified retirement plan that must be distributed to you each year after you attain the age of 70 ½. The only exception to this table is if (1) you are married to a person who is more than ten years younger than you and (2) she or he is the only beneficiary on the account. In that case the required amounts are even less than the amounts shown in the table. To be exact, the required amounts are based on the actual joint life expectancy of you and your younger spouse. *Thus, after 2002, there is no negative impact to a person's mandatory lifetime distributions from naming a charity as a primary or contingent beneficiary of any type of qualified retirement plan account, including an IRA.*

TWO SIMPLE STEPS: **Step 1:** Find out the value of your investments in your retirement plan account on the last day of the preceding year. For example, on New Years Day -- look at the closing stock prices for December 31. **Step 2**: Multiply the value of your investments by the percentage in the table that is next to the age that you will be at the end of this year. This is the minimum amount that you must receive this year to avoid a 50% penalty.

> Example: Ann T. Emm had $100,000 in her only IRA at the beginning of the year. She will be age 80 at the end of this year. She must receive at least $5,350 during the year to avoid a 50% penalty (5.35% times $100,000).

--UNIFORM LIFETIME DISTRIBUTION TABLE –

Age	*Payout*						
70	3.65%	80	5.35%	90	8.78%	100	15.88%
71	3.78%	81	5.59%	91	9.26%	101	16.95%
72	3.91%	82	5.85%	92	9.81%	102	18.19%
73	4.05%	83	6.14%	93	10.42%	103	19.24%
74	4.21%	84	6.46%	94	10.99%	104	20.41%
75	4.37%	85	6.76%	95	11.63%	105	22.23%
76	4.55%	86	7.10%	96	12.35%	106	23.81%
77	4.72%	87	7.47%	97	13.16%	107	25.65%
78	4.93%	88	7.88%	98	14.09%	108	27.03%
79	5.13%	89	8.33%	99	14.93%	109	29.42%

[Table computed from Table A-2 of Reg. Sec. 1.401(a)(9)-9 (2002) -- (rounded up)]

D. MANDATORY LIQUIDATION OF ACCOUNT AFTER DEATH

1. LAW: Maximum *Possible* Number of Years to Liquidate the Account: The life expectancy of the person named as the beneficiary! This could be 80 years! An IRA of a decedent paid over the beneficiary's remaining life expectancy is often referred to as a "*stretch IRA*"

2. SPOUSES: A surviving spouse (but nobody else) also has the option to "rollover"a distribution from her/his deceased spouse's retirement account into a new IRA.

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	82.4	20	63.0	40	43.6	60	25.2	80	10.2
1	81.6	21	62.1	41	42.7	61	24.4	81	9.7
2	80.6	22	61.1	42	41.7	62	23.5	82	9.1
3	79.7	23	60.1	43	40.7	63	22.7	83	8.6
4	78.7	24	59.1	44	39.8	64	21.8	84	8.1
5	77.7	25	58.2	45	38.8	65	21.0	85	7.6
6	76.7	26	57.2	46	37.9	66	20.2	86	7.1
7	75.8	27	56.2	47	37.0	67	19.4	87	6.7
8	74.8	28	55.3	48	36.0	68	18.6	88	6.3
9	73.8	29	54.3	49	35.1	69	17.8	89	5.9
10	72.8	30	53.3	50	34.2	70	17.0	90	5.5
11	71.8	31	52.4	51	33.3	71	16.3	91	5.2
12	70.8	32	51.4	52	32.3	72	15.5	92	4.9
13	69.9	33	50.4	53	31.4	73	14.8	93	4.6
14	68.9	34	49.4	54	30.5	74	14.1	94	4.3
15	67.9	35	48.5	55	29.6	75	13.4	95	4.1
16	66.9	36	47.5	56	28.7	76	12.7	96	3.8
17	66.0	37	46.5	57	27.9	77	12.1	97	3.6
18	65.0	38	45.6	58	27.0	78	11.4	98	3.4
19	64.0	39	44.6	59	26.1	79	10.8	99	3.1

Table A-1 of Reg. Sec. 1.401(a)(9)-9 ("single life "), required by Reg. Sec. 1.401(a)(9)-5, Q&A 5(a) & 5(c) and Q&A 6.

3. COMPANY POLICIES: liquidate account within one year of death.

a. STRETCH 401(k) POSSIBLE? Whereas *every qualified plan* <u>*can*</u> legally make distributions over a person's life expectancy, *most company plans* <u>*don't*</u>. Most corporations have policies to liquidate accounts within one year of death. Companies don't want the hassle of tracking down every descendent of every employee for the next 80 years. That is why stretched payout arrangements are referred to as "*stretch IRAs*" – IRA administrators are glad to have the business from the heirs for 30, 40 or 50 years or more, but employers don't want the burden.

b. CHARITABLE PLANNING OPPORTUNITY – Whereas a surviving spouse can *rollover* a complete distribution from a deceased employee's retirement account, nobody else can. Employees who are not married might consider naming a tax-exempt charitable remainder trust as a beneficiary. The CRT can have the effect of a post-death IRA rollover.

EXAMPLE: Wynn Doh Sill, a widower, works for a company that routinely liquidates retirement accounts within one year of an employee's death. He has a $200,000 balance in his account which would shrink to $120,000 if it were liquidated in one year (after paying $80,000 of federal and state income taxes on the taxable distribution). He had planned to name his two sons (Penn Sill and Sten Sill) as beneficiaries upon his death, but then they would incur the $80,000 income tax liability when the inherited the $200,000 taxable IRD distribution. They could *not* do a rollover of an inherited distribution – only a surviving spouse can do that. When Wynn retires he could rollover the entire amount into an IRA that could eventually become a stretch IRA for his children upon his death, but how can he protect his children if he dies on the job?

SOLUTION: Name a charitable remainder trust as the beneficiary of his company retirement account. If he dies while still employed, the retirement account would make a tax-free transfer of the $200,000 to a tax-exempt CRT. PLRs 199901023 (Oct. 8, 1998), 9634019 (May 24, 1996), 9253038 (Oct. 5, 1992) and 9237020 (June 12, 1992). The CRT will be able to invest the entire $200,000 to produce investment income, whereas his sons might have only had the $120,000 of after-tax proceeds to invest. Upon the death of the last son, the entire $200,000 in the CRT will be distributed to his favorite charity to support a charitable cause.

ANNUITY CONTACTS: Some annuity contracts have lump sum payments if an annuitant dies within 10 years of purchasing the contract. These payments are usually IRD. A charitable remainder trust could provide the virtual equivalent of "rollover" treatment for such payments.

IV. INCOME TAX IMPLICATIONS OF LIFETIME GIFTS -- FAMILY and CHARITY

A. Income Tax Consequences of Charitable Gifts from Retirement Accounts

1. Lifetime outright gifts - current law

Any lifetime charitable gift from any sort of retirement plan account (IRA, 403(b), 401(k), profit sharing, etc.) must be reported on the account owner's income tax return. The donor can then claim an offsetting charitable income tax deduction.

> Example: In October, Ms. Donor caused $10,000 to be transferred directly from her Sec. 403(b) tax-sheltered annuity to her favorite charity. She never touched the money. In January she will receive a Form 1099-R that informs her that she must report a taxable distribution of $10,000 on her income tax return. She can claim an offsetting $10,000 charitable income tax deduction as an itemized deduction.

2. Lifetime Outright Gifts - Charitable IRA Rollover

If enacted, a person who has assets transferred directly from her or his IRA to a charity:
(1) will not have to report the distribution on an income tax return, and
(2) will not be entitled to claim a charitable income tax deduction for the gift. An exception would permit a deduction for the portion of any distribution that would have been tax-free to the IRA owner, such as a distribution of a non-deductible contribution that was made to the account.

Requirements for Charitable IRA Rollover – The exact details will depend on the legislation that is finally enacted by Congress. The following requirements appear likely for people to make lifetime charitable gifts from IRAs without having to report the distributions as taxable income:

i. *Donor must be over a certain age.* The exact age will be determined in the final legislation. The minimum age will likely be 70 ½, but may be as low as 59 ½.

ii. *IRAs only.* Distribution to charities from other types of retirement accounts – such as 403(b) plans, 401(k) plans, profit sharing plans and pension plans – will still have to be reported as taxable distribution to the account owners.

iii. *Directly to a charity .... or possibly to a deferred giving arrangement.* The money must go straight from the IRA to a U.S. charity. Both the Senate and House bills would also permit IRA distributions to be made to *charitable remainder trusts, pooled income funds and to charities to acquire charitable gift annuities.* – NOT charitable lead trusts.

iv. *The payment would otherwise fully qualify for a charitable income tax deduction.* This eliminates favorable tax treatment for IRA distributions that are used for auctions, raffle tickets, fund-raising dinners or any other type of quid-pro-quo transaction.

3. Lifetime deferred gifts - current law

a. General Rule - Retirement Accounts are LOUSY sources of lifetime deferred gifts. Distributions from retirement accounts are usually 100% taxable as ordinary income. By comparison, contributions to a charitable remainder trust or a charitable gift annuity only provide a fractional income tax deduction for the charitable remainder interest. Thus, a person who withdraws $100,000 from an IRA to purchase a $100,000 charitable gift annuity will have to report $100,000 of taxable income but will have an offsetting charitable income tax deduction of only $40,000 or $45,000. Income tax will be due.

An example is the income tax *disaster* in PLR 20056024 (Apr. 6, 2005). Taxpayer withdrew money from his IRA to purchase charitable gift annuities. The entire distribution was taxable and there was only a partial offsetting charitable income tax deduction. Taxpayer pleaded for relief to rollover the money into a new IRA (the normal 60 day limit had expired). The IRS rejected the plea. BETTER SOLUTION: Leave the money in the IRA and name a charity as the beneficiary of the IRA at death. Both the IRA and the deferred charitable gift provide retirement income and both will pay the remaining proceeds to the charity at death. It makes no sense to pay income tax to transfer money from one retirement vehicle to another.

b. Exception: Charitable opportunities for distributions that include company stock.

Private Letter Rulings 200335017, 200302048, 200215032, 200202078, 200038050 and 199919039 involve individuals who wanted to make a contribution to a charitable remainder trust. Each had just received a "lump sum distribution" that included "employer stock" from his company's retirement plan, and the stock had a significant amount of "net unrealized appreciation" ("NUA"). These technical terms are defined and explained in the footnote.[1] In most of the rulings, the employee contributed the stock to the CRT and rolled over the remainder of the distribution to an IRA.

The transaction is basically a twist on the standard practice of contributing *appreciated* stock to a charitable remainder trust. Since NUA will always generate a long-term capital gain, a person who receives a distribution of employer stock from a company retirement plan can contribute the stock at anytime to a deferred charitable giving arrangement and claim an income tax deduction based on an appreciated value of the stock rather than the lower tax basis. There is no need to hold the stock for more than one year to qualify for long-term capital gain status, as is usually the case. IRS Notice 98-24, 1998-17 I.R.B. 5.

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1 **DEFINITIONS**

QRP - A qualified retirement plan, such as a money purchase pension plan, profit sharing plan stock bonus plan. Sec. 401(a). An IRA and a Sec. 403(b) plan are also considered QRPs for some purposes (Sec. 4974(c)), but "lump sum distributions" from them do *not* qualify for the favorable tax consequences described in this article. Sec. 402(d) only applies to Sec. 401(a) QRPs.

ESOP - An Employee Stock Ownership Plan, a special type of QRP whose principal asset is employer stock. Sec. 4975(e)(7). Distributions from an ESOP will usually be employer stock.

Employer Stock - A distribution from any type of QRP that physically consists of stock of the company that manages the QRP. Sec. 402(e)(4). Example: a distribution from the IBM profit sharing plan of IBM stock would be a distribution of employer stock.

***NUA* - "Net Unrealized Appreciation."** A person who receives employer stock as part of a "lump sum distribution" (described below) only has to recognize as income the purchase price that the QRP paid for the stock rather than the full value of the stock. Sec. 402(e)(4)(B); Reg. Sec. 1.402(a)-1(b)(2)(i). The NUA is not taxed in the year that the stock is received. Instead, NUA is taxable when the stock is sold. NUA qualifies for long-term capital gain treatment even if the recipient held the stock for less than one year. Notice 98-24, 1998-17 I.R.B. 5.

Lump Sum Distribution - A liquidation of an employee's entire account balance in a QRP account within one year. Sec. 402(e)(4)(D). To qualify for the most favorable tax treatment, the account must be payable to the employee (or, if deceased, to the surviving beneficiary): (i) on account of the employee's death, (ii) after the employee attains age 59 ½, (iii) on account of the employee's separation from service, or (iv) after the employee becomes disabled.

Note that the favorable consequences for distributions of "employer stock" and for the "forward averaging tax" described in this article only apply to a lump sum distribution from a company's QRP or from a Keogh retirement plan (either a Sec. 401(a) QRP or a 401(k) plan). *The favorable tax consequences for lump sum distributions do not apply to a complete distribution from an IRA or a 403(b) plan.*

EXAMPLE: An employee of Procter & Gamble receives a lump sum distribution from the company's retirement plan of P&G stock worth $100,000 that the plan had purchased for only $10,000, the employee only has to recognize $10,000 of income and does not have to recognize the $90,000 of NUA as income until the stock is sold. Sec. 402(e)(4)(B). If he holds the stock for only one week and sells it for $105,000, then he will have a $90,000 long-term capital gain attributable to the NUA and a $5,000 short-term capital gain from the additional appreciation. All of the private letter rulings cited on the preceding page authorized the individual to base his charitable contribution deduction to the charitable remainder trust based on an appreciated value of the stock that included the NUA. In this example, if the stock was worth $105,000, the income tax deduction would be based on the $100,000 value which includes the $90,000 long-term capital gain but excludes the $5,000 short-term capital gain. Sec. 170(e)(1)(A).

ADVANTAGES: If the employer stock in a qualified retirement plan is *appreciated* (so that there is NUA), then an employee who receives a lump sum distribution from a retirement plan upon termination of service may find it advantageous (1) to rollover the cash to an IRA but (2) to contribute the employer stock to a charitable remainder trust. There are three advantages from the CRT. First, the employee can claim a charitable income tax deduction for the gift, which will usually be the value of the stock upon distribution rather than cost basis. Second, the CRT can sell the stock tax free to diversify. Third, payments from the CRT might be 2nd-tier *long-term capital gain* income, whereas distributions from a rollover IRA will always be taxed at the highest income tax rates imposed on *ordinary income.*

HOW COMMON IS THIS? Despite encouragement from financial planners that investments be diversified, many employees continue to own sizable blocks of employer stock in their retirement accounts. In 2003, employer stock constituted 16% of all assets in 401(k) retirement plans, down from 19% in 2001 (the year the Enron scandal broke).[2]

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[2] Holden, Sarah and VanDerhei, Jack, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2003," *Employee Benefit Research Institute Issue Brief No. 272* (Aug 2004). Many 401(k) plans hold much more employer stock than 16%. See Purcell, Patrick, "The Enron Bankruptcy And Employer Stock In Retirement Plans" *Congressional Research Service RS21115* (Jan. 22, 2002), which disclosed numerous corporate 401(k) retirement plans that had 2/3's or more of their assets in employer stock in November, 2001, including the following percentages in the following company 401(k) plans:

94.7%	Procter & Gamble	77.4%	General Electric
91.6%	Sherwin-Williams	75.7%	Texas Instruments
90.2%	Abbott Laboratories	75.6%	William Wrigley, Jr.
85.5%	Pfizer	75.0%	Williams
81.7%	BB&T	74.3%	McDonald's
81.6%	Anheuser-Busch	72.0%	Home Depot
81.5%	Coca-Cola	70.0%	Textron

4. Lifetime deferred gifts - Charitable IRA Rollover

The proposed Charitable IRA Rollover legislation would permit tax-free lifetime transfer of assets from her or his IRA directly to an eligible deferred charitable giving arrangement (a charitable remainder trust, pooled income fund or charitable gift annuity) that will provide an income stream *only* to the owner and/or spouse:

(1) the IRA Owner will not report the IRA distribution as taxable income, and
(2) will not be entitled to claim a charitable income tax deduction for the gift.

Distributions from the deferred giving arrangement to the IRA owner (and/or spouse) will always be taxed as *ordinary income*. There will never be any long-term or short-term capital gain distributions.

The rules for transferring assets from IRAs to deferred charitable giving arrangement are more complicated than for outright charitable gifts. Whereas every U.S. charity can receive an outright gift from an IRA, some established CRTs and pooled income funds are not eligible to receive a tax-free distribution from an IRA. The hazards are the greatest for transfers to CRTs, both because the laws are more complex and because the dollar amount of the transfers will likely be larger than for other gifts. What's worse, the tax ramifications for a botched distribution to any sort of deferred giving arrangement are *much* worse than for a botched distribution of an outright gift to a charity. If a mistake is made with a deferred gift, there will likely be a significant income tax liability.[3] By comparison, the tax cost from messing up an outright gift will usually be very small.[4]

5. Impact on planning charitable gifts: How will Charitable IRA Rollover change the planning perspective for using IRAs for lifetime charitable gifts?

a. Who Wins Big with Charitable IRA Rollover?

- *Donors who do not itemize deductions* (2/3s of the nation's taxpayers). The charitable contribution deduction is an itemized income tax deduction. Donors who do not itemize currently have the worst tax result when they use IRA distributions for charitable gifts. They have taxable income from the distribution but no offsetting charitable tax deduction.

- *Donors who live in states with a state income tax that provides no tax breaks for charitable gifts.* For example, Indiana, Michigan, New Jersey, Ohio and Massachusetts state income tax computations do not permit charitable income tax deductions.

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[3] The offsetting charitable tax deduction from contributing a taxable retirement plan distribution to a deferred giving arrangement will only be a fraction of the taxable income generated by the distribution.

[4] If an IRA distribution is taxable, then the donor who makes an outright charitable gift can usually claim a charitable tax deduction for the full amount, which completely offsets all of the taxable income.

- *Donors subject to the 50% charitable deduction limitation.*

- *Donors who want to make very, very large gifts. .*

- *Donors with AGI above about $143,000* (they are subject to the 3% phase-out of itemized deductions -- they will benefit by keeping their gross income lower from excluded IRA distributions).

- *Donors who experience a phase-out of specific itemized deductions as their AGI increases (*2% for "miscellaneous itemized deductions", 7 ½% for medical expenses and 10% for nonbusiness casualty losses (e.g., damage to a vacation home), etc. etc.)

b. Charitable IRA Rollover -- Planning for donors who itemize charitable income tax deductions

1. IRA as only asset (e.g., physicians) – Charitable IRA Rollover will be a welcome option for large gifts.

2. IRA compared to appreciated stock – Charitable gifts of appreciated stock, mutual funds and real estate have traditionally provided donors with greater income tax benefits than gifts of most other types of assets. If the sale of such property would generate a long-term capital gain, then donors can deduct the appreciated value of the property and never pay tax on the appreciation. *In most cases, these highly appreciated long-term capital gain assets will continue to provide greater tax benefits than gifts from an IRA.* On the other hand, if the donor is subject to the annual charitable income tax deduction limitation, the donor could be better off making a gift from an IRA.

Example: Ms. Donor has a $10,000 IRA and has stock worth $10,000 that she bought years ago for $2,000. She is 75 years old and has AGI of $200,000. If she makes a charitable gift from her IRA under "charitable IRA rollover," she will save a little bit of money compared to receiving a taxable IRA distribution ($189, or 1.9% of the distribution because of the 3% itemized deduction phase-out). However, she will still own her stock. If she sells the stock, she will have an $8,000 taxable gain subject to a federal 15% capital gains tax ($1,200). Consequently, even if charitable IRA rollover is enacted, she should probably receive taxable distributions from her IRA and contribute her stock to produce an offsetting charitable income tax deduction. She can use the cash from the distribution for any purpose that she chooses, including the purchase of new stock that will give her a new tax basis of $10,000.

V. INCOME TAX IMPLICATIONS OF BEQUESTS

A. Under Current Law, Retirement Accounts Are Great for Bequests! IRD Goes to Tax-Exempt Charity and Avoids Income Tax That The Family Would Have Paid.

Whereas every lifetime distribution from a retirement account is taxable income to the account owner, a different rule applies after death. The income is taxed to the person who has the right to receive the distribution: the beneficiary who actually receives the check. If the beneficiary is a tax-exempt organization, it will not recognize any taxable income, nor will the estate or any of the other heirs of the decedent. PLR 9723038 (March 11, 1997) (public charity); PLRs 9838028 and 9818009 (private foundation); PLRs 9901023 (Oct. 8, 1998) and 9634019 (May 24, 1996) (charitable remainder trust).

B. Tie-in to Leave A Legacy

1, IRD is the best asset to leave to charity at death.

2, Bequests from retirement accounts are usually simpler than bequests in a will. Just change IRA beneficiary forms to add a charity. No need to have lawyer redraft a will.
No formalities of having witnesses certify that they observed the signing of the will, etc. etc.

C. Married Employee -- Retirement account can be more complicated

A. **General Rule -- Spouse entitled to 100% upon employee's death.** If the assets are held by a *Section 401(a), Section 401(k) or a 403(b) plan* and if the employee is married, then the assets cannot be transferred to a charity or a deferred giving arrangement unless the spouse has first executed a written waiver. Sections 417(a)(2)(A) and 417(a)(6)(B); Reg. Sec. 1.401(a)-20, Q & A 33. In the absence of a proper waiver, the entire amount will be distributed to the surviving spouse as a matter of law (even if the employee had designated the charity as the beneficiary on the forms she or he filed with the employer) or will be paid to the surviving spouse as part of a qualified joint and survivor annuity. Sections 401(a)(11)(B)(iii) and 401(a)(11)(A).

B. **IRA? Spouse Not Have Such A Right Under Federal Law.** Most retirees rolled over their company account balance into an IRA in the year that they retired, so that the spouse's right to Sec. 401(a), 401(k) and 403(b) retirement account balances might not be a big problem in practice.

D. New Opportunity – Charitable Disclaimers

1. What happens when a person disclaims an interest in an inherited retirement plan account? That is, upon the employee's death, the primary beneficiary makes a "qualified disclaimer" within the applicable 9 month period so that the property passes to a contingent beneficiary, such as a charity. The person who disclaims will not be treated as having received the property and will not be treated as having made a gift of the property. In addition, the taxable income produced by the retirement account will be taxed to the person who receives the account after the disclaimer compared to the person who made the disclaimer.

2. Special Break for Disclaiming Retirement Accounts. The IRS will allow a primary beneficiary to disclaim all or part of an inherited retirement account *even if he or she received a mandatory distribution from the account in the year of the account owner's death!* Rev. Rul.2005-36, 2005-26 IRB 1368. The estate can then claim an estate tax charitable deduction for the amount that was transferred to a charity by way of the disclaimer. Reg. Section 20.2055-2(c)(1). By comparison, any acceptance of benefits will normally disqualify a disclaimer. This provides a very important planning opportunity for retirement accoutns.

EXAMPLE WITH A CHARITY: Assume that Mother's estate is comprised of a $1.1 million retirement account and $1 million of other assets. Mother named Daughter as the primary beneficiary and named Charity as a contingent beneficiary of her retirement account. Upon Mother's death, Daughter could make a qualified disclaimer of just $100,000, generating a $100,000 charitable estate tax deduction. Mother's taxable estate would be just $2 million, thereby avoiding the estate tax. Daughter would not have to recognize any taxable income nor would she be treated as having made a gift. Rev. Rul. 2005-36.

CAUTION #1: Disclaimers of property that pass to a ***private foundation*** pose tax problems. A solution that has been approved by the IRS is to make a disclaimer to a ***donor advised fund*** of a community foundation rather than a private foundation. [5]

CAUTION #2: Generally avoid this strategy for transferring assets to a *charitable remainder trust*. A person (except for a surviving spouse) cannot make a valid disclaimer to a trust if he or she will also be a beneficiary of that trust. Reg. Sec. 25.2518-2(e)(3).

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[5] A problem exists if a parent names a child as a beneficiary of an estate and through the child's disclaimer the property passes to a private foundation where the child is a director. The child's participation in the private foundation's selection of charitable grant recipients could prevent the disclaimer from being a qualified disclaimer. This is because the child would be normally involved in selecting the ultimate charitable beneficiaries of the private foundation, which could violate the requirement that the interest in property passes "without any direction on the part of the person making the disclaimer." Reg. Sec. 25.2518-2(d)(1) & (2); 25.2518-2(e)(1)(I). *One solution* to deal with this is for the private foundation to amend its bylaws so as to prohibit the child and the child's spouse from participating in the selection of grant recipients from amounts that are attributable to the disclaimed property. See PLRs 9317039 (Feb. 2, 1993) and 9141017 (July 10, 1991). This is a fairly clumsy solution that interferes with a parent's desire to allow children to be involved with a private foundation. *A better solution* may be to have a child disclaim property to an advised fund of a community foundation. The IRS concluded that the advisory nature of a child's or grandchild's grant recommendations did not pose a problem. PLRs 200518012 (Dec. 17, 2004) (disclaimers by grandchildren) and PLR 9532027 (May 12, 1995) (disclaimers by children).

VI AVOIDING PITFALLS ON THE ESTATE'S INCOME TAX RETURN

A. Basic Strategy

There is generally a two-prong planning strategy to avoid problems on the estate's income tax return if IRD will be transferred to charity:

(1) try to keep the IRD off of the estate's income tax return, and
(2) in the event some IRD is reported by the estate, then have the estate qualify for a charitable income tax deduction for the payment to the charity.

B. Keeping the Income Off of The Estate's Income Tax Return

1. IRAs and Qualified Retirement Plans: *Focus On The Beneficiary Designation Forms Rather Than the Will.*

The largest source of IRD will usually be an IRA or a QRP, which is a separate trust that is not governed by the will or by the decedent's trust instrument. IRA and QRP assets do not pass through probate, unless the owner made the mistake of naming the probate estate as the beneficiary of these assets. Instead, these assets are transferred directly to the beneficiary who is named as the successor beneficiary on the forms provided by the retirement plan.

If the assets are to be transferred to a charity or a charitable remainder trust, then the charity or a charitable remainder trust should usually be named as the successor beneficiary on these forms. *Usually you will want to avoid naming the estate as a beneficiary. Instead the charity or charitable remainder trust should be named as a beneficiary.* That way the estate will not have to report any income on the estate's income tax return since the estate would not be legally entitled to any amount from the retirement plan. Reg. Sec. 1.691(a)-2(a)(2). Of course, if the income is not reported on the estate's income tax return, there is no corresponding income tax charitable deduction either. Reg. Sec. 1.642(c)-3(b). In the event that amounts are payable to an estate, there may be some tax-saving strategies available (please see the next page).

2. Conventional IRD Assets (and IRAs!): *Give the trustee/executor discretion to make non-pro rata distributions of IRD assets*

A non-pro rata distribution is when the assets of an estate are not proportionately divided among the beneficiaries of an estate but, instead, one beneficiary receives proportionately more or less of a particular asset. For example, suppose that a decedent had $100,000 of savings bonds (an IRD asset) at the time of his death and that his will instructed the executor to divide his $400,000 estate equally among his three children and his favorite charity. With a pro-rata distribution, each child and the charity would receive $25,000 of savings bonds. If the executor did not have the power to make a pro-rata distribution and simply gave all $100,000 of savings bonds to the charity, the IRS would conclude that there had been a taxable exchange among the beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159. However, if either the will or state law gives an executor discretion to make non-pro rata cash or in-kind distributions, then there may be no taxable income when the executor distributes all of the savings bonds to a charity and all of the non-IRD assets to the children. Private Letter Ruling 9537011 (June 16, 1995).

The IRS permitted executors to assign a decedent's IRAs, 403(b) accounts and deferred annuity contracts to charities under similar circumstances. The decedent had named the *estate* as the beneficiary of his retirement accounts and had made charitable bequests. Because the will authorized the executor to use any asset for any distribution, the IRS concluded that the executor could "assign" the retirement accounts to charity. Neither the estate nor any other beneficiary would have to report any taxable income when the distributions were made to the charities. Private Letter Rulings 200511174 (Feb 8, 2005) (***IRAs & 401(k) plan*** where *residue* of estate was left to charity); 200526010 (Mar. 22, 2005) (***IRAs*** payable to ***trust*** with charitable residue); 200452004 (Aug. 10, 2004) (***IRAs*** and ***deferred annuity contracts*** to charitable *residuary*) and 200234019 (May 13, 2002) (***IRAs*** and ***403(b) accounts*** where *portion* of estate went to charity).

C. Claiming a Charitable Income Tax Deduction In The Event IRD Is Recognized By The Estate

1. Drafting the Will or the Trust Instrument >> *Very important: The will or living trust should contain instructions that all charitable bequests should be made, to the extent possible, with IRD assets.* Every will and living trust that provides for a charitable bequest should probably contain language along the following lines:

> "I instruct that all of my charitable gifts, bequests and devises shall be made, to the extent possible, from property that constitutes "income in respect of a decedent" as that term is defined under the U.S. income tax laws."

Without such language an estate will not be able to claim either a charitable *income* tax deduction nor a *DNI* deduction for a distribution of principal to a charity (e.g., a typical charitable bequest). Rev. Rul. 2003-123, 2003-50 IRB 1200, citing *Crestar Bank (Estate Of James A. Linen) v. IRS*, 47 F Supp 2d 670 (E.D. Virginia, April, 1999); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987); and *Riggs National Bank v. U.S.*, 352 F. 2d 812 (Ct. Cl. 1965). This is because Sec. 642 imposes a "tracing" requirement for charitable income tax deductions of estates: the source of the contribution must be traced to the estate's income. The requirement is usually met when, for example, the governing instrument requires income to be distributed to a charity.

With this language, there is a good argument that if an estate has any income from IRD, then the estate can claim on offsetting charitable income tax deduction for the payment that was made to charity or the total amount of IRD, whichever is less. Rev. Rul. 83-75, 1983-1 C.B. 114. Since IRD could be subject to two taxes (both the estate tax and the income tax), then when IRD is required to be distributed to a charity and is in fact so distributed, the estate should be entitled to claim both an estate tax deduction and an income tax charitable deduction for the same charitable gift.

2. Strategies if the Will or the Trust Instrument Does Not Contain Such Language.

If the will or trust instrument does not include instructions that charitable bequests should be made with IRD, there may be ways to administer the estate so that the taxable income from IRD assets will be directed to charities. First, if the will or trust authorizes non-pro rata distributions, an executor may be able to "assign" the IRAs to the charities so that the estate does not have to recognize any income. See PLRs 200452004 and 200234019 described above..

Another strategy is to pay the charities last. Assume, for example, that an individual's will specifies that the residue of the estate will be paid to charities following specific bequests to individuals. Also assume that the individual named his estate as the beneficiary of his IRA. In Year 1, the executor could pay most administrative expenses and all of the specific bequests to the individuals, leaving the charity as the only remaining beneficiary at the end of Year 1. Then in Year 2 the estate could receive the entire IRA. Under these facts, the IRS concluded that an estate was entitled to a charitable set-aside income tax deduction that would offset the taxable income from the IRA. PLRs 200221011 (Feb. 12, 2002); 200336030 (June 3, 2003) (IRAs and ***savings bonds***); PLR 200526010 (Mar. 22, 2005) (IRAs and ***savings bonds***).

VII AVOIDING PITFALLS WITH MANDATORY DISTRIBUTIONS AFTER DEATH

A. General Rule - The IRA administrator will generally want to "cash out" the charity's share of an IRA account before the "determination date" (September 30 of the year that follows the year that the account owner died). If the remaining beneficiaries are all "designated beneficiaries" (e.g., human beings), then the decedent's IRA can be a "stretch IRA."

B. DEFINITIONS

"Beneficiaries" versus "Designated Beneficiary" ("DB") - A beneficiary is any person or entity that is entitled to receive benefits from a QRP or IRA account after the account owner's death. By comparison, a *designated beneficiary* is an individual who is entitled to the benefits of the IRA or QRP account upon the death of the employee / participant / IRA owner (hereafter "account owner").[6] Neither a charity nor the decedent's estate will qualify as a DB since neither has a life expectancy. If certain criteria are met, a trust may be the beneficiary of an IRA or QRP and distributions will be based on the beneficiaries of that trust.

Determination Date - The date when the beneficiaries must be determined is September 30 of the calendar year that follows the calendar year of the account owner's death.[7] Example: Sarah died on June 15, 2005, the determination date for her IRA and QRP accounts will be September 30, 2006. The minimum distributions will be computed based only on the beneficiaries who still have an interest on the determination date. If a beneficiary's interest is eliminated between the time that the account owner died and the determination date – for example by a cash out or a disclaimer -- then that beneficiary will not have any impact on the required minimum distributions.

There are basically three ways to eliminate some of the beneficiaries before the determination date: (1) disclaimers, (2) cash-out of a beneficiary and (3) separate accounts for different beneficiaries.

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6 Sec. 401(a)(9)(E); Reg. Sec. 1.401(a)(9)-4, Q&A 1.

7 Reg. Sec. 1.401(a)(9)-4, Q&A 4.

C. Case Studies - Required Distributions After Death (the "*stretch IRA*")

[What follows is a bare-bone basics for the typical situation of someone over the age of 71 who would like to make a bequest of an IRA in part to a charity and in part to a younger person, such as a child. The regulations should be examined in detail for more complicated situations (e.g., a trust is a beneficiary, contingent beneficiaries, etc.)]

EXAMPLE WITH A CHARITABLE LEAD TRUST: Sam died at the age of 79 and named a 15 year charitable lead trust as the beneficiary (payments to a charity for 15 years, then remainder to his granddaughter who is currently 19 years old). His IRA must be emptied over the next 11 years, since a 79 year old person has a life expectancy of nearly 11 years. The minimum required for each year is 1/11th the first year, 1/10th the second year, 1/9th the third year, and so on (oversimplified). Reg. Sec. 1.401(a)(9)-5, Q&A 5(c)(1).

>> THIS IS HORRIBLE FOR TAX PURPOSES! A charitable lead trust is not exempt from the income tax. The IRA will be fully liquidated in 11 years and the assets will have shrunk.

EXAMPLE OF STRETCH IRA: When Sam died at the age of 79 he had named his 19 year old granddaughter as the sole beneficiary of the IRA. The year after his death, his granddaughter attained age 20. According to the life expectancy tables, a 20 year old has a life expectancy of 63 years. Thus, instead of distributing the amounts over 11 years, the amounts can be distributed over 63 years. The first required distribution is 1/63rd, next year it is 1/62nd, etc. etc. generally very willing to administer the accounts for extended periods of time. Reg. Sec. 1.401(a)(9)-5, Q&A 5(c)(1).

WHAT IF THERE ARE TWO OR MORE BENEFICIARIES? Generally the distributions are measured by the beneficiary with the shortest life expectancy. Reg. Sec. 1.401(a)(9)-5, Q&A 7(a)(1). However, separate distribution computations may be possible with separate accounts. Reg. 1.401(a)(9)-8, Q&A 2 & 3.

EXAMPLE: Sam named both his 58 year old nephew and his 22 year granddaughter as equal co-beneficiaries. Distributions to both beneficiaries are based on the older nephew's life expectancy (i.e., of someone who is age 59 following the year of death). However, separate distribution computations may be possible with separate accounts for each beneficiary.

WHAT IF ONE BENEFICIARY IS A CHARITY? GENERAL RULE: The minimum distributions revert to the decedent's remaining life expectancy. The other beneficiaries (e.g., children and grandchildren) cannot use their longer life expectancies. The logic is that a charity does not have a life expectancy. Reg. Sec. 1.401(a)(9)-5, Q&A 5(a)(2) and 5(c)(3).

D. Solutions When a Charity Is a Beneficiary:

#1: CASH OUT THE CHARITY's INTEREST BEFORE SEPTEMBER 30 OF THE NEXT YEAR: If the charity's entire share is distributed before September 30 of the calendar year that follows the year of death, then the charity is no longer a beneficiary and will not affect the distribution period. This is because the point in time when the final beneficiaries are determined is September 30 of the calendar year following the calendar year of the account owner's death. Reg. Sec. 1.401(a)(9)-4, Q&A 4(a).

#2: SEPARATE ACCOUNT FOR THE CHARITY: In that case, the distributions to the other beneficiaries are computed without regard to the account for the charity. Reg. Sec. 1.401(a)(9)-8, Q&A 2 and 3.

VIII ESTATE TAX – MORE INCENTIVE FOR CHARITABLE BEQUESTS OF RETIREMENT ASSETS

A. Combination of Estate Tax And Income Tax – 70% or More in Most States

Whereas most inheritances are exempt from income tax, retirement plan assets get a double whammy of both the estate tax and the income tax. People wealthy enough to pay the estate tax will find they are already making a 70% charitable gift – to the government! Better to pick the charitable purpose intentionally.

B. Scheduled Estate Tax Thresholds

The thresholds are summarized in the table below (changes are highlighted in bold):

Year	Lifetime Gift Tax Threshold	Estate Tax Exemption Amount	Highest Estate & Gift Tax Rate
2001	$675,OOO	$675,OOO	55% (+5% surtax)
2002	**$1 million**	**$1 million**	50%
2003	$1 million	$1 million	49%
2004	$1 million	**$1.5 million**	48%
2005	$1 million	$1.5 million	47%
2006	$1 million	**$2 million**	46%
2007	$1 million	$2 million	45%
2008	$1 million	$2 million	45%
2009	$1 million	**$3.5 million**	45%
2010	$1 million	**Repealed !**	Max gift tax rate = max inc tax rate
2011	$1 million	**Reinstate:$1 million**	55% (+5% surtax)

C. COMBINATION OF *FEDERAL* ESTATE AND INCOME TAXES ON INCOME IN RESPECT OF A DECEDENT -- (Years 2007 through 2009). State estate and income taxes are extra!

EXAMPLE: Assume that Mother's total taxable estate is $4,000,000 and that all of it will be transferred to her sole heir: Daughter. Assume that the probate estate will pay the entire estate tax regardless of how her daughter acquired the assets (e.g., joint tenancy, etc.). If $100,000 in an IRA is immediately distributed to Daughter and if Daughter is in a *35% marginal income tax bracket*, then the combination of *federal* estate and income taxes on the $100,000 of IRA assets would be **$64,250 (64.25%)**. The amount is calculated as follows:

Beginning Balance in Retirement Plan			$ 100,000
Minus: Total Estate Tax Paid by the Probate Estate			(45,000)
Minus: Income Tax On Distribution			
Gross Taxable Income		$ 100,000	
Reduced By §691(c) Deduction for Federal Estate Tax			
Total Estate Tax	$ 45,000		
State Tax Credit*	Zero		
Deduction for Federal Estate Tax **		(45,000)	
Net Taxable Income ***		$ 55,000	
Times Income Tax Rate		x 35.0%	
Net Income Tax on Income In Respect Of Decedent			(19,250)
NET AFTER-TAX AMOUNT TO DAUGHTER			$ 35,750

* Treas. Reg. Section 1.691(c)-1(a) limits the deduction to *federal* estate tax. The 2001 Tax Act provides that the Section 2011 state tax credit will be fully repealed by the year 2007 so there is no state tax adjustment.

** The deduction is an itemized deduction on Schedule A that is claimed on the last line of the form ("other miscellaneous deductions"). It is not subject to the 2%-of-adjusted-gross-income ("AGI") limitation that most miscellaneous deductions are subject to. Sec. 67(b)(7).

*** The net taxable income from the IRD will actually be greater than this amount The IRD will increase the recipient's AGI by $100,000 which will decrease the recipient's itemized deductions by 3%, which would be $3,000 in this example. Sec. 68. The 3% reduction was omitted from this calculation in order to simplify the computation.

