FAMILY AND CHARITABLE PLANNING WITH RETIREMENT ACCOUNTS

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RECENT DEVELOPMENTS

WHAT IS GOING ON WITH THE FEDERAL ESTATE TAX?

The 2010 and 2012 tax acts significantly increased the amount that a person's estate can have at death without being subject to estate tax. The estate tax was completely repealed in the year 2010 (with an option to have it apply at a $5 million level to obtain a stepped-up income tax basis in inherited property). The 2010 tax act provided a two year record high threshold of $5 million (indexed for inflation) for the estate tax, gift tax and generation skipping tax. The 2012 tax act made the $5 million threshold (indexed for inflation) permanent.

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)
2002-03	**$1 million**	**$1 million**	50%
2004-05	$1 million	**$1.5 million**	48%
2006-08	$1 million	**$2 million**	45%
2009	$1 million	**$3.5 million**	45%
2010	**$5 million**	**Repealed !**	**<<***Carryover basis*
		or	
	$5 million	**$5 million**	<<*Step-Up basis* **(35% tax rate)**
2011-12	$5 million+	$5 million+	35%
2013	**$5.25 million**	**$5.25 million**	**40%**

* The generation skipping tax threshold is also $5.25 million in 2013, indexed for inflation.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, established an exemption amount of $5 million for 2010 and 2011 and indexed this amount for inflation for years after 2011. Section 101(a) and (c) of *The American Taxpayer Relief Act of 2012* made permanent the exemption provisions and raised the estate tax rate to 40%.

FEDERAL ESTATE TAX RETURNS
RETIREMENT PLAN ASSETS AND ANNUITIES; CHARITABLE DEDUCTIONS

	TOTALS		RETIREMENT PLANS/ANNUITIES				CHARITABLE DEDUCTIONS			
Year Filed	# of Returns	Gross Estates (millions)	# of Returns	%	Value (millions)	%	# of Returns	%	Value (millions)	%
2011est	8,238	$120,666	5,193	63	$ 5,721	4.7	2,227	27	$13,398	11.1
2007	38,031	$203,096	23,230	**61**	$13,993	**6.9**	7,672	**20**	$19,702	**9.7**
2004	62,718	$192,635	36,733	59	$17,499	7.5	11,599	18	$14,958	7.8
2001	108,112	$215,649	58,664	54	$18,398	**8.5**	18,711	17	$16.150	7.5
1998	97,856	$173,798	45,752	47	$12,039	6.9	16,982	17	$10,861	6.2
1995	69,772	$117,735	30,938	44	$ 6,632	5.6	13,063	19	$8,707	7.4
1992	59,176	$ 98,850	22,738	38	$ 4,095	4.1	11,053	19	$6,785	6.9
1989	45,695	$ 77,997	14,223	31	$ 2,309	3.0	8,471	19	$4,925	6.3
1986	45,125	$ 59,805	11,244	**25**	$ 1,350	**2.3**	7,835	**17**	$3,573	**6.0**

SOURCE: IRS Statistics of Income Bulletins. See web <http://www.irs.ustreas.gov/prod/tax_stats/estate.html>

Estate Tax Returns Filed in 2002: Estate Size and Charitable Deductions

[All figures are estimates based on samples--money amounts are in thousands of dollars.]

Size of Gross Estate	Gross Estate		Charitable deduction				Average amt (in thous. $)
	Number of returns	Amount (in thous. $)	Number of returns	(%) of returns	Amount (in thous. $)	(%) of estate	
All returns	**98,359**	**$ 211,212,218**	**16,105**	**16%**	**$ 17,828,921**	**8%**	
$ 675,000 < $ 1,000,000	36,809	30,210,377	4,624	13%	683,015	2%	148
$ 1,000,000 < $ 2,500,000	46,361	68,575,863	7,688	17%	3,131,444	5%	407
$ 2,500,000 < $ 5,000,000	9,882	33,618,289	2,097	21%	1,819,776	5%	868
$ 5,000,000 < $10,000,000	3,439	23,598,243	970	28%	1,749,224	7%	1,803
$10,000,000 <$20,000,000	1,198	16,187,674	420	35%	1,523,675	9%	3,628
$20,000,000 or more	671	39,021,771	307	46%	8,921,787	23%	29,061
Taxable returns	**44,407**	**$ 117,230,253**	**8,691**	20%	**$ 11,509,315**	10%	
$ 675,000 < $ 1,000,000	13,026	11,265,400	1,355	10%	34,765	0%	26
$ 1,000,000 < $ 2,500,000	22,993	33,795,007	4,576	20%	582,739	2%	127
$ 2,500,000 < $ 5,000,000	5,049	17,433,073	1,405	28%	702,587	4%	500
$ 5,000,000 < $10,000,000	2,101	14,544,190	762	36%	1,062,025	7%	1,394
$10,000,000 < $20,000,000	755	10,250,877	330	44%	908,359	9%	2,753
$20,000,000 or more	484	29,941,706	262	54%	8,218,840	27%	31,370
Nontaxable returns	**53,952**	**$ 93,981,965**	**7,414**	14%	**$ 6,319,606**	7%	
$ 675,000 < $ 1,000,000	23,783	18,944,977	3,268	14%	648,250	3%	198
$ 1,000,000 < $ 2,500,000	23,368	34,780,856	3,112	13%	2,548,705	7%	819
$ 2,500,000 <$ 5,000,000	4,833	16,185,216	692	14%	1,117,189	7%	1,614
$ 5,000,000 < $10,000,000	1,338	9,054,053	208	16%	687,198	8%	3,304
$10,000,000 <$20,000,000	443	5,936,797	90	20%	615,316	10%	6,837
$20,000,000 or more	187	9,080,065	45	24%	702,947	8%	15,621

For this and other IRS statistics, see the IRS web cite <http://www.irs.ustreas.gov/prod/tax_stats/estate.html>.

Estate Tax Returns Filed in 2002: Retirement Plans, IRAs and Annuities

[All figures are estimates based on samples--money amounts are in thousands of dollars.]

Size of Gross Estate	Total Estate Tax Returns		IRAs, Retirement Plans & Annuities				Average amt
	Number of returns	Amount (in thous. $)	Number of returns	(%) of returns	Amount (in thous. $)	(%) of estate	(in thous. $)
All returns	**98,359**	**$ 211,212,218**	**55,168**	**56%**	**$ 17,498,702**	**8%**	
$ 675,000 < $ 1,000,000	36,809	30,210,377	19,858	54%	3,340,282	11%	168
$ 1,000,000 < $ 2,500,000	46,361	68,575,863	26,887	58%	8,102,511	12%	301
$ 2,500,000 < $ 5,000,000	9,882	33,618,289	5,842	59%	3,448,768	10%	590
$ 5,000,000 < $10,000,000	3,439	23,598,243	1,673	49%	1,520,009	6%	909
$10,000,000 <$20,000,000	1,198	16,187,674	580	48%	602,709	4%	1,039
$20,000,000 or more	671	39,021,771	329	49%	484,422	1%	1,472
Taxable returns	**44,407**	**$ 117,230,253**	**21,093**	47%	**$ 6,546,006**	6%	
$ 675,000 < $ 1,000,000	13,026	11,265,400	6,399	49%	1,090,216	10%	170
$1,000,000 < $ 2,500,000	22,993	33,795,007	10,874	47%	2,945,366	9%	271
$2,500,000 < $ 5,000,000	5,049	17,433,073	2,518	50%	1,275,626	7%	507
$5,000,000 < $10,000,000	2,101	14,544,190	793	38%	659,442	5%	832
$10,000,000 <$20,000,000	755	10,250,877	302	40%	283,725	3%	939
$20,000,000 or more	484	29,941,706	206	43%	291,631	1%	1,416
Nontaxable returns	**53,952**	**$ 93,981,965**	**34,075**	63%	**$ 10,952,696**	12%	
$ 675,000 < $ 1,000,000	23,783	18,944,977	13,458	57%	2,250,066	12%	167
$1,000,000 < $ 2,500,000	23,368	34,780,856	16,013	69%	5,157,145	15%	322
$2,500,000 < $ 5,000,000	4,833	16,185,216	3,324	69%	2,173,142	13%	654
$5,000,000 < $10,000,000	1,338	9,054,053	880	66%	860,567	10%	978
$10,000,000 <$20,000,000	443	5,936,797	277	63%	318,984	5%	1,152
$20,000,000 or more	187	9,080,065	123	66%	192,791	2%	1,567

("Taxable Returns" and "Nontaxable returns" -- Most non-taxable returns claimed the marital deduction to avoid the federal estate tax (typically the estate of the first spouse to die).
For this and other IRS statistics, see the IRS web cite <http://wwwirsustreasgov/prod/tax_stats/estatehtml>

Estate Tax Returns Filed in 2004: Retirement Plans, IRAs and Annuities -- Variations Based on Age and Gender

(A) Percent of Returns that Report Any Retirement Plan Assets and
(B) Percent of All Assets that are in Retirement Plan Accounts

	MALE		**FEMALE**	
ALL 2004 RETURNS	23,746	110,300 ($ millions)	18,493	75,621 ($ millions)
	% of returns with retirement assets	% of all assets	% of returns with retirement assets	% of all assets
% OF ALL RETURNS REPORTING RETIREMENT ACCOUNTS	47%	9%	31%	4%
Under age 50	63%	7%	64%	10%
Ages 50 to 65	69%	14%	62%	10%
Over age 65	43%	8%	28%	3%

Source: Brian G. Raub, "Federal Estate Tax Returns Filed for 2004 Decedents," Figures B and G, IRS Statistics of Information Bulletin, available at <http://wwwirsustreasgov/prod/tax_stats/estatehtml>. Percentage of returns is computed from 1998 data.

ESTATE TAX, GIFT TAX & GENERATION SKIPPING TAX IN 2013

[from pages 14-15 of the *Overview of the Federal Tax System As in Effect for 2013,* Joint Committee on Taxation, JCX-2-13R (Jan 8, 2013)]

The United States generally imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift.

The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $14,000 (for 2013) or less per donor and per donee generally are not subject to tax.

An estate tax also is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death. The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

The gift and estate taxes are unified such that a single graduated rate schedule and effective exemption amount apply to an individual's cumulative taxable gifts and bequests. ... A unified credit of $2,045,800 (for 2013) is available with respect to taxable transfers by gift or at death. This credit effectively exempts a total of $5.25 million (for 2013) in cumulative taxable transfers from the gift tax or the estate tax. *1* The unified credit thus generally also has the effect of rendering the marginal rates below 40 percent inapplicable. Unused exemption as of the death of a spouse generally is available for use by the surviving spouse; this feature of the law sometimes is referred to as exemption portability.

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate or gift tax that is normally imposed on such transfers. This tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than one generation below that of the transferor. For 2013, the generation-skipping transfer tax is imposed at a flat rate of 40 percent on generation-skipping transfers in excess of $5.25 million.

1 - The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, establishes an exemption amount of $5 million for 2010 and 2011 and indexes this amount for inflation for years after 2011. The American Taxpayer Relief Act of 2012 makes permanent the exemption provisions of the 2010 Act.

PORTABILITY OF UNUSED EXEMPTION BETWEEN SPOUSES

[explanation from pages 50-53 of the *Technical Explanation of the Revenue Provisions in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*; Joint Committee on Taxation, JCX-55-10 (Dec. 10, 2010)]

Under the legislation, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount. The legislation does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last such deceased spouse. A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse’s own $5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return.

Example –Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example With Remarriage.–Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2’s $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2’s $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

INDIVIDUAL INCOME TAX IN 2013

[from pages 3-8 of the *Overview of the Federal Tax System As in Effect for 2013,* Joint Committee on Taxation, JCX-2-13R (Jan 8, 2013)]

Federal Individual Income Tax Rates for 2013

Single Individuals

Not over $8,925 .... 10% of the taxable income
Over $8,925 but not over $36,250 .... $892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850 .... $4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250 .... $17,891.25 plus 28% of the excess over $87,850
Over $183,250 but not over $398,350 .... $44,603.25 plus 33% of the excess over $183,250
Over $398,350 but not over $400,000 .... $115,586.25 plus 35% of the excess over $398,350
Over $400,000 ....$116,163.75 plus **39.6%** of the excess over $400,000

Married Individuals Filing Joint Returns and Surviving Spouses

Not over $17,850 .... 10% of the taxable income
Over $17,850 but not over $72,500 .... $1,785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400 .... $9,982.50 plus 25% of the excess over $72,500
Over $146,400 but not over $223,050 .... $28,457.50 plus 28% of the excess over $146,400
Over $223,050 but not over $398,350 .... $49,919.50 plus 33% of the excess over $223,050
Over $398,350 but not over $450,000 .... $107,768.50 plus 35% of the excess over $398,350
Over $450,000 .... $125,846 plus **39.6%** of the excess over $450,000

Special long-term capital gains and dividends rates

For 2013, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent on any amount of gain that otherwise would be taxed at a 39.6 rate. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise taxed at rates greater than 15-percent but less than 39.6 percent is taxed at a 15 percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Dividends are generally taxed at the same rate as capital gains. *[Note from Hoyt: If adjusted gross income is over $200,000 ($250,000 joint), then long-term capital gains and dividends are subject to an additional 3.8%% health care surtax. This brings the effective tax rate as high as 23.8% for taxpayers who are in the 39.6% tax bracket and 18.8% for taxpayers in lower tax brackets with modified adjusted gross income over $200,000 ($250,000 joint). Even higher if the phaseout of itemized deductions applies to the taxpayer]*

HEALTH CARE SURTAXES - Modified AGI over $200,000 ($250,000 jt)

3.8% Surtax on Net Investment Income

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust.

In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of *modified adjusted gross income* *2* over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. These thresholds are not indexed for inflation.

2 - Modified adjusted gross income is AGI increased by the amount excluded from income as foreign earned income under section 911(a)(1).

Net investment income is the excess of
(1) the sum of
(a) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (b) net gain attributable to the disposition of property other than property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities,

over
(2) deductions properly allocable to such gross income or net gain.

Some income is exempt: retirement plan distributions and Subchapter S corporation or partnership income (provided the recipient is employed at the business). To be treated as being employed at the business, generally an individual will should meet the "material participation" tests that apply to the "passive loss limitation" rules. In most cases, that means working at least 500 hours during the year (500 hours is one-quarter time; full time is usually 2,000 hours). Sec. 1411(as modified by Sec. 1402 of *The Health Care and Education Reconciliation Act of 2010* (P.L. 111-152)

In the case of an **estate or trust**, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.*3* In 2013, all income above $12,000 will be subject to the highest marginal tax rates.

3 - The tax does not apply to a nonresident alien or to a trust in which all the unexpired interests are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

0.9% Surtax on Wages and Earned Income

For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a specific threshold amount. Sec. 3101(b), as amended by the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148. The employer does not pay a matching 0.9% surtax, but is expected to withhold the employee's 0.9% tax once compensation income for an employee exceeds $200,000 for the year.

Unlike the general 1.45 percent HI tax on wages, this additional 0.9% tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarried individual, head of household or surviving spouse). These threshold amounts are not indexed for inflation.

The same additional HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold.

6.2%% Social Security Tax Threshold for 2013: $113,700

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. The Federal Insurance Contributions Act ("FICA") imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts:

(1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($113,700 in 2013);
and
(2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages. Since 1994, the HI payroll tax has not been subject to a wage cap.

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer.

Parallel to FICA taxes, the Self-Employment Contributions Act ("SECA") imposes taxes on the net income from self-employment of self-employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies. *4*

4 - For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

PHASEOUT ITEMIZED DEDUCTIONS & PERSONAL EXEMPTION - *Adjusted Gross Income* over $250,000 ($300,000 joint returns)

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions.

3% Phaseout of Itemized Deductions

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income**,** sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI).

The total amount of itemized deductions allowed is reduced by three percent ($0.03 for each dollar) of AGI in excess of $250,000 (single), $275,000 (head-of-household), $300,000 (married filing jointly) and $150,000 (married filing separately). These threshold amounts are indexed for inflation. This rule is sometimes referred to as the "Pease limitation." A taxpayer may not lose more than 80 percent of his or her deductions as a result of this provision.

Personal Exemption Phased Out for AGI Between $250,000-$372,000 ($300,000-$422,000 joint returns)

Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2013, the amount deductible for each personal exemption is $3,900. This amount is indexed annually for inflation.

The <u>personal exemption phase-out</u> ("PEP") reduces a taxpayer's personal exemptions by <u>two percent</u> for each $2,500 ($1,250 for married filing separately), or fraction thereof, by which the taxpayer's AGI exceeds $250,000 (single), $275,000 (head-of-household), $300,000 (married filing jointly) and $150,000 (married filing separately). These threshold amounts are indexed for inflation. In 2013, a taxpayer will have all personal exemptions completely phased out at incomes of $372, 501 (single), $397,501 (head-of-household), $422,501 (married filing jointly) and $211,251 (married filing separately).

HIGHEST 39.6% MARGINAL TAX RATE -*Taxable Income* (not AGI) over $400,000 ($450,000 joint returns)

CHARITABLE DEFINED VALUE FORMULA CLAUSES

I. Overview

A defined value formula clause attempts to reduce the estate or gift tax liability that could occur if an IRS audit changes the valuation of transferred property from the value that was originally reported on an estate tax or gift tax return. Although some clauses have repeatedly failed to avoid a tax liability in past court cases (*Procter* and its progeny), three recent court decisions validated clauses that allocated the entire increased valuation amounts to charities. The increased charitable tax deduction eliminated any increased estate or gift tax liability:

***Petter v. Commissioner**,* 653 F.3d 1012 (9th Cir. 2011) affirming T.C. Memo. 2009-280 (Dec. 7, 2009) (gift tax),
Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009), affirming 130 T.C. 1 (2008) (estate tax),
Hendrix v. Commissioner, T.C. Memo. 2011-133 (June 15, 2011)(gift tax).
Wandry v. Commissioner, T.C. Memo 2012-88 (a charity is not needed for formula clause)

The Service argued that such clauses violated public policy because they removed any financial incentive for the Service to audit an estate tax return, but both the Tax Court and the Eighth Circuit rejected this argument. Both courts concluded that the clauses only changed the allocation of the transferred property and that it was also public policy to encourage charitable contributions. Thus, these three court decisions provide stronger authority to bolster the use of defined value clauses than the previous charitable allocation case where the public policy arguments had not been addressed: ***McCord v. Commissioner***, 461 F.3d 614 (5th Cir. 2006), rev'g 120 T.C. 358 (2003).

II. Defined Value Clauses That Have Failed in the Past: *Procter* and Its Progeny

A. "Savings Clauses"- a formula that limits the total amount transferred - held *void*

B. A savings clause requires the recipient to return to the donor a portion of a gift if the property's value is increased from the original reported value following an IRS examination. These formulas were held void against public policy in ***Commissioner v. Procter***, 142 F.2d 824 (4th Cir.1944) and several subsequent court cases.[1]

[1] *Knight v. Commissioner*, 115 T.C. 506, 515 & n.4, 516 (2000); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner*, 82 T.C. 239 (1984) affd. without published opinion 786 F.2d 1174 (9th Cir. 1986).

C. EXAMPLE OF A SAVINGS CLAUSE:

Father gave to his child ("Son") 100 shares of closely-held stock that was valued on the gift tax return at $1 million. The gift instrument provided that if the value of property was "finally determined for federal gift tax purposes" to be higher than the amount originally reported on the gift tax return, then Son was obligated to return sufficient shares for the gift amount to be exactly $1 million.

Father had claimed a 50% valuation discount but after audit it was determined that the appropriate discount should have been 35%. The parties intended that Son should return 23 shares to the Father, so that the ultimate gift to accomplish the $1 million gift was 77 shares rather than 100 shares.

This is essentially the formula that the Fourth Circuit Court of Appeals faced in the case of *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.1944). The court concluded that it would not work: the entire 100 shares was treated as a taxable gift. The clause was contrary to public policy.[2]

D. One court decision where a "price adjustment clause" worked was *King v. U.S.,* 545 F. 2d 700, 703-704 (10th Cir. 1976).[3] In Rev. Rul. 86-41, 1986-1 C.B. 300, the IRS concluded that the price adjustment clause in *King* was similar to the savings clause in *Procter* and that the Service would disregard both.

III. Defined Value Clauses That Succeeded: *Petter, Christiansen, Hendrix & McCord*

A. A "formula allocation clause" changes the allocation of a gift among various recipients based on the valuations "finally determined for federal estate tax (or gift tax) purposes." The presence of a charitable recipient is important because of the charitable tax deduction.

B. Types of Defined Value Clauses

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[2] The *Procter* clause was held to be "contrary to public policy" for three reasons:
º The clause had a "tendency to discourage the collection of the tax," since efforts to collect would simply undo the gift;
º The effect of the clause would be to "obstruct the administration of justice by requiring the courts to pass upon a moot case;" and
º A judicial proclamation on the value of the trust would be a declaratory judgment, because "the condition is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment." *Commissioner v. Procter*, 142 F.2d 824, at 827-28 (4th Cir. 1944), cited at *Petter v. Commissioner,* T.C. Memo 2009-280, 98 TCM (CCH) 534, at 541 (Dec. 7, 2009).

[3] The price adjustment clause stated: "'If the fair market value of The Colorado Corporation stock * * * is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined * * * above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service.'" *King v. United States*, 545 F.2d 700, at 703-04 (10th Cir. 1976).

1. “Confirmation Agreement” – the various parties (e.g., trusts and charities) agree to the value of the property based on a willing buyer and a willing seller. *Hendrix & McCord*
2. “As Finally Determined for Gift Tax/ Estate Tax Values” – the various parties (e.g., trusts and charities) are required to reallocate the total amount of the gift in the event that the value of the property is changed by an IRS audit. *Petter & Christiansen*

C. In contrast to a savings clause, courts have found a formula allocation clause to be valid since it does not change the amount of a completed gift; it only changes the allocation among various recipients.

“[W]e start with two maxims of gift-tax law: A gift is valued as of the time it is completed, and later events are off limits. ... And gift tax is computed at the value of what the donor gives, not what the donee receives....*A shorthand for this distinction is that savings clauses are void, but formula clauses are fine*. “ U.S. Tax Court Judge Mark V. Holmes from the *Petter* opinion; *Petter v. Commissioner,* T.C. Memo 2009-280, 98 TCM (CCH) 534, at 542 (Dec. 7, 2009).

D. Examples of estate plans that eliminate estate tax with charitable deductions: The author has seen estate plans where the individuals essentially stated in their wills and trust instruments: “Give to my family the federal estate tax threshold in the year that I die [e.g., $1 million or $5 million or $3.5 million or whatever] and give the excess to charity.” Their obvious intent was to avoid estate tax. Although this might not be difficult when the estate/trust consists of very liquid assets with undisputable valuations, there can be a problem if there are illiquid assets with a wide potential range of values (real estate; LLC or partnership interests; etc.) A defined value clause can be very helpful for such situations to accomplish the intent of the settlors.

E. EXAMPLE OF A FORMULA ALLOCATION CLAUSE “AS FINALLY DETERMINED FOR FEDERAL GIFT TAX PURPOSES” :

Mother transferred 100 shares of an LLC interest to two trusts (one for each of her two children) and to two charities. As a condition of receiving the gift, the gift instrument provided that if the value of property was “finally determined for federal gift tax purposes” to be different than the amount reported on the gift tax return, then the recipients were obligated to transfer interests amongst each other so that the taxable gift to the trusts would be $1 million.

An appraiser concluded that there should be a 53% discount. Using this valuation, Mother made a gift of 100 shares to the trusts and charities. Following the gifts, Mother owned 17% of the LLC, the children’s trusts owned 75% and the charities owned 8%.

Following an IRS examination, the parties settled on a 35% discount. The trusts then transferred interests to the charities, so that the ownership interest in the LLC ultimately was: Mother still owned 17% of the LLC, the children’s trusts owned 54% (down from 75%) and the charities owned 29% (up from 8%) The reallocation did not change the total amount of Mother’s gift: it was still 100 shares. The only changes was the allocation of the 100 shares among the charitable and non-charitable beneficiaries. By comparison, the *Procter* formula would have reduced the gift from 100 shares to 77 shares by having shares returned to the donor (see example above)

This example is a variation of the underlying facts of the *Petter* case. The charitable beneficiaries were *donor advised funds* at community foundations. The Tax Court held that the allocation formula was valid and that the donor was entitled to an offsetting charitable tax deduction in the same year that the original gift was made, even though the reallocation actually took place several years later because of the IRS audit.

IV. Using Disclaimers to Accomplish the Allocation - *Christiansen* and Extra Tax Concerns

A. The estate planner in the *Petter* case made the potential reallocation of the gift a condition of receiving the gift. The estate planner in the *Christiansen* case used a <u>disclaimer</u> to implement the formula allocation clause. The advantage of the disclaimer strategy is that it offers flexibility and choice: the beneficiary can choose to either accept the property (despite the higher tax cost from the increased valuation assessment) or can disclaim to the contingent-beneficiary charity and generate a charitable tax deduction. The disadvantage of using a disclaimer is that there is an added layer of legal complexity: all of the disclaimer laws must be met, which proved to be a problem in the *Christiansen* case.

B. A "qualified disclaimer" must meet the following five requirements:
(1) It must be an irrevocable and unqualified *refusal by a person to accept an interest in property*;

(2) the refusal must be in writing;
(3) the writing must be received by the transferor of the interest (or his legal representative) not later than nine months after the later of (a) the date on which the transfer creating the interest in such person is made or (b) the date on which such person reaches age twenty-one;
(4) *the person has not accepted the interest or any of its benefits*; and
(5) as a result of the refusal, *the interest passes without any direction on the part of the person making the disclaimer* and passes either to the spouse of the decedent or *to a person other than the person making the disclaimer*. Section 2518.

C. The *Christiansen* case: The will of Mrs.Christiansen provided that if the primary beneficiary of her estate (her daughter) disclaimed any of the inheritance, then 75% of the disclaimed amount would be distributed to a charitable lead trust (CLT) and the remaining 25% would be distributed to a private foundation. The daughter disclaimed a sufficient amount that she hoped would produce a charitable estate tax deduction that would eliminate the tax liability that had been generated by the IRS' revaluation of the property held by the estate.

Her daughter was the contingent remainder beneficiary of the CLT was she was also a director of the private foundation. The attempted disclaimer to the CLT proved to be invalid since the daughter was treated as a beneficiary of the CLT and a person cannot disclaim property to a trust of which that person will be a beneficiary – the person's interest in the trust property invalidates the disclaimer.[4] The Tax Court and the Eighth Circuit permitted the disclaimer to the private foundation to stand and allowed an increased charitable estate tax deduction.

D. A disclaimer to a private foundation can pose additional tax challenges that were not addressed in the *Christiansen* court decision.

1. 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's involvement in selecting charitable recipients to receive grants from the disclaimed property could violate the requirement that the interest in property pass "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).

2. *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 the disclaimed property. The disclaimed assets are generally isolated from other assets and held in a separate account. See PLRs 200802010 (Sep. 12, 2007), 200744005 (June 28, 2007), 200649023 (Aug. 23, 2006), 200616026 (Dec. 22, 2005), 200420007 (Jan. 23, 2004), 9317039 (Feb. 2, 1993) and 9141017 (July 10, 1991). This is a fairly clumsy solution that interferes with a parent's desire to allow a child to be involved with a private foundation.

3. *A better solution* may be to have a child disclaim property to a *donor advised fund* at 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).

E. Conclusion: Possible solutions to disclaimer problems:

1. Use the formula allocation clause found in *Petter* to avoid the disclaimer hazards (e.g., not made within 9 months; actions that invalidate the disclaimer as was the case in *Christiansen*).
2. If there will be a disclaimer to a charitable grant-making entity, then use a donor advised fund as the philanthropic grant-making vehicle rather than a private foundation. The Service has issued several rulings that explicitly permit disclaimers to donor advised funds and allow the person who made the disclaimer to recommend charitable grants from the fund.

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[4] Reg. Sec. 25.2518-2(e)(3) (although a surviving spouse is permitted to disclaim to a trust where the surviving spouse is a beneficiary).

V. What Drafting Language Is Used for a Formula Allocation Clause?

Here is the actual language used in the *Petter* gift instrument to transfer units to a trust for the benefit of one child and to a donor advised fund (for which that same child was an advisor) at a community foundation:[5]

1.1.1 "assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $ 907,820, so that the amount of this gift should be $ 453,910; and

1.1.2 "assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.

The gift documents also provide in section 1.2: " The Trust agrees that, *if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1*, Trustee will, *on behalf of the Trust and as a condition of the gift to it*, transfer the excess Units to The Seattle Foundation as soon as practicable." [emphasis added by Hoyt]

VI. Practical Tips For Dealing With The Charity

A. Picking the Charity – Find a Charity a That the Child/Beneficiary Likes. The private foundation in the *Christiansen* case and the donor advised fund in the *Petter, Hendrix and MccCord* cases can be very appealing to a child or beneficiary because of their own personal involvement with the charitable activity.

B. Planning an Exit Strategy – Charities Want To Sell Illiquid Assets Donated To Them

C. Private Foundations and Donor Advised Funds - An Exit Strategy May Be Mandatory

1. Definitions

   a. Private foundations are Sec. 501(c)(3) charities that receive most of their financial resources from either (i) contributions from one family or company or (ii) from endowed investment income. Their reliance on these two sources of revenue causes them to fail the "public support test". The majority of private foundations are grant-making charities.

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5 Similar language transferred the other half to a trust and donor advised fund with respect to the donor's other child.

b. A donor advised fund ("DAF") is a separately named fund that is held by a larger charity where a donor may recommend grants from the fund to eligible charitable recipients. Sec. 4966(d)(1). The governing body can accept or reject each recommendation, although as a practical matter they usually follow the donor's recommendation whenever the recipient is an eligible public charity. DAFs have become a very popular alternative to grant-making private foundations.

2. Both PFs and DAFs Must Dispose of Certain Business Interests Within Five Years Under The *Excess Business Holdings* Rules

a. Unlike most other charities, both private foundations and donor advised funds are subject to the excess business holdings tax. Sec. 4943(a) (PF) and 4943(e)(DAF). Essentially, they face a penalty unless they dispose of donated closely-held business interests that they own in conjunction with "disqualified person" within five years.[6]

b. In other words, an "exit strategy" is usually required as a matter of law for most closely-held business interests held by a PF and a DAf , rather than as a matter of investment policy as if the case for most other charities.

3. PFs Are Subject To Harsher Self-Dealing Prohibitions Concerning Sales to Related Parties than Are DAFs – Be Careful Who You Sell To

a. Private foundations are subject to a special self dealing tax if property is sold to a disqualified person. A private foundation's sale of an asset to a donor or to a related family member will likely trigger the tax. Sec. 4941(d)(2)(F). An arrangement that can solve the problem is if the business (as opposed to a family member) offers to buy an interest from all owners at a fair price and the private foundation accepts that offer.[7]

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[6] The Section 4943 excess business holdings tax obliges a private foundation to dispose of its interest in a business if more than 20% (or in some cases, 35%) of the business is owned by a combination of the private foundation, the donor, the donor's family, the donor's businesses and other disqualified persons. This is likely to be the case with a family business.

[7] See, for example, PLRs 200720021 (Feb 20, 2007) and 200230004 (Apr 10, 2002).

b. By comparison, a donor advised fund is only subject to the usual rule that property must be sold for a reasonable price – there is no self-dealing penalty for a *sale* transaction with a donor advised fund.[8]

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CLAUSE: "Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

COURT OPINION: "It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. <u>The gift documents do not allow for petitioners to "take property back"</u>. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman's value. <u>The clauses at issue are valid formula clauses</u>."

"In *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a "severe and immediate" public policy concern."

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8 A DAF is prohibited from paying a donor or family member for services and from making a grant or loan to such a person. Sec. 4958(c)(2). There is, though, no automatic prohibition for a sale transaction. Instead, there is the usual "excess benefit" penalty for an unfair price when a sale involves an insider at the charity or a substantial contributor. Secs. 4958(c)(1)(A) and 4958(f)(1).

CHARITABLE IRA ROLLOVER IN 2014 ?

I. Introduction

The Pension Protection Act of 2006 enacted a *temporary* law that permitted a person over age 70 ½ to make up to $100,000 of charitable gifts directly from an Individual Retirement Account ("IRA") (extended through 2013 by The American Taxpayer Relief Act of 2012). The donor will benefit by not having to report the IRA distribution as taxable income, although the donor will not be able to claim a charitable income tax deduction for the gift. Many retirees have been particularly motivated to apply their charitable IRA gifts to satisfy their mandatory minimum distributions. For example, a 76 year old who would normally be required to receive a taxable distribution of just over 4% from an IRA could satisfy the requirement by contributing 3% to a charity and receive a taxable distribution of just 1%.[9] NOTE: Congress waived all mandatory distributions in the year 2009 because of the severely depressed stock prices in 2008. (Worker, Retiree and Employer Recovery Act of 2008)

The new law makes no change to the rules that govern charitable bequests of IRA assets, either outright to charities or to deferred giving arrangements. Such transactions qualified for favorable income tax consequences in the past and will continue to be an attractive planning strategy in the future. The new law only changes rules for lifetime charitable gifts from IRAs.

How popular were these IRA gifts in the last four months of 2006 when the law became effective? In a survey of 1,468 such gifts totaling $30 million made from IRAs administered by over 230 financial institutions, The National Committee on Planned Giving (*NCPG*) found the median gift was $5,000. Approximately 52% of the gifts were $5,000 or less and 9% of the gifts were the legal maximum of $100,000, resulting in a higher average gift size of $20,365.[10] Nearly 20% of the donors indicated that the charitable gift satisfied all or part of their minimum required IRA distribution for the year and many others cited their desire to accelerate a promised future gift or to satisfy a pledge.[11] Harvard University received 150 such IRA gifts totaling $2.5 million in 2006, with 11 (7.3%) at the maximum $100,000 level and some gifts as small as $100.[12] The University of Kansas received approximately 100 such gifts totaling $1.6 million.

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9 "Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision." *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006*," Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 266. See also IRS Notice 2007-7; 2007-5 IRB 1, Q&A 42.

10 http: //www.ncpg.org/gov_relations/NCPG IRA survey--general results (1-18-07).pdf

11 *Id*.

12 Dale, Arden, "Charities Love IRA Rollovers", *The Wall Street Journal,* Jan. 27, 2007, p. B2, Col. 3.

II. Who Wins With Charitable IRA Rollover?
A. Donors who don't itemize their deductions

Probably the biggest winners under this new law are IRA owners over age 70 ½ who do not itemize income tax deductions (i.e., they take the standard deduction). Since the charitable deduction is an itemized deduction, they normally have the worst tax consequences from the gifts they make from their IRA distributions: they had to report the entire distribution as taxable income but received no offsetting income tax deduction. In theory, they should take advantage of the charitable IRA exclusion and make all of their charitable gifts from their IRAs. The primary obstacle is the practical impediment of making numerous small gifts -- e.g., $10 or $20 -- from an IRA. The "IRA checkbooks" offered at many brokerage houses may offer the most practical solution to this problem. Nearly two thirds of American taxpayers claim the standard deduction and the percentage is even higher for taxpayers over age 70 ½. By comparison, the new charitable IRA exclusion law gives eligible IRA donors the equivalent of an unlimited charitable income tax deduction for up to $100,000 of the charitable gifts that they make from their IRAs.

TAXPAYERS WHO USE THE STANDARD DEDUCTION
AND RECEIVE NO FEDERAL TAX BENEFIT FROM CHARITABLE GIFTS
2001 Federal Income Tax Returns

	All Taxpayers	AGI Over $100,000	AGI Over $200,000
Nationwide	**65%**	**9%**	**7%**
Detail on Selected States			
-- States With A State Income Tax			
California	61%	4%	2%
New York	61%	1%	1%
Ohio	65%	5%	2%
-- States With No State Income Tax			
Florida	71%	20%	19%
Texas	77%	21%	21%

Although non-itemizers are typically middle and lower income taxpayers, many are wealthy. The IRS estimates that there are 5.2 million *higher-income taxpayers* who claim the standard deduction and cannot get any tax benefit from their charitable gifts.[13] They tend to live in the nine states that do not have a state income tax: **Alaska, Florida, Nevada, New Hampshire, South**

[13] Parisi, Michael and Hollenbeck, Scott, "Individual Income Tax Returns, 2003," *Statistics of Income Bulletin,* Internal Revenue Service, Fall, 2005, at. p. 13.

Dakota, Tennessee, Texas, Washington and Wyoming. Donors (and, consequently, charities) who reside in these states will generally benefit more from the new charitable IRA exclusion law than donors who live in other states.

B. Donors Who Pay More Tax As AGI (adjusted gross income) Increases.

1. The health care surtax. Taxpayers are subject to the health care surtax once adjusted gross income ("AGI") exceeds $200,000 ($250,000 married filing jointly). There is a 3.8% surtax on investment income (interest, dividends, rents, annuities and capital gains) and a 0.9% surtax on wages and earned income. For donors near the threshold, using charitable IRA rollover to keep AGI low may protect their investment income from the 3.8% surtax.

2. The 3% phaseout of itemized deductions. The most common lost deduction has been the phaseout of itemized deductions. The law was temporarily waived in years 2011 and 2012, but returned in the year 2013. For every $100 of adjusted gross income that a taxpayer has over $250,000 ($300,000 for married filing jointly), taxpayers lose an additional $3 of itemized deductions. The phaseout had been 3% in 2005, 2% in 2006- 2007, and 1% in 2008-2009 and was eliminated in 2010-2012. By keeping AGI low, donors can deduct more of their itemized deductions.

3. Phaseout of $3,900 Dependent & Personal Exemption Deductions. Wealthy taxpayers cannot claim personal exemptions for themselves or their dependents. The personal exemption phase-out ("PEP") occurs for AGI between $250,000-$372,000 ($300,000-$422,000 on joint returns) . The PEPreduces a taxpayer's personal exemptions by <u>two percent</u> for each $2,500 above the AGI threshold. By avoiding the recognition of IRA distributions, taxpayers in the affected thresholds may be able to deduct personal exemptions and dependent deductions.

4. Reduced Income Tax on Social Security Payments. If a social security recipient's modified AGI is over either $44,000 (married-joint) or $34,000 (single or head-of-household), 85% of the social security payments are taxable and 15% are tax-exempt. However, if modified AGI is under either $32,000 or $25,000, then <u>all</u> of the social security payments are tax-exempt. By avoiding the recognition of taxable IRA distributions an eligible social security recipient may be able to pay less tax on social security distributions. The thresholds might not apply to married individuals who live together and file separately.

5. Other Deductions That Are Phased out as AGI Increases. Other deductions that are subject to income phase-outs, and the rates of phase-out, are:

* Medicare "B" premium rates jump when income is over $85,000 ($170,000 joint)
* 2% for "miscellaneous itemized deductions" (employee expense and investment expense deductions)
* 7 ½% for medical expense deductions
* 10% for nonbusiness casualty losses (e.g., damage to a vacation home)

C. Donors who live in states with a state income tax that provides no tax breaks for charitable gifts: Connecticut, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia state income tax computations do not permit itemized deductions. Consequently, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia residents gets no state income tax breaks from charitable gifts. Eligible donors in these states will save taxes at their highest marginal state income tax rate (e.g., 4% or 6%) for every charitable gift that they make from their IRAs instead of from their checking accounts. Although **Illinois** residents also cannot claim charitable income tax deductions, all distributions from retirement plans are exempt from the income tax so they would not see any benefit on their state returns from this new law. **Michigan and New Jersey** residents also might not see benefits since they may receive threshold amounts of retirement income exempt from state income tax and only excess amounts are subject to state taxes. The thresholds are $10,000 ($20,000 married) in New Jersey and about $40,000 ($80,000 married) in Michigan.

D. Donors who are subject to the 50% annual charitable deduction limitation. Charitable deductions cannot exceeds 50% of a taxpayer's adjusted gross income ("AGI") in any year.[14] A donor who is subject to the annual deduction limitation and who uses a taxable distribution from a retirement plan account to make an additional charitable gift would generally be able to deduct only 50% of the amount in the year of the gift. The other 50% of the distribution would be subject to income tax that year. If, instead, the charitable gift is made directly from an IRA to the charity, a donor over age 70 ½ would not pay any extra income tax.

E. Wealthy Individuals Who Want to Reduce the Size of Retirement Assets in Their Estates. Whereas most inherited stock, real estate and other assets receive a step-up in tax basis, inherited retirement distributions are generally taxed as income in respect of a decedent. The combination of estate taxes and income taxes – particularly in states that have both a state estate tax and a state income tax – can produce an effective tax rate on such inherited distributions of over 80%. Some senior citizens draw down their retirement accounts to reduce the proportion of their wealth in these assets. The charitable IRA exclusion offers an opportunity to withdraw up to $100,000 for charitable gifts without triggering some of the problems that large distributions might normally cause (e.g., the phaseout of itemized deductions and the 50% charitable deduction limitation).

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[14] Secs. 170(b)(1)(A) and (C) and Reg. Sec. 1.170A-9(e)(11)(ii). There is a 5 year carryforward for the charitable contributions that exceed 50% of AGI. Sec. 170(b)(1)(C)(ii) and last sentence of Section 170(b)(1)(B).

III. Who Doesn't Win With Charitable IRA Rollover?

A. Donors Who Are About To Sell Appreciated Stock and Appreciated Real Estate. The sale of such property will trigger a <u>15% federal long-term capital gains tax.</u> This tax could be avoided by instead donating the property to a charity before the sales negotiations are finalized. The issue, then, is whether the tax savings from the charitable IRA exclusion can exceed the pending 15% tax.

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. *In most cases, gifts of these assets will continue to provide greater tax benefits than gifts from an IRA.* On the other hand, if the donor is subject to some of the tax challenges described above – such as the 50% 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 that qualifies for the charitable IRA exclusion, she will save a little bit of money compared to receiving a taxable IRA distribution (roughly $140, or 1.4% of the distribution, due to the phaseout of her personal exemption and the 2% loss of itemized deductions). 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 with the opportunity to make a tax-free charitable gift from her IRA, she should probably receive a taxable $10,000 distribution from her IRA and contribute her stock to produce an offsetting $10,000 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.

Compare – wealthy donors in poor health have an incentive to keep appreciated stock and to instead make charitable gifts from their IRAs: "stepped-up basis." Whereas appreciated stock will receive a step-up in basis in the hands of the beneficiaries -- generally the value at the time of death -- retirement accounts receive no step-up in basis and distributions to beneficiaries are generally taxed as ordinary income. Many individuals –especially those who are so wealthy that their estates will be subject to estate tax – consciously strive to reduce the amount of retirement assets in their estates. If they plan to hold appreciated stock until death, they may prefer to make their charitable gifts from their IRAs rather than use appreciated stock.

> Example: Ms. Donor has a $10,000 IRA and has stock worth $10,000 that she bought years ago for $2,000. She loves the stock and does not think it wise to sell it. She is 75 years old, in poor health and has AGI of $200,000 and would like to make a charitable gift of $10,000. She should use the IRA for her charitable gift. Upon her death the stock will receive a new tax basis – i.e., about $10,000 – and the potential capital gains tax on the $8,000 of appreciation would be eliminated. By comparison, had she donated the stock to charity and died with $10,000 in an IRA, the distribution to her beneficiaries would produce $10,000 of taxable income.

B. Donors Who Reside In States Where the State Income Tax Laws Pose Problems

For example, the **Colorado**, **Kentucky** and **New York** state income tax laws exempt the first $41,000 of retirement income and also allow a charitable income tax deduction to reduce state income taxes. Consequently, a retiree who withdraws $1,000 from an IRA and then donates $1,000 to a charity usually has a tax advantage that the withdrawal was tax-free but the gift produced tax savings. Suppose that the $1,000 charitable gift was made directly from the IRA. On the state income tax return the donor would not report any taxable income but would lose the state income tax deduction and, consequently, would pay more state income tax.

C. Donors Who Would Not Receive Any Tax Savings from the Charitable IRA Exclusion and Who Encounter Administrative Hassles Trying to Make a Charitable Gift Directly from an IRA. Millions of donors won't save any income taxes with the charitable IRA exclusion. Who are they? They are donors who itemize tax deductions (and can therefore deduct charitable gifts) with incomes under $150,000 (so they are not subject to the 2% phase-out of itemized deductions) who can't realistically make social security benefits tax-exempt and who live in states that allow charitable income tax deductions. Most of these donors have not incurred a tax cost from their charitable gifts since the charitable income tax deduction has offset the taxable income from an IRA distribution. If the IRA administrator balks at making charitable grants from an IRA or has fees for the transaction, it will be much easier to simply receive a taxable distribution from an IRA and then write a check to make a charitable gift.

III. LEGAL REQUIREMENTS

A. Overview

A person over age 70 ½ who makes an outright charitable gift from her or his IRA:

(1) will not report the distribution as taxable income,[15] and
(2) will not be entitled to claim a charitable income tax deduction for the gift.[16]

B. Seven Basic Requirements

In order to make a lifetime charitable gift from an IRA without having to report the payment as a taxable distribution, the distribution must meet the definition of a **"qualified charitable distribution" (hereafter "QCD").**[17] Unless a distribution qualifies as a QCD, any lifetime charitable gift from any sort of retirement plan account (IRA, 403(b), 401(k), profit sharing, etc.) must be reported as a taxable distribution. The donor can then claim an offsetting charitable income

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15 Sec. 408(d)(8)(A).

16 Sec. 408(d)(8)(E).

17 Sec. 408(d)(8)(B).

tax deduction.[18]

There are seven requirements for an IRA distribution to qualify as a QCD:

1. Donor must be at least age 70 ½. The distribution must be made on or after the date that the IRA owner attained age 70 ½.[19] In most cases such donors will be retirees. Donors under age 70 ½ will have to report charitable gifts from their IRAs as taxable distributions and can claim offsetting charitable income tax deductions if they itemize their deductions.

Tax Trap in The Year a Person Attains Age 70 ½: There can be a lot of confusion in the year that a person attains age 70 ½. All distributions that are made at any time during that year can be applied toward satisfying the minimum distribution requirement to avoid the 50% penalty tax for insufficient distributions. However, only the distributions that are made after attaining the age of 70 ½ qualify for the charitable exclusion. This can be a problem for someone who attains age 70 ½ late in the year, say on December 28. The law should be changed by a technical corrections act to conform the charitable IRA exclusion rules with the minimum distribution requirements. That is, all distributions should qualify for the charitable exclusion if made "within or after the calendar year that the individual for whose benefit the plan is maintained has attained age 70 ½". Tax administration would be simplified and innocent parties would not be caught in a tax trap.

2. IRAs only. The distribution must be made from an individual retirement plan.[20] That means only an IRA -- not a qualified retirement plan or a Section 403(b) annuity. Distributions to charities from other types of retirement accounts -- such as 403(b) plans, 401(k) plans, profit sharing plans and pension plans -- will still be treated as taxable distributions to the account owners eligible for an offsetting charitable income tax deduction.

In most cases, the restriction of such favorable tax treatment to IRAs should not pose a significant problem. Many retirees have large IRA balances because they rolled over distributions from their company retirement accounts into IRAs when they retired. Donors without IRAs who would like to take advantage of the charitable IRA exclusion can establish a new IRA and then rollover some assets from their other qualified retirement plans into the new IRA.[21]

Whereas distributions from IRAs that were once part of an SEP or a SIMPLE plan qualify for the charitable exclusion, grants made from either an *ongoing* SEP IRA or an *ongoing* SIMPLE IRA do not. Small employers often establish an SEP IRA plan or a SIMPLE IRA plan as the company's only retirement plan. The employer makes contributions to each employee's IRA rather than to the

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[18] IRS Notice 2007-7; 2007-5 IRB 1, Q&A 43.

[19] Sec. 408(d)(8)(B)(ii).

[20] Sec. 408(d)(8)(B).

[21] Sec. 408(d)(3). Employees who receive distributions from any type of qualified retirement account can rollover the distribution to an IRA.

usual arrangement of a single retirement trust maintained by the employer. An SEP IRA or a SIMPLE IRA is an *ongoing* arrangement if a contribution was made to it during the year. Thus , a retired individual who has an SEP IRA or a SIMPLE IRA that received employer contributions during her or his working career can make charitable distributions from that IRA if no employer contributions were deposited in the same year as the charitable gift.[22]

3. *Directly* from the IRA to the charity.[23] The check from the IRA must be issued payable to the charity. If a check is issued from the IRA payable to the IRA owner who then endorses the check to the charity, it must be reported as a taxable distribution to the IRA owner.

Does the IRA Administrator have to mail the check to the charity? Can the check be issued payable to a charity and then mailed to the IRA account owner who then forwards the check to the charity? Yes. The IRS concluded that this arrangement would be a "direct payment" to the charity.[24] This is a very good result. The NCPG survey reported that charities received about 15% of IRA gifts from donors and 83% from IRA administrators, and that when they received checks from IRA administrators, they had difficulty identifying the correct donor 10% of the time (e.g., "$1,000 from the IRA of John Smith. Which John Smith? We have several donors with that name").[25]

4. The recipient organization must be a public charity or a private operating foundation, or possibly a conduit private foundation. The recipient organization must be described in Sec. 170(b)(1)(A).[26] This statute includes most public charities as well as private *operating* foundations. **Two exceptions: donor advised funds and supporting organizations:** Although contributions to donor advised funds and Sec. 509(a)(3) supporting organizations qualify for public charity tax deductions, they are not eligible beneficiaries for the charitable IRA exclusion. In that case, the donor must report the IRA distribution as taxable income and then claim an offsetting charitable income tax deduction.[27]

Grant-making private foundations are generally excluded, except the legislation appears to permit grants from IRAs to two types of grant-making private foundations: conduit private foundations and donor-directed funds.[28] A conduit private foundation is typically a grant-making

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22 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 36.

23 Sec. 408(d)(8)(B)(ii).

24 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 41.

25 NCPG survey, at *supra* n. 2.

26 Sec. 408(d)(8)(B)(i).

27 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 43.

28 Conduit private foundations are described in Sec. 170(b)(1)(A) and so therefore be eligible. Specifically, they are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(ii). Donor

foundation that in any given year makes an election to distribute by March 15 (oversimplified) 100% of the contributions that it received that year. A donor-directed fund allows a donor to control, not just advise, the recipient of the fund's income. Private operating foundations, such as libraries and museums that are endowed by one family, are also eligible recipients.[29] However, payments to organizations that qualify for charitable income tax deductions but which are not eligible public charities – notably veterans organizations, certain fraternal organizations and cemetery companies – are not eligible for the charitable exclusion for IRA distribution.[30]

5. The payment would otherwise fully qualify for a full charitable income tax deduction.[31] A distribution will qualify as a QCD only if a person would normally be able to claim a charitable income tax deduction for the entire payment. 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. If there is any financial benefit, then the entire distribution is taxable income and the donor must hope to get a partially offsetting charitable income tax deduction. This eliminates the possibility that an IRA distribution will qualify as a QCD if it is used to obtain a *charitable gift annuity.*

6. Distribution would otherwise be a taxable distribution, with a maximum amount of $100,000 per year.[32] By way of background, most IRA distributions are fully taxable. However, if an IRA owner made any nondeductible contributions to the IRA, then those distributions to the IRA owner are normally tax-free. A QCD only applies to the taxable portion.

The new law provides very favorable tax treatment for outright charitable gifts from IRAs that hold non-deductible contributions. Charitable distributions are deemed to come first from the taxable portion, thereby leaving the maximum amount of tax-free dollars in the IRA.[33] An example is in the footnote.[34]

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directed funds are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(iii).

29 Private operating foundations are described in Sec. 170(b)(1)(A)(vii) via Sec. 170(b)(1)(E)(i).

30 Charities are one of five categories of organization that are eligible to receive contributions that qualify for charitable income tax deductions: (1) governments, (2) U.S. charities, (3) veterans organizations, (4) certain fraternal organizations and (5) cemetery companies. Sec. 170(c). By comparison, only organizations described in Sec. 170(b)(1)(A) – generally public charities – are eligible for the charitable IRA exclusion.

31 Sec. 408(d)(8)(C).

32 Sec. 408(d)(8)(B) (last sentence).

33 Sec. 408(d)(8)(D).

34 Example: An IRA owner has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and accumulated

If any tax-free amounts are distributed to a charity, that portion does not qualify as a QCD. Instead, the donor is deemed to have received that amount free from income tax and can claim a charitable income tax deduction for a charitable gift of that part of the payment.

7. Donor must have documentation from the charity that would qualify the gift for a full charitable income tax deduction under normal circumstances.[35]

Part of the challenge of this new law is that the donor will have to obtain the required documentation from the charity necessary to qualify the payment for the customary charitable income tax deduction.[36] That is, the charity must issue a "contemporary written acknowledgment" that describes the amount of cash contributed and that certifies that the donor did not receive any financial benefits in exchange for the gift. Failure to obtain such an acknowledgment will cause the IRA distribution to be a taxable distribution to the IRA account owner and, in the absence of the documentation necessary to justify a charitable income tax deduction, presumably might cause the person to lose an offsetting charitable income tax deduction. Many charities are "tweaking" their letters to refer to the IRA distribution, so there is less chance of confusion with other tax-deductible charitable gifts that the donor might make. For example, a letter might state "thank you for your charitable gift from your IRA of ...."

C. Technical Issues

1. How does the IRA administrator report charitable distributions to the IRS and to the

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earnings. Normally, 80% of a distribution to the IRA owner would be taxable and 20% would be a tax-free return of non-deductible contributions. If however, there is a distribution to a charity that qualifies as a QCD, all of the distribution is deemed to come first from the taxable portion. Thus, if the IRA trustee makes an $80,000 distribution to a charity, the entire $80,000 is deemed to come from the taxable portion of the IRA and is a QCD. No amount is included in the IRA owner's taxable income. The $20,000 that remains in the IRA is treated as entirely nondeductible contributions.

Modified from from Example 2 of *Technical Explanation Of H.R. 4, The Pension Protection Act of 2006*, Prepared by the Staff of the Joint Committee On Taxation August 3, 2006 (JCX-38-06) on page 268.

[35] The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, *or if a deduction is not allowable because the donor did not obtain sufficient substantiation*, the exclusion is not available with respect to any part of the IRA distribution." (Emphasis added). *Technical Explanation of H.r. 4, The "Pension Protection Act of 2006*," Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 267."

[36] For any gift of $250 or more, the donor must produce a "contemporary written acknowledgment" from the charity that describes the gift and that states the value, if any, of a financial benefit that the charity provided the donor. Sec. 170(f)(8). For a contribution from an IRA, there cannot be any such benefit.

IRA owner on the Form 1099-R?

For 2006 distributions, there is no special reporting responsibility for IRA administrators. Both the charitable distributions and the distributions received by the IRA owner are reported as presumably taxable distributions to the IRA owner.

2. How does the IRA owner report the charitable IRA exclusion on his or her income tax return (Form 1040)?

Since the IRA administrator does not make any distinction between charitable and non-charitable IRA distributions, the burden falls on the IRA owner to make the adjustments on his or her personal return. From a policy perceptive this is a good practice since the IRA owner is in the best position to know whether a charitable distribution in fact qualifies for the charitable IRA exclusion or not.

The IRA owner should report all of the IRA distributions on the front page on the income tax return (Form 1040 - *total distributions* on Line 15A) but should then report only the *taxable distributions* on line 15B. Source: Form 1040 instructions, page 25. Thus, the charitable IRA exclusion will be reported similarly to a traditional rollover, where a person may have received a taxable distribution from an IRA but is able to avoid taxation by rolling over the amount within 60 days to another IRA. These charitable IRA gifts will not be disclosed in any way on Schedule A, where a person claims an itemized income tax deduction for conventional charitable gifts.

Example: Mr. Smith, age 76, is required to withdraw $4,000 from his IRA in 2007 to avoid the 50% penalty for failure to take minimum required distributions after age 70 1/2. He had the IRA trustee send a $1,000 check to his favorite charity. Mr. Smith received an acknowledgment from the charity that stated that he received no personal benefit and that the entire gift qualified for a charitable income tax deduction under the normal rules (such an acknowledgment is necessary for the charitable IRA exclusion). Mr. Smith personally withdrew an additional $3,000 from the IRA.

The IRA custodian will issue Form 1099-R and will report $4,000 of total distributions. Mr. Smith will report the $4,000 of total distributions on Line 15A of Form 1040 but will report only $3,000 of taxable distributions on Line 15B.[37] The $1,000 gift will not be disclosed or reported on Schedule A where Mr. Smith deducts the other charitable gifts that he made.

3. A person over age 70 ½ who is the beneficiary of an *inherited* IRA can take advantage of the charitable IRA exclusion.[38].

4. Can a charitable IRA distribution be used to satisfy a pledge? Yes. This is a very important development. The payment of a pledge from an IRA was a recurring reason donors cited

[37] See the instructions to Form 1040 at http://www.irs.gov/pub/irs-pdf/f1040.pdf

[38] IRS Notice 2007-7; 2007-5 IRB 1, Q&A 37.

for made a charitable gift from an IRA.[39]

a. No violation of IRA self dealing rules. Charitable IRA distributions can satisfy pledges without violating the IRA self-dealing prohibited transaction rules. "The Department of Labor, which has interpretive jurisdiction with respect to section 4975(d), has advised Treasury and the IRS that a distribution made by an IRA trustee directly to a section 170(b)(1)(A) organization (as permitted by section 408(d)(8)(B)(i)) will be treated as a receipt by the IRA owner under section 4975(d)(9), and thus would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization."[40]

b. No income to the donor, even though normally there can be income when a third party pays off a person's personal liability. For a legally binding pledge (as opposed to a non-binding pledge), some people raise the argument that a donor might have taxable income if a legal liability is discharged by a third party, thereby making the donor richer. However, Section 108(e)(2) provides that a taxpayer does not have taxable income if there is a discharge of indebtedness and the payment would have been deductible. Since the payment of a pledge provides a charitable deduction, a donor should not have taxable income if a third party pays it.

5. Each spouse over age 70 ½ is eligible to contribute up to $100,000 from that spouse's IRA to eligible charities, with the maximum charitable IRA exclusion on a joint return of $200,000. The distribution must come from each spouse's respective IRA. For example, a married couple would not be able to exclude $140,000 of charitable gifts from one IRA and $60,000 of charitable gifts from another since the $140,000 would exceed the annual $100,000 limit.[41] IRS Notice 2007-7; 2007-5 IRB 1, Q&A 34.

6. A charitable IRA distribution is not subject to withholding taxes. The IRA administrator may rely upon reasonable representations made by the IRA owner. A qualified charitable distribution is not subject to withholding under section 3405 because an IRA owner that requests such a distribution is deemed to have elected out of withholding under section 3405(a)(2). IRS Notice 2007-7; 2007-5 IRB 1, Q&A 40.

7. The exclusion applies to any such charitable distribution made during 2006, even those made before the law was enacted on August 17, 2006. IRS Notice 2007-7; 2007-5 IRB 1, Q&A 38. This may be advantageous to people who have "IRA checkbooks" (typically at brokerage houses) where they can write checks directly from an IRA. A person over age 70 ½ who wrote such a check to a qualifying charity early in 2006 can take advantage of the exclusion.

IV. CONCLUSION - An eligible IRA owner over the age of 70- ½ should attempt to make a qualified charitable distribution from an IRA if the tax savings exceed the administrative costs that the transaction might generate. For people who itemize their deductions and can

39 NCPG survey, at *supra* n. 2.

40 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 44.

41 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 34.

claim offsetting charitable income tax deduction, it will usually be administratively easier to simply receive a check from the IRA and then make a charitable gift. However, for those individuals who do not itemize, who live in states with no charitable deduction or who otherwise benefit by keeping their AGI lower, it may be worth the effort to work with the IRA administrator to make that large charitable gift from the IRA.

ANOTHER LIFETIME USE OF IRA ASSETS: A LOAN FROM AN IRA TO A CHARITY. CHARITY COULD USE LOAN PROCEEDS TO PURCHASE LIFE INSURANCE. Private Letter Ruling 200741016 (July 12, 2007).

www.chirafinancialservices.com (patent application was filed)

A taxpayer proposed lending money from an IRA to a charity with a reasonable interest rate and with payment of the loan due upon his death. The charity anticipated using part of the loan proceeds to purchase a life insurance policy on the life of the IRA Owner. The Service concluded in PLR 200741016 that the IRA loan was not a "prohibited transaction" under the IRA prohibitions contained in Section 4975. Furthermore, the Service concluded that the charity's purchase of a life insurance policy was not a "prohibited investment in insurance" under Section 408(a)(3)." The IRS said there was no problem with either.

Implications: #1 Benefit from lifetime charitable use of IRA assets. by lending money from an IRA to a charity, a person can allow the lifetime use of her or his IRA assets by the charity. This can be more tax-efficient than receiving a distribution from the IRA and then donating or lending it to the charity. Except for the $100,000 provision for donors over age 70 ½ ("Charitable IRA Rollover"), usually there is taxable income from lifetime IRA withdrawals.

A charitably-inclined individual might also want to make a charitable bequest of those IRA assets to the charity at death in order to cancel the debt. Thus, instead of purchasing life insurance, this could be a great vehicle for using loan proceeds to construct a dormitory at a college or a wing at a hospital while the donor is still alive. Upon death the charity would receive its own promissory note and the debt would be canceled.

#2 – IRAs are prohibited from owning life insurance. This arrangement permits IRA dollars to indirectly be used for the purchase of insurance.

Planning tip: Probably need a self-directed IRA to do this since conventional IRA trustees and custodians usually limit investments in mutual funds, etc. and might not consent to a large loan to one charitable institution.

PLANNING BEQUESTS FROM RETIREMENT ACCOUNTS - MINIMUM DISTRIBUTIONS AND THE 50% PENALTY TAX

A. OBJECTIVES

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.[42] 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.[43] 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."

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42 Sec. 72(t).

43 Sec. 4974; Reg. Sec. 54.4974-2. If there is reasonable cause for the failure, the penalty can be waived. Reg. Sec. 54.4974-2, Q&A 7. In addition, a qualified retirement plan could be disqualified for failing to make the required distributions. Sec. 401(a)(9).

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.

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%

Lifetime distributions are generally unaffected by who you name to be the beneficiary of your account after your death (unlike prior law). The only exception is if the sole beneficiary of your account is a spouse who is more than ten years younger than you. Other than that, the minimum lifetime distributions over the rest of your life will be the same whether you name a charity, your father, your mother, your sister, your brother, your child, your grandchild, your dog or your cat. However, distributions after your death can vary depending on who the beneficiary is. [Table computed from Table A-2 of Reg. Sec. 1.401(a)(9)-9 (2002) -- (rounded up)]

D. MAXIMUM YEARS FOR PAYOUTS AFTER ACCOUNT OWNER'S DEATH

This table contains the maximum number of years that distributions may be made from an IRA or some other type of qualified retirement plan after the account owner's death. The maximum term of years is the remaining life expectancy of either (#1) the account owner, measured by his or her birthday in the year of death (or just 5 years if the account owner dies before the required beginning date (RMD), or (#2) the life expectancy of a designated beneficiary, based on that beneficiary's age at the end of the year that follows the account owner's death.

Whether the term will be #1 or #2 is determined by the identity of the beneficiaries who have not been paid in full by the "determination date" (September 30 following the year of death). The term will be based on the account owner's age (i.e., #1) if on the determination date there is any beneficiary who fails to qualify as a "designated beneficiary" (e.g., a charity or the account owner's estate). If, instead, all of the beneficiaries are designated beneficiaries, then the payout is determined by the age of the oldest designated beneficiary (i.e., #2).

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.

E. REQUIRED DISTRIBUTIONS AFTER DEATH-- Terminology

Required Beginning Date ("RBD") - The first date that a distribution must be made from an IRA, QRP or 403(b) account to the account owner in order to avoid the 50% penalty tax.[44]

IRAs**:** The RBD for an IRA is April 1 following the calendar year that the IRA account owner attains age 70 ½.[45]

QRP or 403(b): The RBD for a qualified retirement plan or a tax-sheltered annuity is the *later* of (a) April 1 following the calendar year that the account owner attains age 70 ½ or (b) April 1 following the calendar year that the employee separates from service (e.g., somebody who works past age 71).[46] Individuals who own 5% or more of a business are not eligible for this later RBD: their RBD is April 1 following the calendar year that they attain age 70 ½.

"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").[47] 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 (a "look-through 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.[48] Example: Sarah died on June 15, 2013, the determination date for her IRA and QRP accounts will be September 30, 2014. 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 impact the required minimum distributions. PLR 200740018 (July 12, 2007).

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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44 Sec. 4974; Reg. Sec. 54.4974-2, Q&A 1 and 2.

45 Sec. 408(a)(6); Reg. Sec. 1.408-8 Q&A 3.

46 Sec. 401(a)(9)(E); Reg. Sec. 1.401(a)(9)-2, Q&A 2.

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

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

F. DISCLAIMERS -- 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 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 (by comparison, any acceptance of benefits will normally disqualify a disclaimer). The estate can then claim an estate tax charitable deduction for the amount that was transferred to a charity by way of the disclaimer.[49]

> 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.[50]

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. [51]

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.[52]

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49 Reg. Section 20.2055-2(c)(1).

50 Rev. Rul.2005-36, 2005-26 IRB 1368

51 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 200649023 (Aug. 23, 2006), 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).

52 Reg. Sec. 25.2518-2(e)(3).

REQUIRED MINIMUM DISTRIBUTIONS FROM IRAs AND QRPs AFTER THE ACCOUNT OWNER'S DEATH, BASED ON THE BENEFICIARIES AS OF THE "DETERMINATION DATE"

BENEFICIARY	DEATH BEFORE RBD	DEATH AFTER RBD
The estate, a charity, a charitable remainder trust, charitable lead trust, an ineligible trust, or *no designated beneficiary* ("DB")	Five Years	Remaining life expectancy of someone who was the *decedent's age* in the year *of* death
NON-SPOUSE DESIG. BENIF.		
General Rule	Remaining life expectancy of the *Designated Beneficiary*,* fixed as of the year *after* death. Distributions must begin before the end of the year that follows the year of death.	– Same Rule -- * - (if the DB is older than the deceased, use life expect. based on deceased's age)
Rollover option?	Not available to anyone but a surviving spouse.**	** - Possible to transfer decedent's account from a company plan (but not from an IRA) to an IRA payable over the life expectancy of non-spouse.
Multiple DBs	Remaining life expectancy of the ***oldest DB***, fixed as of the year after death, unless there are separate accounts for the DBs. Distributions must begin before the end of the year that follows the year of death.	– Same Rule --
Both a charity and a DB	Five Years, unless there are separate accounts for the beneficiaries	Remaining life expectancy of someone who was the *decedent's age*, unless separate accounts for the beneficiaries.
SPECIAL RULES		
"Look-through" trust/ "See-through" trust	"Look through" to life expectancies of the beneficiaries (note: a charity does not have a life expectancy).	– Same Rule --
Remainder beneficiary of an "accumulation trust"	A remainder beneficiary is counted as a beneficiary (e.g., charitable remainder trust) and is not a contingent beneficiary.	– Same Rule –

BENEFICIARY	DEATH BEFORE RBD	DEATH AFTER RBD
SPOUSE IS THE SOLE DB		
Rollover Option?	Yes, available	Yes, available
Leave in deceased's account?		
-- General Rule	Minimum distributions over the surviving spouse's remaining life expectancy, *gradually extended* each year as the spouse ages.	– Same Rule --
-- IRAs only: elect to treat as own IRA	Surviving spouse can elect to leave assets in deceased's IRA but treat that IRA like a rollover IRA.	– Same Rule --
-- Decedent died before age 70 ½?	Can defer first distribution until the year that the deceased spouse would have been age 70 ½.	Not applicable
MULTIPLE DBs; ONE IS THE SPOUSE		
Both spouse and another DB are the beneficiaries	Remaining life expectancy of the **oldest DB**, *fixed* as of the determination date, unless there are separate accounts for the DBs.	– Same Rule --
Both spouse and charity are beneficiaries	Five Years, unless separate accounts for the beneficiaries.	Remaining life expectancy of someone who was the *decedent's age*, unless separate accounts for the beneficiaries.
"Look-through" trust/ "See-through" trust	"Look through" to life expectancies of the beneficiaries (note: a charity does not have a life expectancy).	– Same Rule --
Remainder beneficiary	A remainder beneficiary is counted as a beneficiary.	– Same Rule –

GLOSSARY

Designated Beneficiary ("DB") - 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").[53] Neither a charity nor the decedent's estate will qualify as a DB since neither has a life expectancy.[54] 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 (an "eligible trust").[55]

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.[56] Example: Sarah died in 2008 the determination date for her IRA and QRP accounts will be September 30, 2009. 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. PLR 200740018 (July 12, 2007).

Five Year Rule - If an account is subject to the five year rule, then the entire account must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's death.[57] For example, if an employee died on January 11, 2008, the entire interest must be distributed by December 31, 2013.

Ineligible Trust - If a trust is not an eligible trust, then the IRA is deemed to have no DB.[58]

Life expectancy / remaining life expectancy - The maximum number of years that a deceased account owner's IRA or QRP account can hold assets before it must finally be depleted is usually based on the life expectancy of either a designated beneficiary (DB) or of someone who is the same age as the deceased account owner.[59] Whereas the number of years is usually frozen based on a person's life expectancy as of the determination date, a surviving spouse who is the *sole* beneficiary of the account is permitted to extend the date as she or he ages.[60]

Look-Through Trust (a/k/a "See-through Trust") -- If certain criteria are met, a trust can be named as a beneficiary of either an IRA or a QRP account and each of the individuals who are beneficiaries of the trust will be considered beneficiaries of the IRA or QRP.[61]

Qualified Retirement Plan ("QRP") - Profit sharing plan, 401(k) plan, pension plan, money purchase plan, defined benefit plan, or employee stock ownership plan ("ESOP").[62] For purposes of this paper, the term will also include Sec. 403(b) plans.

Remainder Beneficiary - A beneficiary that is entitled to payments upon the termination of someone else's

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

54 Reg. Sec. 1.401(a)(9)-4, Q&A 3.

55 Reg. Sec. 1.401(a)(9)-4, Q&A 5 and 6.

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

57 Section 401(a)(9)(B)(ii); Reg. Sec. 1.401(a)(9)-3, Q&A 1(a) and 2.

58 Reg. Sec. 1.401(a)(9)-4, Q&A 5(a).

59 After the account owner's death, life expectancies are based on the figures contained in Table A-1 of Reg. Sec. 1.401(a)(9)-9. See Reg. Sec. 1.401(a)(9)-5, Q&A 5(a)-(c) and Q&A 6.

60 Compare Reg. Sec. 1.401(a)(9)-5, Q&A (c)(1) (a nonspouse beneficiary) with Q&A (c)(2) (spouse is sole beneficiary).

61 Reg. Sec. 1.401(a)(9)-4, Q&A 5 and 6.

62 Sec. 401(a); Reg. Sec. 1.401-1(a).

rights (e.g., upon the termination of an income beneficiary's interest).[63]

Required Beginning Date ("RBD") - The first date that a distribution must be made from an IRA, QRP or 403(b) account to avoid the 50% penalty tax.[64]

IRAs**:** The RBD for an IRA is April 1 following the calendar year that the IRA account owner attains age 70 ½.[65] ***QRP or 403(b)***: The RBD for a qualified retirement plan or a tax-sheltered annuity is the *later* of (a) April 1 following the calendar year that the account owner attains age 70 ½ or (b) April 1 following the calendar year that the employee separates from service (e.g., somebody who works past age 71).[66] Individuals who own 5% or more of a business are not eligible for this later RBD: their RBD is April 1 following the calendar year that they attain age 70 ½.[67]

Rollover - A surviving spouse is the only person who can rollover a distribution from an inherited IRA or QRP account into a new IRA that treats the surviving spouse as the new account owner.[68] No other person can rollover an inherited retirement plan distribution; he or she must report each distribution as taxable income in the year that it is made from the deceased's account.[69]
See-through Trust -- Same as "Look-Through Trust"

Separate Accounts – If an IRA or QRP account is divided into separate accounts, then the minimum distributions after the account owner's death are generally computed separately based on the beneficiary of each of the separate accounts. In other words, the separate accounts are treated like separate IRAs. A separate account is a portion of the deceased's IRA or QRP account that is determined using an acceptable separate accounting and to which a pro rata allocation of investment gains and losses, etc. is made in a reasonable and consistent manner.[70] For an example of separate payout streams when an IRA was payable to a trust that provided 10% for charities and 90% for family, see PLR 200218039 (Feb. 4, 2002)(using the 1987 proposed regulations).

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63 Private Letter Ruling 9820021 concluded that a charity that was a remainder beneficiary of a trust would be considered as one of the beneficiaries of the trust for purposes of computing the minimum required distributions.

64 Sec. 4974; Reg. Sec. 54.4974-2, Q&A 1 and 2.

65 Sec. 408(a)(6); Reg. Sec. 1.408-8 Q&A 3.

66 Sec. 401(a)(9)(E); Reg. Sec. 1.401(a)(9)-2, Q&A 2.

67 Reg. Sec. 1.401(a)(9)-2, Q&A 2(b) and (c).

68 Sec. 402(c)(9) for inherited QRP accounts and Sec. 408(d)(3)(C)(ii)(II) for inherited IRAs.

69 The general prohibition against rolling over an inherited IRA is described in Sec. 408(d)(3)(C).

70 Reg. Sec. 1.401(a)(9)-8, Q&A 2 and 3.

G. REQUIRED DISTRIBUTIONS AFTER DEATH FOR PEOPLE WHO DIE AFTER "THE REQUIRED BEGINNING DATE" (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.)]

*RULES IF SPOUSE IS NOT A DESIGNATED BENEFICIARY (*Spouses generally qualify for the most favorable treatment, such as rollovers). GENERAL RULE The general rule is that distributions can be extended over the life expectancy of a person who is the same age as the account owner in the year of death. This applies if there is no "designated beneficiary" -- i.e., no individual. Reg. Sec. 1.401(a)(9)-5, Q&A 5(c)(1). For example, if the beneficiary is a charity or the decedent's estate there is no "designated beneficiary."

EXAMPLE: 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).

EXCEPTION IF THERE IS A YOUNGER DESIGNATED BENEFICIARY

Instead of distributing the amounts over the life expectancy of someone who is the decedent's age, amounts can be distributed over the longer life expectancy of a younger designated beneficiary. The life expectancy of the designated beneficiary is determined by using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the account owner's death. Reg. Sec. 1.401(a)(9)-5, Q&A 5(c)(1).

EXAMPLE: 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.

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* The term "stretch IRA" usually refers to an IRA where, after the original account owner's death, the distributions from the IRA are stretched over the life expectancy of the designated beneficiary (e.g, a grandchild). As a practical matter, most planning focuses on IRAs rather than company retirement plans or even 403(b) plans, despite the fact that the laws on minimum lifetime and testamentary distributions are basically the same for all these plans. Many companies choose to distribute account balances in full upon an employee's retirement or death to eliminate the burden of maintaining the account, even though the tax laws permit distributions to occur over a much longer time period. By comparison, banks and mutual funds that administer IRAs are generally very willing to administer the accounts for extended time periods.

OBSERVATION: If there is a designated beneficiary who is *older* than the account owner, then the account can be distributed based on the life expectancy of someone who was the same age as the account owner rather than over the shorter remaining life expectancy of the older designated beneficiary. EXAMPLE: When Sam died at the age of 79 he had named his 85 year old sister as the sole beneficiary of the IRA. Next year his sister was age 86. The mandatory distributions are based on the remaining life expectancy of a 79 year old (rather than an 85 or 86 year old) determined in the year of Sam's death (rather than in the subsequent year). Reg. Sec. 1.401(a)(9)-5, Q&A 5(a)(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 are 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).
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); PLR 200740018 (July 12, 2007).

#2: SEPARATE ACCOUNT FOR THE CHARITY: Reg. Sec. 1.401(a)(9)-8, Q&A 2 and 3. In that case, the distributions to the other beneficiaries are computed without regard to the account for the charity. For an example of separate payout streams when an IRA was payable to a trust that provided 10% for charities and 90% for family, see PLR 200218039 (Feb. 4, 2002) (using the 1987 proposed regulations).

III. FUNDING TRUSTS WITH RETIREMENT ASSETS AT DEATH

INCOME TAX OBJECTIVE: To be able to liquidate the IRA over the maximum possible number of years, which will usually be the remaining life expectancy of the trust's "designated beneficiary." Normally neither an estate nor a trust qualifies as a designated beneficiary. However, under certain circumstances the tax regulations permit a trust to be named as the beneficiary of an IRA and the IRA can be liquidated over the life expectancy of the trust's beneficiary. There is no such exception when an estate is named as the beneficiary of an IRA.

A. CHECKLIST OF PLANNING CONSIDERATIONS

1. The post-death IRA distribution rules tend to work better if individuals are named as beneficiaries instead of trusts. If a trust can be avoided, the IRA liquidation rules will often operate more clearly and efficiently. The stretch IRA regulations were drafted assuming that individuals were named as beneficiaries. A trust adds a layer of complexity. If a person has a financially savvy spouse or child, the stretch IRA liquidation rules will usually favor naming them as beneficiaries rather than a trust. On the other hand, in some circumstances a trust may be necessary. Such situations include incompetent beneficiaries, multiple beneficiaries with conflicting interests, and situations where the IRA owner desires greater asset protection because of fears that a beneficiary may have problems with future creditors or a future divorce.

2. If a retirement account will make distributions to a trust, in many cases the trust instrument should specifically address how it will redistribute these amounts to the trust's beneficiaries separately from other trust income. Unless there are specific instructions in the trust instrument, retirement plan distributions might be "trapping distributions" – taxable income under the income tax laws but trust corpus under state trust laws. In addition, the marital estate tax deduction could be at risk. Usually the trust beneficiary will be in a lower income tax bracket than the trust and it may make sense to instruct that retirement plan distributions be redistributed to the trust beneficiary. This will generally be most important for trusts that distribute traditional concepts of "net income" compared to trusts that distribute a unitrust amount (e.g., 4% of corpus each year).

EXAMPLE: In many states the Uniform Principal and Income Act provides that *unless* the trust instrument states otherwise, receipts of deferred compensation payments will be classified as 90% principal and 10% income. Thus, if a $100,000 IRA makes a mandatory distribution of $6,000 (6%) to a trust that pays "net income" to a surviving spouse, the trustee may be required under state law to retain $5,400 (subject to the trust's high income tax rates) and only distribute $600 to the surviving spouse. The spouse who receives a $600 check from a $100,000 IRA might feel short-changed. Thus, it is best to plan in advance the portion of the mandatory IRA distributions that should be distributed to the trust beneficiary and to draft these provisions into the trust instrument. ***If a marital estate tax deduction is needed***: The IRS does not want to see the surviving spouse restricted to receiving only 10% of retirement plan distributions made to a trust. Instead, the spouse should be entitled to demand all of the income earned by the retirement account, with income determined under state law. Rev. Rul. 2006-26, 2006-22 I.R.B. 1 (amplifying Rev. Rul 2000-2 and Rev. Rul. 89-89).

3. Don't Satisfy A Pecuniary Bequest With Retirement Assets. The IRS Chief Counsel concluded that satisfying a pecuniary charitable bequest with an IRA will trigger taxable income to the estate. The memorandum also stated that the trust could not claim an offsetting charitable income tax deduction since the decedent's trust instrument contained no instructions to pay any income to charities. ILM 200644020 (Dec. 15, 2005 -- released to the public in November, 2006). This new ruling comes as a surprise since the IRS had issued several private letter rulings in the 1990s in which there was no hint of taxable income when IRAs payable to estates were used for *marital trusts funded with pecuniary formulas*. PLRs 9524020 (June 16, 1995), 9608036 (Feb. 23, 1996), 9623056 (June 7, 1996) and 9808043 (Feb 20, 1998). For analysis of these marital trust rulings and disclaimer strategies for pecuniary amounts in marital and credit shelter trusts, see Choate, "Assignment of the Right-To-Receive IRD", *Life and Death Planning for Retirement Benefits* (5th ed. 2002), Section 2.2.06, pages 92-94. Until this legal controversy is resolved, it would be prudent to avoid satisfying pecuniary bequests with retirement assets.

3. In order to use the life expectancy of a trust's beneficiary, four conditions in the tax regulation must be met to have a "look-through trust" (a/k/a/ "see-through trust") -- If a trust is named as a beneficiary of an IRA or some other type of qualified retirement plan account, Reg. Sec. 1.409(a)(9)-4, Q&A 5 and 6 permit beneficiaries of the trust to be treated as beneficiaries of the retirement account for purposes of determining minimum mandatory distributions if the following conditions are met:

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
(2) The trust is irrevocable or will become irrevocable upon the death of the employee.
(3) The beneficiaries of the trust are identifiable from the trust instrument, and

(4) Either one of the following documents has been provided to the plan administrator:
  (a) a document that contains:
    (i) a list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement sufficient to establish whether or not the spouse is the sole beneficiary) entitled to receive retirement assets;
    (ii) a certification that the list is correct and complete and that the preceding 3 requirements have been met to the best of the retirement account owner's knowledge),
    (iii) a statement that if the trust instrument is amended at any time in the future, the retirement account owner will provide corrected certifications to the plan administrator, and
    (iv) a statement that the retirement account owner agrees to provide a copy of the trust instrument to the plan administrator upon demand.

  (b) A copy of the entire trust instrument, together with a statement that the account owner will provide copies of future amendments.

4. The trust instrument should provide that following September 29 after the year of death, retirement distributions may only be made to individuals and cannot be used to pay creditors or estate expenses or taxes, nor can they be paid to a contingent beneficiary who is older than the primary beneficiary. If retirement distributions could be paid to or for the benefit of the estate, then the estate will be considered a beneficiary and payments cannot be measured by the life expectancy of a beneficiary of the trust (an exception in PLR 200432027). For examples of restrictions accepted by the IRS, see PLRs 200453023, 200432027-200432029 and 200235038.

5. If a trust that is named as the IRA beneficiary will be divided into subtrusts for each individual after the settlor's death, expect the IRS to insist that every subtrust receive distributions based on the life expectancy of the oldest beneficiary of the original trust. This may not be a problem if all of the beneficiaries are close in age, such as the children of the decedent, but it can be a problem if there is an elderly beneficiary with a short life expectancy and several younger beneficiaries who have long life expectancies. PLRs 200528031-200528035, 200444033-200444034, 200410019 & 200317041. ***SOLUTION APPROVED BY THE IRS >>*** If the IRS Owner separately names each of the sub-trusts on the IRA beneficiary form, the IRS will permit each trust to receive payments based on the life expectancy of the individual beneficiary of that trust. PLR 200537044 (Mar. 29, 2005).

6. Trusts with both elderly and young beneficiaries pose problems under the IRA distribution rules, since the IRA will usually have to be liquidated over the elderly person's short remaining life expectancy. This is a common problem for bypass and QTIP trusts that benefit an elderly spouse and younger children. The average age of decedents on federal estate tax returns is 77 years for men and 81 years for women. Half die over these ages; half die younger (oversimplified). For the approximately 50% who die over these ages and who have a surviving spouse who is roughly the same age, an IRA payable to a trust that benefits both the spouse and a 50-year old child will have to be liquidated over the short (12 years or less) remaining life expectancy of the spouse rather than the child's 34 year remaining life expectancy. Planning strategies to cope with this situation are addressed in this paper.

7. If the IRA owner has lived past the "required beginning date" (e.g., is over age 71) and the only beneficiary of the trust will be someone other than a spouse who is older than the IRA owner, then don't worry about #3 through #6 above. In that case the IRA will be liquidated over the life expectancy of someone who was the IRA owner's age in the year of death. There is no advantage to try to use the older beneficiary's life expectancy. On the other hand, if the IRA owner has not reached the required beginning date, it will be important to meet these requirements or else the IRA will have to be liquidated within just 5 years. In addition, if the beneficiary is the spouse, it is usually better for the surviving spouse to do a rollover than to have the IRA liquidated over the spouse's remaining life expectancy.

PRIVATE LETTER RULINGS THAT ADDRESS PROBLEMS OF FUNDING TRUSTS WITH RETIREMENT ASSETS

Remote Contingent Beneficiaries of Trust Must Be Considered

A young client with two minor children established a conventional trust that would provide payments for the benefit of his two minor children. The trust would terminate when the youngest child attained age 30. However, in the event that all family members died before the youngest child attained age 30, the assets would pass to his uncle, who was then age 67.

The client named the trust as the beneficiary of his IRA. The IRS concluded that the 67 year old uncle must be considered as one of the potential beneficiaries. PLR 200228025 (Apr. 18, 2002). Consequently, mandatory IRA payouts to the two minor children might be computed based on the life expectancy of the 67 year old (who might be in his 80's when the client died)!! Shock waves!!! In addition to family members, this could make it difficult to name a charity as a remote contingent beneficiary in the event of a family catastrophe.

SOLUTIONS: Potential solutions until the IRS changes its view:

#1: PROHIBIT DISTRIBUTIONS TO OLDER BENEFICIARIES AFTER SEPTEMBER 30: Add a restriction to the trust instrument that after September 30 of the year following death, no retirement plan assets can be paid to someone who is older than the primary beneficiary. There could be a similar restriction that retirement assets may be used for administrative expenses and taxes up to September 29 following the year of death, but that on or after September 30 such assets may only be used for or paid to designated beneficiaries, so that their life expectancies can be used to measure the distribution period. PLR 200235038 and PLRs 200432027- 200432029 (May 12, 2004).

#2: HAVE TRUST QUALIFY AS A CONDUIT TRUST: A conduit trust is a trust where the governing trust instrument requires all retirement plan payments to be made directly to the primary intended beneficiary so that no retirement assets accumulate in the trust. For purposes of computing the mandatory IRA distributions, contingent trust beneficiaries of conduit trusts are not considered. Reg. Sec. 1.401(a)(9)-5, Q&A 7(c)(3), Example 2. What happens if everybody dies in a car accident? Who will receive the IRA money? Consider giving someone a power of appointment under these circumstances to name beneficiaries of the retirement assets, with the restriction that all beneficiaries must be younger than the original intended beneficiaries of the conduit trust. CONDUIT TRUST COULD BE CONVERTED TO ACCUMULATION TRUST BY TRUST PROTECTOR: The IRS permitted a Trust Protector to exercise a power to convert a conduit trust into an accumulation trust under certain circumstances. PLR 200537044 (Mar. 29, 2005)

DANGER OF SUBTRUSTS: If a trust will split into subtrusts after death, the distribution period for all subtrusts might be measured by the life expectancy of the oldest beneficiary of the original trust rather than by the life expectancy of each beneficiary of each subtrust. SOLUTION: Name each subtrust as a beneficiary on the IRA beneficiary designation form rather than the original master trust. PLR 200537044.

THE ISSUE: IRA Owner named a trust for his three children as the beneficiary of his IRA. Upon the IRA Owner's death, the trust would split into three subtrusts. The IRA Owner had hoped to split the IRA into three separate IRAs and then have each IRA pay amounts to each subtrust. He had hoped each IRA could be liquidated over each child's respective life expectancy.

THE DANGER: IRS disagrees. There was only one trust named as the beneficiary of the IRA, so the IRA must be emptied over the oldest beneficiary's life expectancy. This could be a problem if there is a big spread in ages among the children (e.g., decedent had two marriages and has children from each marriage with a wide disparity of ages). PLRs 200528031-200528035 (Apr. 18, 2005), 200444033-200444034 (Aug 3. 2004), 200432027- 200432029 (May 12, 2004), 200410019 (Dec. 9, 2003) and 200317041 (Dec. 19, 2002)

> ADMINISTRATIVE CONVENIENCE: Under these circumstances, the IRS will permit an IRA to be subdivided into subaccounts for each subtrust for the administrative convenience of having separate investments and separate distributions for each beneficiary. These subaccounts are not considered "separate accounts" under the qualified plan regulations. "Separate accounts" permit separate life expectancy computations for each beneficiary. Where all parties agreed to liquidate the IRA based on the life expectancy of the oldest beneficiary of the original trust, the IRS did not object to having the administrative advantages of independent subaccounts for investments and distributions. The accounts were accomplished with trustee-to-trustee transfers. PLRs 200444033 & 200444034 (Aug 3. 2004).

THE SOLUTION: If the IRS Owner separately names each of the subtrusts on the IRA beneficiary form rather than the single master trust, the IRS will permit each such trust to receive payments based on the life expectancy of the individual beneficiary of that trust. PLR 200537044 (Mar. 29, 2005). In that ruling, nine sub-trusts would be established after the IRA owner's death for nine individuals. The IRS concluded that each subtrust could receive distributions over each individual's life expectancy. Each subtrust was a conduit trust. The IRS permitted the arrangement to stand even though a Trust Protector had the power to convert each conduit trust into an accumulation trust.

Stretch IRA Over Child's Life Expectancy Is OK Even Though Retirement Assets Were Used to Pay Administrative Expenses and Estate Taxes and There Is A Contingent Liability to Pay Estate Taxes After September 30. The typical trust provides for the payment of administrative expenses and taxes. If retirement assets could be used for these purposes, then one of the beneficiaries could be the estate or some other beneficiary that is not a human being. In that case, payments could not be made over the extended life expectancy of a beneficiary. One solution is to insert a provision in the trust instrument that prohibits the use of retirement assets for such expenditures after September 30. Instead, other assets must be used.

PLRs 200432027- 200432029 (May 12, 2004)**:** In these rulings, all of the expenses were in fact paid by September 30. However, the federal estate tax return had not been audited and, until the statute of limitations expired, there would be the continuing possibility that additional tax might be due. In this case, the IRA was the only asset that would be able to produce the cash to pay the tax. Thus, language instructing the trustee not to use retirement assets for estate taxes might not prevent the IRS from seizing the assets and actually applying them toward the tax liability. The IRS ignored this risk and held that all of the beneficiaries of the trust were designated beneficiaries and that payments could be made over the life expectancy of the oldest beneficiary. This ruling applied the September 30 cut-off "at the close of business" on September 30, suggesting that it may be possible to still have a beneficiary other than a designated beneficiary on the morning of September 30!

Trust is Beneficiary of IRA; Trust Can Terminate Early and "Distribute" IRA to Beneficiaries Without Triggering Taxable Income.

ISSUE: What happens if a look-through trust for three children is named as the beneficiary of an IRA, and then the trust terminates early? Will the IRA have to be liquidated, thereby triggering taxable income?

SOLUTION IN PLRs 200432027- 200432029 (May 12, 2004): The look-through trust may treat the IRA as a form of property (e.g., like stock or real estate) and effectively "distribute" the IRA from the trust to the children. The IRA itself retains its assets and there is no taxable income until each child receives distributions from his or her IRA. The IRS required the IRA to be liquidated to all three children based on the life expectancy of the oldest beneficiary, based on the logic of the subtrust rulings described above.

WILL IRA ADMINISTRATORS GO ALONG WITH THIS? What does an IRA administrator do when the IRA beneficiary form states that the beneficiary is Trust XYZ but a lawyer calls and says that the children are now the beneficiaries instead? Some have balked. Two of the nation's IRA powerhouses – Fidelity and Vanguard mutual funds -- are willing to accept this arrangement. One writer suggested that if an IRA administrator resists cooperating, consider transferring the IRA to an institution that is willing to follow the procedure outlined in this PLR. Choate, Natalie, "Estate Planning for Retirement Benefits: New Developments," Salvation Army's 12th Annual Estate and Charitable Gift Planning Institute, p.6 (Sept. 14, 2004).

B. Using CRUTs as Bypass Trusts and QTIP Trusts for Retirement Assets.

After a person's death, a charitable remainder unitrust ("CRUT") can beat a "stretch IRA" if there will be a sequence of beneficiaries (e.g., "to A for life, then to B for life"). Estate planners should consider a CRUT as a potential beneficiary of a retirement plan account anytime a client expresses an interest in a sequence of beneficiaries. However, a CRUT will be much less attractive if the estate paid an estate tax liability.

Although the stretch IRA regulations were significantly liberalized in 2002, there still are some situations where estate planners are frustrated. A significant challenge exists when there is a sequence of beneficiaries (e.g., "to A for life, then to B for life"). The stretch IRA regulations require distributions to be made from an IRA or other QRP over a time period that does not extend beyond the life expectancy of the *oldest* beneficiary. The IRA will likely be depleted when the oldest beneficiary dies. Whereas an IRA cannot make distributions over the lives of the younger beneficiaries, a CRUT can. Like an IRA, a CRUT pays no income tax. Unlike an IRA, the term of a CRUT can last until the last of the multiple beneficiaries dies, which will usually be the *youngest* beneficiary.

The benefits will usually be greatest if there is a significant age difference among the beneficiaries or if one of the beneficiaries is elderly. An illustration of such multi-generation payouts can be found in a IRS private letter ruling that authorized payments to five beneficiaries (it looked like "to parents for life then to three children for life"). Private Letter Ruling 200150019 (Sept. 13, 2001). Perhaps some life insurance would be appropriate in the event of an early death of one of the children.

EXAMPLE WITH AN ELDERLY SIBLING: A seriously ill 80 year old widower has a large IRA. After his death he would like the IRA to distribute income to his 76 year old sister for the rest of her life and then, after her death, to distribute income for life to his two children, currently ages 53 and 51. His taxable estate is under $5 million, so no estate tax will be due.

> ***Stretch IRA*:** He could state on the IRA beneficiary form something like "to my sister for life, then to my children for life" or he could name a trust as a beneficiary that had the same instructions. However, the stretch IRA regulations will *not* permit him to accomplish his objectives. If there are multiple beneficiaries of the same retirement account, the tax regulations provide that the amount in the IRA must be distributed based on the *life expectancy* of the *oldest beneficiary*. Thus, the IRA will have to be fully distributed by the year that his sister attains age 89, even if she in fact lives to be 100. See Reg. Sec. 1.401(a)(9)-5, Q&A 6(a) and Q&A 7(a)and Example 1 of Reg. Sec. 1.401(a)(9)-5, Q&A 7(c)(3). The objective to "pay income to A for life, then to B for life" can never be obtained under the stretch IRA regulations if A is older than B.
>
> ***CRUT*:** He names a CRUT as the beneficiary of his IRA and upon his death the entire IRA will be paid outright in a tax-free transaction to the CRUT. The CRUT can then reinvest the entire amount without any reduction for income taxes and make distributions to his sister for *life*, then to his children for *life*, and then make a lump sum distribution to his favorite

charity. *The CRUT can basically extend the payout period from 13 years to possibly 40 or 50 or more years* -- from the *life expectancy* of a 76 year old to the *actual years* lived by a 51 year old or a 53 year old.

STRETCH IRAs and ROLLOVERS – *Rollovers to Surviving Spouses Usually Work Best, but Sometimes They Cause Problems*

The tax laws require that a person's account in a qualified retirement plan must begin to be liquidated after the person's death. The question is "how fast"? It is usually possible to make the payments over the life expectancy of the designated beneficiary, which is what most financial planners recommend. The best results therefor occur when younger individuals, who have long remaining life expectancies, are named as beneficiaries and the worst results usually occur when older individuals are named as beneficiaries. In oversimplified terms, the account balance can stay at or above $100,000 for more years with younger beneficiaries than with older ones.

A *stretch IRA* is the common description of an IRA that makes payments over a designated beneficiary's life expectancy. Although the post-death mandatory distribution laws for IRAs are essentially the same as the laws that apply to all other types of qualified retirement plans (profit sharing plans, 401(k), 403(b), etc.), as a practical matter the maximum stretch payments are only available through IRAs since most employers opt to quickly liquidate the accounts of deceased employees. Naming beneficiaries can also be easier with IRAs since there are few legal restrictions. By comparison, a married individual cannot name someone other than a spouse -- such as a bypass trust or a child -- as a beneficiary of a company retirement plan unless the spouse gives written consent. Code Secs. 401(a)(11)(iii) and 417(a)(2).

Regardless of the type of qualified retirement plan, the laws give a surviving spouse an advantage that is not available to any other beneficiary: a *rollover*. Normally this is the best way for a surviving spouse to keep the largest possible balance from a deceased spouse's retirement accounts. The surviving spouse can establish a new IRA that can receive the assets from the deceased spouse's IRA or qualified retirement plan account in a tax-free transfer. See Code Secs. 402(c)(9) for qualified retirement plans and 408(d)(3)(C) for IRAs. The surviving spouse can then treat the rollover IRA virtually the same as any IRA that she had established during her working career. Upon her death, her rollover IRA can become a stretch IRA for the children.

There are, however, *three situations* when a rollover to a new IRA is not possible or is not desirable. One of them is a bypass trust. In these cases, the usual strategy is to leave the money in the decedent's IRA and to make the decedent's IRA a stretch IRA. As will be shown below, the income tax benefits from the stretch IRA will usually be less -- often far less -- than what can be achieved from a rollover to a surviving spouse. The estate planner and the client must then decide whether the income tax deferral benefits from a rollover are sufficiently large to offset other non-income tax objectives that would discourage a rollover.

First Situation: IRA Owner is Not Married

The first situation when a rollover is not possible is when the decedent is not married. Only a surviving spouse can rollover an inherited distribution from a qualified retirement plan. If a rollover is not available, usually the best solution is for the IRA to become a stretch IRA for the beneficiary.

The more troublesome situation, however, is when the decedent's retirement account is at a company which has a policy of quickly liquidating a deceased employee's account. The $100,000 account is quickly reduced to $60,000. How can the non-spouse beneficiaries -- typically children, siblings or partners of the employee – obtain any income tax deferral under this circumstance? Three solutions may be available. First, some companies are willing to purchase an annuity for the beneficiary rather than make a lump sum distribution. Another strategy is for the employee to make a lifetime rollover from the company plan account to an IRA, in which case the IRA can become a stretch IRA for the beneficiary after the employee's death. Code Sec. 408(d)(3). If a lifetime rollover to an IRA is not possible, a third strategy is to name a charitable remainder trust ("CRT") as the beneficiary of the employee's account. Since a CRT is exempt from income tax, the transfer can be made tax-free and the $100,000 balance can remain $100,000 and provide a payout of the stated percentage (e.g., 5% or 6%) to the beneficiary for the rest of her or his life and then terminate to a charity. PLRs 199901023, 9820021, 9634019, 9253038 and 9237020. The CRT solution is much less attractive if the decedent's estate will subject to estate tax since the beneficiary will likely lose the Sec. 691(c) deduction for estate taxes paid on IRD. PLR 199901023.

Second Situation: Client is in a Second Marriage

The second situation when a rollover might not be desirable is if the client is in a second marriage and would like assurance that the retirement assets will benefit children from a prior marriage after the death of the second spouse. Estate planners usually recommend QTIP trusts for these situations. These trusts can work well for assets that have a step-up in basis, but QTIP trusts usually experience the same problem that applies to bypass trusts that are named as beneficiaries of stretch IRAs (described below). Consequently, although Rev. Rul. 2000-2, 2000-1 C.B. 305 permits an IRA to qualify as a QTIP trust, there are very few income tax advantages if the decedent and the spouse are roughly the same age.

EXAMPLE: Mr. Husband has a terminal illness. He would like his IRA to provide income to his second wife (age 70) for the rest of her life and then provide income to his children from his first marriage (currently ages 42 and 45) for the rest of their lives. If his IRA is payable to a QTIP trust that benefits both his spouse and children, the IRA must be completely distributed by the year his wife attains age 87 (the life expectancy of a 70 year old is 17 years). Reg. Sec. 1.401(a)(9)-5, Q&A 7(a) and 7(c)(3), Ex. (1). The result? The IRA will likely be empty when the surviving spouse dies, leaving nothing in the IRA for the children. What's worse, the IRA must be empty when the surviving spouse attains age 87, even if the spouse in fact lives to be 100! By comparison, if the IRA is distributed to a CRUT upon his death, the CRUT will provide income to his wife for the rest of her life (which could be well beyond age 87) and then provide income to his children for the rest of their lives. In other words, the CRUT can extend payouts from the *life expectancy* of a 70 year old to the *actual years* lived by a 42 year old or a 45 year old. The CRUT also provides estate tax advantages: none of the assets in the CRUT will be included on the estate tax return of the surviving spouse. Furthermore, Mr. Husband has the personal satisfaction of benefitting his favorite charity.

ESTATE TAX STRATEGIES FOR MARRIED COUPLES -- BYPASS TRUSTS

The third situation when a rollover might not be desirable is if a married couple might be subject to estate tax. If all of the retirement plan assets of the first spouse to die are rolled over to the surviving spouse, then the estate of the surviving spouse will be increased and subject to greater estate tax. Normally this is the situation that calls for a bypass trust.

By way of background, the most common estate planning arrangement for a married couple with combined wealth over $5 million is to provide that no estate tax will be due upon the death of the first spouse and that estate taxes will be deferred, and hopefully minimized, upon the death of the surviving spouse. This is often accomplished by dividing the estate of the first spouse into two parts: (1) a bypass trust equal to the amount that can pass free from estate tax ($5 million in 2012) and (2) either a marital trust or a QTIP trust that qualifies for the marital estate tax deduction. A bypass trust typically pays income to the surviving spouse for life and then distributes the remainder to the children. Upon the death of the surviving spouse, the assets in the marital or QTIP trust will be included on her/ his federal estate tax return but the assets in the bypass trust will escape taxation.

The problem with funding bypass trusts with retirement plan assets is that the mandatory distributions rules will usually cause the retirement assets to be distributed, and therefor taxed, at a faster rate than would be possible by naming alternative beneficiaries, such as the spouse or the children. This is because when an IRA is payable to two or more beneficiaries, the IRA must be liquidated over the life expectancy of the oldest beneficiary. Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 7(c)(3), Example 1. Usually that is the spouse. In other words, by making the retirement assets payable to a bypass trust, the $100,000 account will be required by law shrink to $60,000 sooner than if the assets were either rolled over to the surviving spouse or if they were left solely to the children. The average age of decedents reported on 1998 federal estate tax returns was 76.6 years for men and 81.4 years for women – leaving only 12 years or 10 years (respectively). Barry Johnson and Jacob Mikow, *Federal Estate Tax Returns, 1998-2000*, IRS SOI BULLETIN, Spring 2002,133, at 136.

This frustrates estate planners. For estate tax purposes, the estate planner would like the assets in the bypass trust, which will escape the estate tax upon the death of the surviving spouse, to grow in value. Conversely, the assets in the marital trust, which will be subject to estate tax upon the death of the surviving spouse, should ideally be frozen or shrink in value. Funding a bypass trust with retirement assets often produces results that are diametrically opposed to these normal estate tax planning objectives. The bypass trust will likely be small because the retirement assets will have been fully distributed and taxed over the surviving spouse's remaining life expectancy. At the same time, the retirement accounts that were rolled over to the surviving spouse's IRAs, and which will be included in the surviving spouse's estate, could be very large since rollover IRAs tend to have relatively small required distributions.

SURVIVING SPOUSE DISTRIBUTION OPTIONS – AT AGE 70

Example: At age 70, Ms. Widow began receiving distributions from several IRAs, including the IRAs of her older husband and her older sister (both of whom had died in the preceding year). Although the life expectancy of a 70 year old is 17 years (i.e., to age 87), Ms. Widow in fact lived to age 92. Whereas the law requires two IRAs (IRAs C and D) to be empty by age 87, amounts could still be in the other IRAs at that age. The minimum amounts required to be distributed from each of five IRAs are listed in the table.

A - ***Her own IRA,*** established with contributions she made during her working career.

B -** ***A rollover IRA, funded after her husband's death with a distribution from his 401(k) plan.

C - ***A stretch IRA -- Her sister's IRA***, where Ms. Widow was named as the beneficiary. Payments from this IRA must be made over a term of years that cannot exceed Ms. Widow's remaining life expectancy in the year that follows her sister's death (i.e., 17 years). A rollover is not possible. Only a surviving spouse can rollover distributions from a deceased person's retirement account.

D - ***Bypass Trust #1 - Her deceased husband's IRA is payable to a standard bypass trust***, where the trust distributes net income to her for life and then to a child. This is treated as a stretch IRA payable to a ***look-through trust*** where the required distributions are based on looking at the ages of the beneficiaries of the trust. The same distribution rules apply to a QTIP trust.

E -** ***Bypass Trust #2 - Her deceased husband's IRA is payable to a similar trust, but the trust requires all retirement plan distributions to be made to Ms. Widow. This provision permits a look-though trust to be treated as a ***conduit trust***. When a surviving spouse is the beneficiary of a conduit trust, she is treated as the "sole" beneficiary of the IRA which permits her life expectancy to be "recalculated" each year rather than frozen for a fixed term of years. The same rules would apply to a QTIP trust.

AGE	IRAs A & B	IRAs C & D	IRA E
70	3.65%	5.88%	5.88%
71	3.78%	6.25%	6.13%
72	3.91%	6.67%	6.45%
73	4.05%	7.14%	6.76%
74	4.21%	7.69%	7.09%
75	4.37%	8.33%	7.46%
76	4.55%	9.09%	7.87%
77	4.72%	10.00%	8.26%
78	4.93%	11.11%	8.77%
79	5.13%	12.50%	9.26%
80	5.35%	14.29%	9.80%

AGE	IRAs A & B	IRAs C & D	IRA E
81	5.59%	16.67%	10.31%
82	5.85%	20.00%	10.99%
83	6.14%	25.00%	11.63%
84	6.46%	33.33%	12.35%
85	6.76%	50.00%	13.16%
86	7.10%	100.00%	14.08%
87	7.47%	empty	14.93%
88	7.88%		15.87%
89	8.33%		16.95%
90	8.78%		18.18%
91	9.26%		19.23%
92	9.81%		20.41%

****Payouts "B" and "E" are <u>only</u> available to a surviving spouse.*** Other payouts are available to anyone.

SURVIVING SPOUSE DISTRIBUTION OPTIONS – AT AGE 80

Example: At age 80, Ms. Widow began receiving distributions from several IRAs, including the IRAs of her older husband and her older sister (both of whom had died in the preceding year). Although the life expectancy of a 80 year old is 10 years (i.e., to age 90), Ms. Widow in fact lived to age 92. Whereas the law requires two IRAs (IRAs C and D) to be empty by age 90, amounts could still be in the other IRAs at that age. The minimum amounts required to be distributed from each of six IRAs are listed in the table.

A - *Her own IRA,* established with contributions she made during her working career.
***B -** *A rollover IRA*, funded after her husband's death with a distribution from his 401(k) plan.
C - ***A stretch IRA -- Her sister's IRA***
D - ***Bypass Trust #1 - Her deceased husband's IRA is payable to a standard bypass trust***, treated as a stretch IRA payable to a ***look-through accumulation trust*** (where the required distributions are based on the age of the oldest beneficiary of the trust. The same distribution rules apply to a QTIP trust.)
E -** ***Bypass Trust #2 - Her deceased husband's IRA is payable to a similar trust, but the trust requires all retirement plan distributions to be made to Ms. Widow. This provision permits a look-though trust to be treated as a ***conduit trust***
CRT - ***Charitable Remainder Trust*** - After his death, her husband's fourth IRA was distributed in a lump sum to a tax-exempt CRT that will annually distribute 5% of its assets to Ms. Widow for the rest of her life, then to her husband's 50-year old child from his first marriage for the rest of the child's life, and then upon the child's death will be distributed to a charity.

AGE	IRAs A & B	IRAs C & D	IRA E	IRA CRT
80	5.35%	9.80%	9.80%	5.00%
81	5.59%	10.87%	10.31%	5.00%
82	5.85%	12.20%	10.99%	5.00%
83	6.14%	13.89%	11.63%	5.00%
84	6.46%	16.13%	12.35%	5.00%
85	6.76%	19.23%	13.16%	5.00%
86	7.10%	23.81%	14.08%	5.00%
87	7.47%	31.25%	14.93%	5.00%
88	7.88%	45.45%	15.87%	5.00%
89	8.33%	83.33%	16.95%	5.00%
90	8.78%	100.00%	18.18%	5.00%
91	9.26%	empty	19.23%	5.00%
92	9.81%		20.41%	5.00%

Payouts "B" and "E" are <u>only</u> available to a surviving spouse. Other payouts are available to anyone.

Legal Authority for Various Payout Rules: **IRA A**: Reg. Sec. 1.401(a)(9)-5, Q&A 4 and Reg. Sec. 1.401(a)(9)-9, Table A-2. **IRA B:** Same, and also Secs. 402(c)(9) and 408(d)(3)(C)(ii)(II). **IRA C:** Sec. 408(d)(3)(C) and Reg. Sec. 1.401(a)(9)-5, Q&A 5(a)(1)(i). **IRA D:** Reg. Sec. 1.401(a)(9)-5, Q&A 7(c)(3), Example 1. **IRA E:** Reg. Sec. 1.401(a)(9)-5, Q&A 7(c)(3), Example 2. The life expectancies are from Reg. Sec. 1.401(a)(9)-9, Table A.

Required Payments <u>after Ms. Widow's Death</u>:

IRAs A & B: IRAs A & B can become "stretch IRAs," where payments are made over the life expectancy of one of the beneficiaries selected by Ms. Widow. Reg. Sec. 1.401(a)(9)-5, Q&A 5(a)(1)(I).

IRA E: After Ms. Widow's death, payments from IRA E must be completed over a term of years based on the life expectancy of someone who was her age in the year of her death. Since she died at age 92, payments must be made over no less than 4.9 years. Reg. Sec. 1.401(a)(9)-5, Q&A 5(c)(2).

IRA CRT (Exhibit G): The charitable remainder unitrust (CRUT) will commence payments to the next beneficiaries (children) upon the death of the surviving spouse. A CRUT must annually distribute at least 5% of the value of its assets, recalculated annually. With a two generation trust (parent and then child), the parties will likely select the 5% amount to be able to get the minimum 10% charitable deduction necessary for the trust to qualify as a CRT.

END OF EXHIBITS

C. CHARITABLE REMAINDER TRUST AS A BYPASS TRUST FOR IRD

One solution that addresses the combination of estate tax and income tax concerns is the use of a two-generation charitable remainder unitrust ("CRUT"). Such a trust can accomplish the estate tax advantages of a traditional bypass trust and can also achieve income tax advantages similar to a two-generation IRA rollover. The feature that makes the income tax benefits possible is the fact that a CRT is exempt from income tax. Code Sec. 664(c). Like an IRA, no income tax is collected from the income generated by a CRT until a distribution is made to a non-charitable beneficiary. Thus, a CRT could produce the estate planning objectives for a decedent's IRD assets that a traditional bypass trust or QTIP trust produce for conventional assets that have a step-up in basis.

EXAMPLE OF CRT THAT ACTS AS A BYPASS TRUST FOR RETIREMENT ASSETS:

Professor Vincent Gogh is married to Professor Winnie Bay Gogh. They have two children, Ami Gogh and Gojohny Gogo Gogh. Virtually all of their wealth is in their 403(b) retirement accounts: he has $1 million and she has $5 million. Regardless of who dies first, each has expressed a desire that the surviving spouse should receive income from both 403(b) accounts for life and that payments should begin to their children only upon the death of the surviving spouse. Vincent is in poor health.

Instead of a traditional bypass trust, Vincent should consider naming a two-generation CRUT (i.e., first to spouse and then to children) as the beneficiary of his entire 403(b) account. There would be no income tax liability triggered by the transfer from the 403(b) account to the tax-exempt CRUT. PLRs 199901023 and 9820021. The CRUT could pay an income stream (e.g., 5% of assets) to Winnie for life, then to his two children for their lives, and upon the death of the last child the assets would be transferred to a charity. If the trust could consistently earn over 5%, the balance in the trust would never shrink below $1,000,000. There are income tax benefits: the $1,000,000 balance will last for the lives of both Winnie and the children. There are also estate tax benefits: none of the $1,000,000 held by the CRUT will be included in Winnie's estate when she dies. Furthermore, they have the satisfaction of knowing that they will benefit a charitable cause.

TECHNICAL ISSUES: There are a host of technical issues with using a CRT as a bypass trust/QTIP trust for IRD assets. For a detailed analysis, see Christopher Hoyt, *When A Charitable Trust Beats A Stretch IRA*, TRUSTS AND ESTATES (May 2002).

D. BASIC PLANNING STRATEGIES FOR FUNDING BYPASS AND QTIP TRUSTS WITH RETIREMENT ASSETS

Estate planners often find that in order to fund a married decedent's maximum credit shelter amount to a bypass trust (a/k/a credit shelter trust or non-marital trust), it will be necessary to utilize some retirement assets. The situation will occur even more frequently with the increase in the credit shelter threshold to $2 million in 2006. Although it is generally preferable to fund these trusts with non-retirement assets, many individuals simply don't have this amount of wealth outside their retirement plans.

Retirement accounts bring unique and difficult challenges for funding bypass trusts. Whereas most assets have a step-up in basis that virtually eliminates income tax problems, distributions from retirement accounts are usually taxable “income in respect of a decedent” (“IRD”). Consequently, when it comes to funding bypass trusts with retirement assets, estate planners need to consider a strategy that integrates three or more distinct sets laws: income tax laws, estate tax laws and ERISA laws for required distributions after an account owner’s death.

*** First, try to fund the bypass trust to the maximum extent possible with non-IRD assets.** If there are insufficient non-IRD assets, some retirement assets will be necessary to fund the full credit shelter amount. Of course, the best solution will be tailored to the wealth and spending patterns of each client. Assuming there is sufficient wealth so that all retirement assets will probably not have to be consumed over the surviving spouse’s lifetime, consider some of the following strategies:

*** Instead of transferring the entire available credit shelter amount to a single bypass trust that benefits both the spouse and children, consider using a portion of IRA assets to establish stretch IRAs solely for the benefit of the youngest beneficiaries.** This is particularly advantageous if the other beneficiaries are considerably younger than the surviving spouse. For example, if $800,000 of IRA assets are needed to fund the credit shelter amount for an individual who has a 78 year old spouse and two children, consider establishing a $200,000 stretch IRA for each child and only using $400,000 for the conventional bypass trust.

*** Consider establishing a two-generation CRUT** (described above) to accomplish both the estate planning objectives of a bypass trust and the income tax advantages of a something akin to a two-generation IRA rollover.

*** Consider establishing a conduit bypass trust** to reduce both the size of the required distributions and the income tax rate imposed on their receipt, but realize that a rollover will probably be more beneficial if the surviving spouse lives a long life.

*** If the surviving spouse is young, consider rolling over the entire retirement account and foregoing a bypass trust for any retirement assets.** The significant income tax benefits from a rollover, which could last for the life of the spouse, could outweigh a speculative amount of estate tax benefits that might not be determinable for decades. Decisions concerning the amount that should fund a bypass trust or whether it should be funded at all can be made after the IRA owner’s death by using disclaimers. See Natalie Choate, Life and Death Planning for Retirement Accounts, 4^{th} ed (2002), p. 342-354.

QTIP Trusts Use similar integrated estate tax and income tax planning strategies when considering the use of retirement assets to fund QTIP trusts. Consider the implications of accelerated payouts that can occur when there is a big spread in the ages of the beneficiaries of the trust (see IRAs “D” and “E” in the attached exhibit). Consider using a two-generation CRUT when appropriate.

Unmarried clients There are no opportunities for marital bypass trusts or for rollovers of inherited retirement accounts of unmarried individuals. Usually stretch IRAs are the best alternative, but consider naming a CRT as a beneficiary if a stretch IRA is not available. If the client is so wealthy that estate tax is likely, consider making a charitable bequest of retirement accounts and other IRD assets so that the resources can be used for charitable purposes rather than a double-whammy of estate and income taxes.

E. Portability and Rollovers

1. Portability Mechanics

In 2010, Congress introduced the law of portability for estates of married decedents to the federal estate tax paradigm. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296. Under this law, the estate of a surviving spouse can use part or all of the first deceased spouse's unused exemption amount ("deceased spousal unused exclusion amount" or DSUEA) to reduce the estate tax liability of the surviving spouse's estate. Sec. 2010(c)(2)

This law essentially gives a married couple a potential combined $10 million exemption – double the $5 million exemption available to others. Section 2010(c) . It provides that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed for inflation to $5.25 million in 2013) , plus (2) a surviving spouse can add the DSUEA from the estate of the first spouse to die.

Portability offers estate tax savings when the poorer spouse dies first. For example, if husband owns $10 million of assets and wife owns nothing, the prior estate tax law exacted punishment if the wife died first and then the husband died in a later year with a $10 million estate. It also permits spouses to transfer wealth in the manner that seems natural – to leave all wealth to the surviving spouse, rather than transfer some or all of it to other beneficiaries when the first spouse dies. Thus, if the husband with $10 million of assets dies in the year 2011, he can leave his entire estate to his wife. If she dies in 2012, then her estate can claim a $10 million exemption (her own $ 5 million and her husband's DSUEA of $5 million) and completely avoid the estate tax. Furthermore, for assets other than retirement accounts, there is the income tax benefit that assets included in both spouse's estates will have their income tax basis increased two times instead of once.

To be eligible to use the DSUEA, there must have been a timely-filed estate tax return when the first spouse died. Sec. 2010(c)(5)(A). This is the case even if the first spouse had less than $5 million of assets at the time of death. The Service described the procedural requirements in IRS Notice 2011-82, 2011-42 I.R.B. 516.

2. Why Estate Planners Often Prefer Credit Shelter Trusts Over Portability

Portability provides simplicity, the natural order of things ("everything to my spouse") and the income tax advantage of two step-ups in tax basis – one time when each spouse dies. Yet many estate planners discourage married couples from planning to rely on the new portability law. Most estate planners feel that the tried and true credit shelter trust (a/k/a "bypass trust") continues to offer more benefits than portability offers, including greater potential estate tax savings and greater asset protection. See, for example, Marc Bekerman, *Credit Shelter Trusts and Portability: Does One Exclude the Other?*, Probate & Property, May/June 2011 at 11-15; Steven R. Akers, *Estate Planning Effects and Strategies Under the "Tax Relief.. . Act of 2010"* ABA Real Property, Trust & Estate Law eReport**,** February 2011, at 10-17, available at

http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2011_aba_rpte_ereport_01_complete.authcheckdam.pdf .

Steve Akers eReport listed several reasons why a credit shelter trust may be superior to portability:

1. Portability requires the administrative cost and hassle of filing a federal estate tax return, even when the estate is under $5 million. IRS Notice 2011-82, 2011-42 I.R.B. 516. There is hope that someday there might be a short form established for this purpose ("706-EZ"), but nothing exists yet. By comparison, a credit shelter trust can be established upon the death of the first spouse even when the estate is under $5 million and no estate tax return is needed (e.g., the poorer spouse dies first).

2. The growth in value of the assets transferred to the surviving spouse are not excluded from the gross estate of the surviving spouse unlike the growth in a credit shelter trust which is excluded. For example, a growth stock worth $2 million when the first spouse died might be worth $20 million when the second spouse dies. With portability, that amount would be included in the surviving spouse's estate, but a credit shelter trust would have prevented inclusion in that estate.

3. The deceased spousal unused exclusion amount is not indexed for inflation.

4. The unused exclusion from a particular predeceased spouse might be lost with remarriages in the future.

5. There are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse.

3. Portability Provides Solution for Retirement Assets

When it comes to retirement plan assets, there is a problem with point #3 above: "The growth in value of the assets transferred to the surviving spouse are not excluded from the gross estate of the surviving spouse unlike the growth in a credit shelter trust which is excluded. " Although this may be true of conventional assets such as stock and real estate, in most cases it will not be true of retirement assets.

There are two main reasons:

First, there will not likely be growth in the value of the retirement assets. Instead, the value of retirement assets that are payable to a credit shelter trust will have likely shrunk because of the income taxes levied on the distributions which, by law, must be larger than the distributions that would have been required if there had been a rollover to an IRA of the surviving spouse.

Second, the majority of retirement assets that are payable to a credit shelter trust will likely be *included* in the surviving spouse's estate. This is because in most cases people will choose a "conduit trust", which requires the credit shelter trust to redistribute to the surviving spouse the entire amount of all distributions that it received from the retirement account. For a surviving spouse who lives to her life expectancy (age 85, 90, or whatever), the majority of retirement assets will likely have been distributed to the surviving spouse and, after payment of income taxes, the remaining proceeds will be included in the surviving spouse's estate.

If an estate planner's objective is to use a credit shelter trust to transfer as much wealth as possible to the next generation by keeping those assets out of the estate of the surviving spouse, then paying retirement assets to a credit shelter trust miserably fails that objective.

BY COMPARISON: A two-generation charitable remainder trust can operate as a credit shelter trust for retirement assets and other income-in respect-of-decedent ("IRD") assets. The CRT's assets will usually not be included in the estate of the surviving spouse. And the CRT offers income tax advantages because it is exempt from the income tax. As was illustrated above, this technique can be very useful for second marriages and when there is an elderly surviving spouse. Annual distributions are usually limited to 5% of the CRT's assets each year, leaving a sizeable amount of wealth to be invested to produce income to the next generation and to make a very large distribution to a charity upon termination of the trust.

COMBINED ESTATES UNDER $10 MILLION: For married couples with a combined estate under $10 million, portability significantly diminishes the concern that a rollover of retirement assets to a surviving spouse will generate a higher estate tax liability when the surviving spouse dies. Even if the surviving spouse's estate is over $5 million, the surviving spouse's estate can use the DSUEA to avoid paying estate tax on the retirement assets, as long as the sum of the two taxable estates is under $10 million. For married individuals who have a disproportionately large portion of their wealth in retirement accounts, portability permits the married couples to do what seems natural: leave 100% of the retirement assets to the surviving spouse who, following a rollover to an IRA, can then leave the remaining retirement assets to beneficiaries as an inherited IRA.

COMBINED ESTATES OVER $10 MILLION: For married couples with a combined estate over $10 million, the tax planning becomes much more challenging. Upon the death of the surviving spouse there will be an estate tax levied on the retirement assets. If the retirement assets are in a traditional taxable retirement account (as opposed to a tax-free Roth account), then the estate is effectively paying estate tax on deferred income taxes. Beneficiaries who receive taxable distributions from an inherited retirement account will be able to deduct the federal (but not any state) estate taxes as itemized deductions on their federal income tax returns under Sec. 691(c), but the outcome isn't pretty.

A married couple with an estate over $10 million should consider a lifetime Roth IRA conversion of retirement assets to reduce the amount of deferred income taxes that inflates the size of their estate. Another alternative is to make a charitable bequest of income-in-respect-of-decedent assets (such as retirement accounts) since such bequests effectively qualify for a combined estate tax and income tax deductions, thereby devoting greater resources to the charitable causes that they support. The use of a two-generation CRT as a credit-shelter trust for IRD assets is another possibility.

Wrap-Up

Estate planning for retirement assets has always been a quandary because of the conflicting incentives offered by the income tax laws and the estate tax laws. In the case of a surviving spouse, the best *income tax* outcome usually occurs when the surviving spouse is named as the beneficiary of a retirement account and she or he then rolls over the decedent spouse's retirement assets into a new IRA. In the past, the positive income tax outcome of a rollover was offset by a negative *estate tax* outcome: the rolled over account could inflate the surviving spouse's estate. Yet the traditional estate tax solution of using a credit shelter trust to mitigate the estate tax upon the death of the surviving spouse has negative income tax consequences under the income tax.

Portability solves this problem for many married couples, especially those with combined estates under $10 million (or whatever the future estate tax exemption becomes). It offers the income tax advantage of a rollover by the surviving spouse with the estate tax advantage that upon the death of the surviving spouse, the estate can use the first deceased spouse's unused exemption amount to reduce or eliminate an estate tax liability. Let's hope that the law, or an even improved version of it, becomes permanent.

For estates over $10 million, and for other situations such as second marriages where there are children from prior marriages, things get more complicated. The estate planner needs to be more resourceful to deal with the estate planning challenges posed by retirement assets.

IRD in a Taxable Estate – Combination of Estate Taxes and Income Taxes

A. Income Tax

1. Generally, every distribution that a person receives from his or her IRA or QRP account is fully taxable as ordinary income. IRC§§ 402(a) and 72 for Section 401(a) QRPs; IRC§§ 408(d) and 72 for IRAs. See Rev. Rul. 92-47, 1992-1 C.B. 198 for inherited IRAs.

2. Exceptions apply if :
   a. The distribution includes a return of non-deductible contributions. The return of a non-deductible contribution will be tax-free to the recipient (IRC§§ 402(a) and 72(b));

   b. A portion of the distribution is "rolled over" into another IRA or QRP (IRC§ 402(c)); or

   c. The distribution is a lump-sum distribution of the entire balance in an account of a Section 401(a) QRP that qualifies for the old ten-year forward-averaging tax. See IRS Form 4972.

3. Inherited Accounts: Payments received after the death of the account owner by a beneficiary or by the probate estate are generally taxed in the same manner. An IRA or QRP will usually issue a Form 1099-R directly to the person who received the distribution and that person will be liable for the income tax rather than the probate estate. IRC§ 691(a)(2); Reg. §§ 1.691(a)-2(a)(2) and 1.691(a)-2(b); Rev. Rul. 92-47, 1992-1 C.B. 198 (Holding 1).

   a. The beneficiary will not be subject to the 10% early distribution penalty even if she or he is under the age of 59 1/2 or even if the account owner died before attaining the age of 59 1/2. Section 72(t)(2)(A)(ii) exempts distributions from the 10 percent early distribution penalty tax if they are made to the estate of the account owner or to a beneficiary after the death of the account owner.

   b. In addition, most distributions after death are exempt from the 20% withholding provisions. There is mandatory income tax withholding for most distributions from QRPs to employees. IRC§§ 3405(c) and 402(c). The 20% withholding requirement generally does not apply to a distribution from a QRP after a participant's death. Reg. § 1.402(c)-2, Q & A-10(b). This is because the withholding requirement technically only applies to distributions that are eligible to be rolled over. IRC§§ 3405(c)(3), 402(c)(4), 402(f)(2)(A) and 403(a)(4). Most distributions after death are not eligible for rollover treatment. The only person who can rollover a distribution received after a participant's death is the surviving spouse. IRC§ 402(c)(9), Reg. § 1.402(c)-2, Q & A-10(a) and Reg. § 1.402(a)(5)-1, Q-1. Consequently, the only post-death distributions that are subject to the 20% withholding requirement are those made to a surviving spouse.

c. The beneficiary could, however, be subject to the 50% penalty tax if distributions are not received in accordance with the minimum distribution rules described above. IRC§§ 4974 and 401(a)(9)(B); Reg. § 54.4974-1.

B. Estate Tax

1. The federal estate tax is imposed on transfers of wealth at death, including assets held in IRAs and QRP accounts. IRAs, QRP assets, conventional annuities, Sec. 403(b) annuities and other deferred compensation assets are reported on the federal estate tax return (Form 706). IRC§ 2039.

2. These assets are fully included in the gross estate, even though one can argue that the amounts are inflated since the heir or the estate will pay income tax upon the receipt of any distribution. At one time Congress had provided relief for this situation by excluding a portion of QRP assets from the estate tax, but Congress repealed this relief for most individuals who die after 1984. Former Section 2039(c) was repealed by the Tax Reform Act of 1984, Pub. L. 98-396. Today the principal relief is that the heir who receives distributions can claim an itemized income tax deduction for the portion of the federal estate tax attributable to the IRD, described below.

3. Income Tax Deduction for Federal Estate Tax on IRD

   a. A beneficiary is entitled to deduct the federal estate tax attributable to IRD in the same taxable year that the IRD is included in the beneficiary's income. IRC§ 691(c)(1)(A); Reg. § 1.691(c)-1(a); Rev. Rul. 92-47, 1992-1 C.B. 198 (Holding 2).

   b. The amount is computed based on the highest marginal estate tax rate imposed on the estate, The estate tax attributable to the IRD is computed by comparing the amount of estate tax that would have been paid if the estate had no IRD with the actual amount of estate tax that the estate paid with the IRD. IRC§ 691(c)(2)©.

   c. The deduction is reduced by any estate tax credits -- most notably the state tax credit. IRC§ 691(c)(2)(A). The state tax credit is contained in Sec. 2011. It was eliminated in the year 2007 but is scheduled to return in the year 2013 after the "Bush Tax Cuts" expire. The net amount of IRD is also reduced by any expenses that are directly associated with the IRD -- "deductions in respect of a decedent" or "DRD". IRC§§ 691(b) and (c)(2)(B). An example would be an attorney who died before collecting a fee (the IRD) and who had incurred unpaid business expenses in connection with the fee (the DRD). Reg. § 1.691(c)-1(d), Example 1.

Such reductions rarely apply to distributions from IRAs or QRPs.

d. If the beneficiary is an individual, the Section 691(c) deduction for the federal estate tax is taken as an itemized deduction. Rev. Rul. 78-203, 1978-1 C.B. 199. The deduction 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. IRC§ 67(b)(7). Individuals who claim the standard deduction will not, therefor, receive any tax benefit from the 691(c) IRD estate tax deduction.

e. An estate or trust that receives IRD can claim the IRD estate tax deduction (Reg. § 1.691(c)-2(a)(3)), unless the IRD is required to be distributed to a beneficiary, in which case the deduction passes through to the beneficiary. IRC§ 691(c)(1)(B); Reg. § 1.691(c)-2(a)(1) & (2).

f. Special rules for computing the IRD estate tax deduction apply to:

(i) lump sum distributions from a Sec. 401(a) QRP where the beneficiary elects the forward averaging tax (IRC§ 691(c)(5); the rules are explained in the instructions to IRS Form 4972);

(ii) IRD included in multiple estates (e.g., grandchild inherits IRD that had been taxed in both her grandfather's and father's estates), in which case the beneficiary is permitted to deduct the estate tax attributable to both estates (Reg. § 1.691(c)-1(b)); and

(iii) long-term capital gains. If the IRD consists of a long-term capital gain, then the IRD deduction is applied to reduce the long-term capital gain, which might be taxed at a rate of only 15% (20% in the year 2013), rather than a deduction against ordinary income where the taxpayer might obtain a benefit at a higher marginal tax rate. IRC§ 691(c)(4).

COMBINATION OF *FEDERAL* ESTATE AND INCOME TAXES ON INCOME IN RESPECT OF A DECEDENT – (Year 2013). ***State estate & income taxes are extra!***

EXAMPLE: Assume Mother's total taxable estate is $6,000,000 and that all of it will be transferred to her sole heir: Daughter. Assume that the estate will pay the entire estate tax regardless of how 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 *39.6% marginal income tax bracket*, then the combined estate and income taxes on the $100,000 of IRA assets would be **$63,760 (63.76%)**.

Beginning Balance in Retirement Plan			$ 100,000
Minus: Total Estate Tax Paid by the Probate Estate			(40,000)
Minus: Income Tax On Distribution			
Gross Taxable Income		$ 100,000	
Reduced By §691(c) Deduction for *Federal* Estate Tax			
Total Estate Tax	$ 40,000		
State Tax Credit*	Zero		
Deduction for Federal Estate Tax **		(40,000)	
Net Taxable Income ***		$ 60,000	
Times Income Tax Rate****		x 39.6%	
Net Income Tax on Income In Respect Of Decedent			(23,760)
NET AFTER-TAX AMOUNT TO DAUGHTER			$ 36,240

* Treas. Reg. Section 1.691(c)-1(a) limits the deduction to *federal* estate tax. The 2001 Tax Act provided that the Section 2011 state tax credit was 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.

**** Whereas retirement income is exempt from the 3.8% health care surtax, if the source of IRD is income that is subject to the surtax (interest, annuity, rents, etc) then the effective marginal income tax rate would be even higher than 39.6%. The 3.8% health care surtax applies when an individual's adjusted gross income exceeds $250,000 ($300,000 on a joint return). For a trust or estate, the 39.6% marginal tax rate (plus the 3.8% health care surtax) applies with taxable income over just $12,000.

C. For Estates Near the $5 Million Threshold, Consider a Pre-Mortem Roth IRA Conversion to Eliminate the Estate Tax

1. By paying the applicable income tax in the year that contributions are made to a Roth account, a person will have a smaller estate that could be subject to estate tax. By comparison, a person with a taxable estate will be paying estate tax on the deferred income taxes in a traditional retirement account.

2. A Roth IRA conversion as a pre-mortem estate tax planning strategy:

   EXAMPLE: Assume that Grandma (age 87) is about to enter the hospital with a serious medical condition and that she has a taxable estate of $5.1 million, which consists of $1 million in a traditional IRA and $4.1 million of cash, stock and real estate.

   Grandma can avoid a federal estate tax liability by doing a Roth IRA conversion of $300,000 from her IRA, which will trigger a $100,000 income tax liability and bring her taxable estate down to the $5.0 million level that eliminates the federal estate tax. If she dies, her family will inherit a $700,000 taxable IRA, a $300,000 tax-exempt Roth IRA, and $4.0 million of cash, stock and real estate.

   Distributions received from the $700,000 inherited traditional IRA are taxable income in respect of a decedent ("IRD") Rev. Rul. 92-47, 1992-1 C.B. 198; Private Letter Ruling 200336020 (June 3, 2003), but distributions from the converted $300,000 amount are exempt from taxation.

   Had she not done the Roth IRA conversion, the estate would have paid a 35% federal estate tax on the $100,000 of deferred income taxes. If Grandma overcomes the medical condition, she has the option to reverse the Roth IRA conversion anytime before her income tax return is due in the following year (a "recharacterization").

D. Consider Charitable Bequests of IRD, Especially if the Income Tax Rates and the Estate Tax Rates Are Higher in Future Years

1. The projected tax rates for 2013 can mean that IRD can easily be subject to tax rates in excess of 75% though the double-whammy of estate taxes and income taxes. The rate is even higher in the 41 states that have state income taxes. Individuals can let their favorite charity be the governments (via taxes), or they can devote these assets to specific charitable causes that they may care more about.

2. Since charitable bequests qualify for both estate and income tax deductions (IRC

§ 2055 and 642), every dollar can be transferred to a charity free from any taxes.[71] 1 In addition, since charities are tax-exempt they can apply all of the IRD toward the individual's charitable purposes.

3. As people investigate the charitable uses of these assets, an attractive option that may benefit children is to contribute these assets to a donor advised fund at a community foundation or to a private foundation. The decedent's children can then have the assets applied toward charitable purposes that are important to them, thereby alleviating them from the burden of using other resources for such gifts. A large donor advised fund or private foundation can increase the child's prestige as a significant contributor to the community.

4. As a general rule it is best to have the IRA or QRP assets transferred directly to the charity or charitable remainder trust after the decedent's death rather than indirectly by way of the probate estate. This will keep the assets off of the estate's income tax return and avoid potentially complicated legal issues.[72] 2 Such a transfer can usually be accomplished by having the individual name the charity as the successor beneficiary on the retirement plan.

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71 Certain precautions should be taken to assure this result. First, the transfer should be structured to qualify for the estate tax deduction. That deduction could be lost if the amount that the charity will receive is uncertain at the time of death. See Englebrecht and Selmonosky, "Contingent Bequests and Estate Tax Charitable Deductions," Trusts and Estates, Sept. 1997, p. 40. Second, the assets should be kept off of the estate's income tax return to avoid issues concerning the estate's income tax deduction for a charitable contribution.

72 In the event an IRA or QRP distribution is included on the estate's income tax return (for example, because the probate estate received the distribution), there could be a problem claiming a charitable income tax deduction. This could be the case if the estate has any source of IRD. An estate is not entitled to claim a charitable income tax deduction unless the payments to the charity can be traced to the trust's or estate's income. IRC§ 642(c); Reg. § 1.642(c)-3(b) analyzed in Van Buren v. Commissioner, 89 T.C. 1101 (1987) at 1108-1109.

OVERCOMING OBSTACLES FOR CHARITABLE BEQUESTS FROM IRAs and QUALIFIED RETIREMENT PLANS

A. INTRODUCTION

There are several obstacles to make a charitable bequest of IRD or a distribution from a qualified retirement plan account. They can be divided into the following categories:

(1) Problems with the income tax return of the estate (Form 1041)
(2) Problems with the mandatory distribution rules from QRPs and IRAs, and
(3) Problems if IRD is transferred to a charitable remainder trust and there is estate tax due (the formula: *IRD + CRT + Estate Tax = Problem*)
(4) Other miscellaneous problems (e.g., require consent of surviving spouse for charitable bequest from company retirement plan (but not an IRA), avoid pooled income funds, etc.)

B. AVOID PROBLEMS ON ESTATE'S INCOME TAX RETURN

1. The Income Tax Nightmare: An estate or a trust has taxable income from receiving taxable retirement plan distributions or other sources of IRD, but it cannot claim an offsetting charitable income tax deduction when that income is distributed to a charity.

IRS Chief Counsel Memorandum ILM 200848020 (July 28, 2008) is a dramatic illustration of how a charitable bequest of IRD can go wrong. The decedent had left his IRA to a trust that benefitted his six children and several charities. The trust received distributions from the IRA for the charitable shares and the trustee immediately paid these amounts to the charities, leaving the six children as the only remaining beneficiaries of the trust. The IRS Chief Counsel's office concluded that the trust had taxable income from the IRA distribution but was not entitled to claim an offsetting charitable income tax deduction since the trust instrument contained no instructions to distribute income to a charity.

2. 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.

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

a. 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, *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). See the next pages for solutions if the estate was named as the beneficiary.

b. Conventional IRD Assets: *#1: Require "In Kind Distributions" To Charity*

An in-kind distribution is a distribution of a particular asset to a specific beneficiary. In order to make an in-kind distribution of IRD assets, the will can contain instructions that specific IRD assets will be given to specific charities. For example, the will could state: "all of my installment sale notes shall become the property of the Christopher R. Hoyt tax-exempt charitable remainder trust; all of my savings bonds shall become the property of charity XYZ etc."

In that case, the estate will distribute the IRD asset to the charity or CRT and it, rather than the estate, will recognize income from the IRD. Sec. 691(a); Reg. Sec. 1.691(a)-4(b)(2); Rev. Rul. 64-104, 1964-1 C.B. 223; see also PLRs 200002011 (Sept. 30, 1999) and 200012076 (Dec. 29, 1999) (bequests of employee stock options). If the recipient is a tax-exempt public charity or charitable remainder trust, no tax will be due. If savings bonds are redeemed by a private foundation, it will be liable for the 2% excise tax on the interest income. Rev. Rul. 80-118, 1980-1 C.B. 254).

c. **Conventional IRD Assets (and IRAs!):** *#2: 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 permits 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 200633009 (May 16, 2006) (***IRAs*** where *residue* of estate to go to charity; executor had power to "make distributions ...either pro-rata or otherwise"); 200850004 (Sep. 8, 2008) (probate court specifies that ***IRAs*** payable to the estate should be the source of payment for the share of the estate allocable to charities); 200845029 (July 10, 2008) (***defined benefit plan*** payable to estate where *residue* of estate is payable to charities); 200826028 (Mar. 27, 2008)(*residue* of trust payable to charities and trust instrument permits in-kind distributions); 200652028 (Sep 13, 2006) (***IRAs*** where *residue* of estate was left to a charity); 200618023 (Jan 18, 2006) (***annuity contracts*** assigned to charitable residuary beneficiaries when *state law,* rather than the will, permitted non-pro rata distributions), 200617020 (Dec 8, 2005) (***IRA*** where *residue* of estate was left to a charity), 200511174 (Feb 8, 2005) (***IRAs & 401(k) plan*** where *residue* of estate was left to charity); PLR 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 the estate went to charity).

d. **But Don't Satisfy A Charitable Pecuniary Bequest With Retirement Assets**

The IRS Chief Counsel concluded that satisfying a pecuniary charitable bequest with an IRA will trigger taxable income to the estate. The memorandum also stated that the trust could not claim an offsetting charitable income tax deduction since the decedent's trust instrument contained no instructions to pay any income to charities. ILM 200644020 (Dec. 15, 2005 -- released to the public in November, 2006). Until this controversy is resolved, it would be best to avoid satisfying pecuniary bequests with retirement accounts. Furthermore, as a precaution it would be helpful to draft wills and trusts so that an offsetting charitable income tax deduction could be claimed (see next page).

The Chief Counsel memorandum addressed a situation where a decedent's IRA was payable to a trust that provided for specific pecuniary bequests to three different charities. The trustee had the power to distribute any asset to any charity, so the trustee instructed the IRA custodian to divide the IRA into shares "each titled in the name of a beneficiary under Trust. Thus, each of the charities became the owner and beneficiary of an IRA equal in value, at the time of division, to the dollar amount it was entitled to under Trust." That way the trust satisfied the pecuniary bequests by distributing the IRAs from the trust to the charities, and then the IRAs would make cash distributions to the charities at a future time.

The drafter of the memo concluded that the trust had taxable income when the IRA was used to satisfy the pecuniary bequest and that the trust would not be entitled to an offsetting charitable income tax deduction. The drafter indicated that the employee plan division of the IRS did not object to the conclusion.

Natalie Choate, one of the nation's premier authorities in the area of taxation of employee benefits, concludes that the Service may be correct if a trustee has the power to pick and choose which asset to give to a pecuniary beneficiary and then selects a retirement account. By comparison, she concludes that when there is no discretion – for example when there is a pecuniary marital formula and an estate that is top-heavy with retirement assets must use some of those assets to satisfy the formula – she believes that one can avoid a taxable gain. See Steve Leimberg's Employee Benefits and Retirement Planning Newsletter # 393 (December 5, 2006) at http://www.leimbergservices.com. The IRS had issued several private letter rulings in the 1990s in which there was no hint of taxable income when IRAs payable to estates were used for *marital trusts funded with pecuniary formulas*. PLRs 9524020 (June 16, 1995), 9608036 (Feb. 23, 1996), 9623056 (June 7, 1996) and 9808043 (Feb 20, 1998). For analysis of these marital trust rulings and disclaimer strategies for pecuniary amounts in marital and credit shelter trusts, see Choate, "Assignment of the Right-To-Receive IRD", *Life and Death Planning for Retirement Benefits* (5th ed. 2002), Section 2.2.06, pages 92-94.

4. Allow the Estate to Claim a Charitable Income Tax Deduction In The Event IRD Is Recognized By The Estate

a. 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, and shall qualify for the charitable income tax deduction under Section 642(c)(5) or any corresponding section of any future Internal Revenue Code."

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). See also IRS Chief Counsel Memorandum ILM 200848020 (July 28, 2008). 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.

Caution: a 2008 proposed tax regulation provides that when a governing instrument specifies a source of income (such as IRD) to be used for a charitable income tax deduction, the instructions must have an economic effect independent of income tax consequences in order to be respected.

The proposed rule is that "a provision in the governing instrument ... that specifically provides the source out of which amounts are to be paid ... for such a [charitable] purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences." See the proposals to modify Reg. Sections 1.642(c)-2(b) and 1.643(a)-5(b) contained in REG-101258-08, 2008-28 I.R.B. 111 that was also published in the Federal Register on Wednesday, June 18, 2008 (73 FR 34670).

This suggests that instructions to use IRD for certain charitable dispositions might not be respected unless those dispositions had an independent economic effect. For example, there is no independent economic effect if a will provides for a $100,000 charitable bequest and specifies that it should be "paid from IRD, if any exists." The charity will receive $100,000 whether there is any IRD or not.

On the other hand, what are the sanctions for failure to have an independent economic effect? The proposed regulations merely address the division of an estate's or trust's taxable and tax-exempt income amongst income beneficiaries, some of which include charities. They do not address whether a charitable income tax deduction will be allowed, denied or partially allowed/denied when a governing instrument contains instructions that all charitable bequests must be satisfied with IRD whenever that is possible.

If instructions to use a specific source of income (such as IRD) for a charitable income tax deduction do not have an independent economic effect, then the proposed regulation states that the estate's or trust's income will instead be allocated between charitable and non-charitable beneficiaries using the same proportionate ratio of all classes of income of the estate or trust. Such a result wouldn't impose a hardship as long as the estate or trust could still claim a charitable income tax deduction. It wouldn't matter that the deduction was comprised of a mix of interest, dividends and IRD. "In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes." Prop. Reg. Sec. 1.642(c)-3(b)(2).

What clauses have a substantial economic effect?

Pay to charity XYZ all of the taxable retirement plan distributions that my estate receives.

Pay the first $300,000 of the taxable retirement plan distributions that my estate receives to charity ABC, and the rest of these distribution to my son, Jacob.

These clauses have a substantial economic effect because the charity will only receive amounts if the estate indeed receives taxable retirement plan distributions. Furthermore, these clauses could "disinherit" other beneficiaries from receiving any or all retirement distributions payable to an estate. Hence, the clauses have an economic effect.

What clauses do <u>not</u> have a substantial economic effect?

Example: Divide the income of my estate equally between Charity and my daughter, but when you report the distributions to the beneficiaries, you should allocate all of the tax-exempt income from municipal bonds to my daughter and none of that income to Charity.

This does not have economic effect. For example, if an estate had $40,000 of tax-exempt municipal bond income and $60,000 of taxable interest (total of $100,000 of income), the estate would distribute $50,000 apiece to the Charity and to daughter. Beyond income tax savings, what is the economic effect of allocating all $40,000 of tax-exempt interest to the daughter? There is nothing in this provision that changes each beneficiary's entitlement from the original $50,000 distribution. Thus, the regulations would instead conclude that only $20,000 of daughter's income was from the municipal bond interest and the remaining $20,000 of such tax-exempt interest was distributed to the charity.

By comparison, if the clause stated: *First pay all municipal bond interest to my daughter and then divide the remaining income equally between Charity and my daughter*, then there would be an economic effect. Daughter would receive $40,000 and then half of the remaining $60,000, which would reduce the Charity's distribution from $50,000 to $30,000, thereby having an economic effect.

b. 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 the private letter rulings cited on the preceding pages.

Another strategy is to pay the charities last. This works best when 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) and 200336030 (June 3, 2003) (**IRAs** and ***savings bonds***); PLR 200526010 (Mar. 22, 2005) (IRAs and ***savings bonds***); PLR 200537019 (May 25, 2005) (***annuity contracts***).

IV. LEGAL AUTHORITY ON POINT

1. CHARITABLE BEQUESTS FROM IRAs AND QUALIFIED PLANS

a. General Principles Neither the donor's estate nor heirs will recognize taxable income if the retirement plan / IRA proceeds are paid directly to the charity or to a charitable remainder trust. PLR 200826028 (Mar. 27, 2008), 200652028 (Sep 13, 2006); 200633009 (May 16, 2006), 200618023 (Jan 18, 2006), 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). If, instead, the plan proceeds are paid to the estate, the estate may be able to claim an offsetting charitable income tax deduction if the residue of the estate will be paid to charity. PLRs 200526010 (Mar. 22, 2005), 200336020 (June 3, 2003) and 200221011 (Feb. 12, 2002). The executor may also be able to "assign" IRAs to charities to satisfy charitable bequests (see "c. Transfers to a Public Charity" below).

b. Transfers to a Private Foundation PLRs 199939039 (June 30, 1999), 9838028 (June 21, 1998), 9818009 (Jan. 8, 1998), 9341008 (July 14, 1993) & 9633006 (May 9, 1996): Transfers to private foundations; neither estate nor beneficiaries have any taxable income when IRA goes to private foundation; no 2% Sec. 4940 p.f. investment income tax on distribution from retirement plan, but yes there is 2% tax on distribution from annuity contract. PLRs 200425027 (Feb 27, 2004) and 9826040 (March 30, 1998). No "self dealing" private foundation tax if private foundation is required by terms of living trust to pay to the estate "IRD" assets in order to pay recomputed estate tax.

c. Transfers to a Public Charity - ***Assign to a charity the IRAs that were originally payable to the estate or to a testamentary trust. The estate or trust has no taxable income.*** - PLRs 200850004 (Sep. 8, 2008) (probate court specifies that *IRAs* payable to the estate should be the source of payment for the share of the estate allocable to charities); 200845029 (July 10, 2008) (*defined benefit plan* payable to estate where *residue* of estate is payable to charities); 200826028 (Mar. 27, 2008)(*residue* of trust payable to charities and trust instrument permits in-kind distributions); 200652028 (Sep 13, 2006) (*IRAs* where *residue* of estate was left to a charity); 200633009 (May 16, 2006) (*IRAs* where *residue* of estate to go to charity; executor had power to "make distributions in cash, in kind or partly in each, either pro-rata or otherwise"); 200617020 (Dec 8, 2005) (*IRA* where *residue* of estate was left to a charity), 200511174 (Feb 8, 2005) (*IRAs & 401(k) plan* where *residue* of estate was left to charity), PLR 200526010 (Mar. 22, 2005) (*IRAs* with charitable residue); PLR 200452004 (Aug. 10, 2004) (*IRAs* and *deferred annuity contracts* where the *residue* of estate was left to charity) and PLR 200234019 (May 13,

2002) (*IRAs* and *403(b) accounts* where *a portion* of the estate went to charity). Also PLR 200618023 (Jan 18, 2006) (*annuity contracts* assigned to charitable *residuary* beneficiaries under applicable *state law* rather than the will). Decedent's estate was named as the beneficiary of IRAs, 401(k) plan, 403(b) accounts and annuity contracts. Decedent's will (or the governing state law) permitted the executor to use any asset for any bequest. IRS allowed the executor to "assign" the IRAs and 403(b) accounts to charities so that neither the estate nor other beneficiaries had to recognize any taxable income when the retirement accounts made their distributions to the charities. Danger: see "d" below for paying a fixed dollar bequest (i.e., pecuniary amount).

PLR 200218039 (Feb. 4, 2002) – Deceased's IRA was payable to a trust where 90% was allocated to family members and the remaining 10% was to be paid to charities (to be chosen by the deceased's children) after the surviving spouse's death. A court reformed the trust so that the 10% charitable share would not affect the 90% payout to family under the mandatary IRA distribution rules (using the 1987 proposed regs).

PLR 200052006 (Sept. 25, 2000) - Sister was named as the beneficiary of decedent's IRAs and there were no contingent beneficiaries. However, decedent's will provided that charitable bequests should be made from the IRAs. Sister disclaimed her interest in the IRAs so that IRAs went to decedent's estate and then, through additional disclaimers, went to charities. Estate receives estate tax charitable deduction.

PLR 9723038 (March 11, 1997): Transfer to public charity that paid the 15% penalty tax of the estate (the 15% penalty tax was repealed later in 1997).

d. Satisfying A Pecuniary Bequest With Retirement Assets -- Triggers income to an estate or trust and there is no offsetting charitable income tax deduction unless there are instructions in the document to leave income to charity. The IRS Chief Counsel concluded that satisfying a pecuniary charitable bequest with an IRA will trigger taxable income to the estate. The memorandum also stated that the trust could not claim an offsetting charitable income tax deduction since the decedent's trust instrument contained no instructions to pay any income to charities. ILM 200644020 (Dec. 15, 2005). This ruling comes as a surprise since the IRS had issued several private letter rulings in the 1990s in which there was no hint of taxable income when IRAs payable to estates were used for *marital trusts funded with pecuniary formulas*. PLRs 9524020 (June 16, 1995), 9608036 (Feb. 23, 1996), 9623056 (June 7, 1996) and 9808043 (Feb 20, 1998).

e. If a testamentary trust has both family and charitable beneficiaries, if the trust pay off charities before September 30 following the year of death, the remaining family members can receive *stretch IRA* distributions over their remaining life expectancies. PLR 200740018 (July 12, 2007). An IRA was payable to a trust to benefit cousins for life. There was also a pecuniary bequest to a charity. The charity received the entire amount before Sept 30 following the year of the IRA owner's death. The IRS concluded that the charity was no longer considered a beneficiary of the trust and that the IRA could make distributions to the trust based on the life expectancy of oldest cousin. The IRS did not rule on whether the trust could claim a charitable income tax deduction for the charitable payments.

<u>**Can such a trust or estate claim a charitable income tax deduction to offset taxable IRA distributions that are immediately distributed to charities?**</u> If a trust does not have instructions to pay income to charity, the IRS holds that there is no offsetting charitable income tax deduction. See IRS

Chief Counsel Memorandum ILM 200848020 (July 28, 2008). It addressed a situation where the decedent had left his IRA to a trust that benefitted his six children and several charities. The trust received distributions from the IRA for the charitable shares and the trustee immediately paid these amounts to the charities, leaving the six children as the only remaining beneficiaries of the trust. The IRS Chief Counsel's office concluded that the trust had taxable income from the IRA distribution but was not entitled to claim an offsetting charitable income tax deduction since the trust instrument contained no instructions to distribute income to a charity. By comparison, when the *residue or remainder of an estate or trust* is payable to charity, it is possible to claim an offsetting charitable income tax deduction. Please see above *"c. Transfers to a Public Charity - Assign to a charity the IRAs that were originally payable to the estate or to a testamentary trust.*"

The ability of an estate or trust to claim a charitable income tax deduction may be further complicated by a new proposed regulation that provides that when a governing instrument specifies a source of income (such as IRD) to be used for a charitable income tax deduction, *the instructions must have an economic effect independent of income tax consequences in order to be respected.* Prop. Reg. 1.642(c)-3(b)(2), REG-101258-08, 2008-28 I.R.B. 111. However, the sanction for failure to have an independent economic effect isn't necessarily the loss of a charitable income tax deduction, but rather, a default that the estate's or trust's income will instead be allocated between charitable and non-charitable beneficiaries using the same proportionate ratio of all classes of income of the estate or trust. Prop. Reg. Sec. 1.642(c)-3(b)(2).

f. Transfers to a Charitable Remainder Trust -- Lifetime Transfers PLRs 200335017 (May 27, 2003), 200302048 (Oct. 15, 2002), 200215032 (Jan. 10, 2002), 200202078 (Oct.19, 2001), 200038050 (June 26, 2000) and 199919039 (Feb. 16, 1999): An employee received a retirement plan distribution that included "employer stock." He put the stock into a CRT and rolled over everything else to an IRA. His taxable income was only the original purchase price that the plan had paid for the stock, but he was able to claim a charitable income tax deduction based on the much higher value of the stock that included the stock's "net unrealized appreciation." The employee had no income when the CRT received or sold the stock. PLR 200335017.

g. Transfers to a Charitable Remainder Trust -- Transfers at Death PLRs 199901023 (Oct. 8, 1998), 9634019 (May 24, 1996), 9253038 (Oct. 5, 1992) and 9237020 (June 12, 1992): General rules on transfers at death to charitable remainder unitrusts.

PLR 9820021 (February 15, 1998): Husband names as beneficiary of IRA: a QTIP trust that will pay income to his wife for life and then the remainder to a charity. Charity is treated as a beneficiary for lifetime and post-death mandatory distributions (applied the 1987 proposed regulations -- no affect on lifetime distributions under the 2002 final regs).

PLR 199901023 (Oct. 8, 1998) - What happens to the income tax deduction for the federal estate tax that is paid when IRD is contributed to a charitable remainder trust? The IRS concludes that it is 4th tier corpus in the charitable remainder trust and only the net amount of IRD is included in first tier income.

PLR 200052006 (Sept. 25, 2000) - Decedent's sister disclaims interest in CRT so that decedent's IRAs and annuity contracts can be paid directly to charities; estate gets charitable deduction.

h. An IRA Can Lend Money To A Charity At Market Interest Rates. The Charity Can Use

the Loan Amount to Purchase Life Insurance. PLR 200741016 (July 12, 2007). The IRS ruled that the loan to the charity at market interest rates was not a "prohibited transaction" under Sec 4975. Had it been a prohibited transaction, the IRA would have lost its favorable tax status. Sec 408(e)(2). Second, whereas Sec. 408(a)(3) prohibits an IRA from investing in life insurance, the IRS concluded that it was permissible for the charity that borrowed the money from the IRA to purchase life insurance. There may be other legal issues that the PLR did not address, such as state law issues of whether the charity has an insurable interest in the IRA owner.

i. Lifetime Distribution from IRA to Acquire a Charitable Gift Annuity An income tax ***disaster!*** 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.

j. Transfer of IRA at Death to Acquire a Charitable Gift Annuity PLR 200230018 (Apr. 22, 2002). An individual named a charity as the beneficiary of an IRA and left instructions with the charity to use the IRA proceeds to issue a charitable gift annuity. On an estate tax return, the full value of the IRA must be reported but there is a partially offsetting charitable estate tax deduction. The estate recognizes no taxable income on the transfer (but the ruling did not explain the income tax consequences to the beneficiary of the annuity).

k. Disclaimer of Retirement Assets Possible Even After Receiving An Inherited Distribution. Rev. Rul.2005-36, 2005-26 IRB 1368. Normally a person cannot make a valid disclaimer of an inheritance if that person ever received any benefit from the property, such as interest income. However, 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.

l. Income Taxes Withheld on Charitable Bequest of Retirement Account. Decedent had named a charity as the beneficiary of his retirement account. When the bequest was distributed, the administrator withheld nearly $40,000 of income taxes on behalf of the charitable beneficiary, which was erroneous since the charity was tax-exempt. The charity, however, failed to file a tax return (Form 990-T for UBIT) to claim the withheld amount until more than three years had passed – after the statue of limitations had expired. A U.S. District Court held that the charity would not be able to bring suit to recover the withheld taxes from the federal government. *Family Leadership Foundation v. United States,* (D.C. - Arizona) No. 06 CV-678, Nov. 3, 2006.

2. CHARITABLE BEQUESTS OF EMPLOYEE STOCK OPTIONS AND NONQUALIFIED RETIREMENT PLANS PLRs 200002011 (Sept. 30, 1999) and 200012076 (Dec. 29, 1999) :
A business executive can make a bequest of his compensatory employee stock options, his nonqualified deferred compensation and his taxable death benefits to a charity and his estate will not recognize any taxable income. The employee stock options (nonqualified stock options rather than Incentive Stock Options) would be transferred by instructions in his will. The charity, rather than the estate, will recognize income when the options are exercised. The nonqualified deferred compensation and the death benefits will be transferred to the charity by designating the charity as the successor beneficiary of those payments.

3. CHARITABLE BEQUESTS OF ANNUITY CONTRACTS

a. Taxable proceeds received by estate but given to charitable beneficiaries qualifies for offsetting charitable income tax deduction (residue of estate to charity)- PLR 200537019 (May 25, 2005)

b. Executor distributes annuities to charity even though payable to a trust or to the estate - Decedent named a charity as the residuary beneficiary of the estate. Because the decedent's will authorized the executor to use any asset for any distribution, the IRS permitted the executor to "assign" the deferred annuity contracts 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. Instead, the charities would report the income. PLRs 200803008 (Oct. 16, 2007) (nonqualified deferred annuity contract payable to a trust where the residue of the trust was payable to charities); 200452004 (Aug. 10, 2004) (both IRAs and deferred annuity contracts). In PLR 200618023 (Jan 18, 2006) the will did not specifically authorize the executor to make non-pro rata distributions, but the executor asserted that such distributions were permitted under state law and the annuity contracts were assigned to the remainderman charitable beneficiaries. The state was not identified.

c. To private foundations - Although normally a bequest of annuity payments to a private foundation would trigger the 2% p.f. excise tax, the tax does not apply if the basis of the annuity contract is greater than its market value. PLR 200425027 (Feb 27, 2004).

d. Disclaimers - Despite being named as the sole beneficiary of decedent's annuity contracts (there were no contingent beneficiaries), sister disclaims her interest in the annuities and in his estate so that the annuity contracts are paid to charities; estate gets charitable deduction. PLR 200052006 (Sept. 25, 2000)

4. CHARITABLE GIFTS AND BEQUESTS OF SAVINGS BONDS

a. Lifetime Gifts - Accrued Interest Is Taxed To Bond Owner. Any lifetime transfer of savings bonds usually triggers interest income. Reg. Sec. 1.454-1(c)(1); Rev. Rul. 55-278, 1955-1 C.B. 471; Rev. Rul. 87-112, 1987-2 C.B. 207 (transfer pursuant to divorce triggers income). An exception is a transfer to a revocable trust. Rev. Rul. 58-2, 1958-1 C.B. 236. For an illustration of a lifetime *charitable* gift of a savings bond, see PLR 8010082 (December 13, 1979).

b. Bequests of Savings Bonds At Death -

1. No Taxable Income To The Estate. In 1998, the IRS released a private letter ruling that confirms that it is possible to transfer savings bonds to a charity upon the owner's death without having any income tax burden imposed on the estate: PLR 9845026 (August 11, 1998). If the recipient is a private foundation, it will be liable for the 2% excise tax on the interest income. Sec. 4940; Rev. Rul. 80-118, 1980-1 C.B. 254.

2. If Income To Estate, How To Claim Charitable Deduction (if residue of estate is paid to charities): PLRs 200826028 (Mar. 27, 2008), PLR 200526010 (March 22, 2005) and 200336020 (June 3, 2003).

3. Distribution of savings bonds to satisfy a pecuniary charitable bequest triggers income taxation to the estate. PLR 9507008 (Nov. 10, 1994).

INCOME TAX DEDUCTIONS FOR CHARITABLE BEQUESTS:

a. General Rule: Neither A Charitable Income Tax Deduction Nor A DNI Deduction for an Estate's Charitable Transfer of Principal (e.g., a Typical Charitable Bequest). Rev. Rul. 2003-123, 2003-50 IRB 1200. 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 met, for example, when the governing instrument requires the trust's or estate's income to be distributed to charity. It may, therefore, be helpful to have instructions in the trust or will that charitable bequests be made with IRD. One rare occasion when the IRS allows charitable income tax deductions in the absence of such an instruction is if a trust or estate holds an interest in a partnership that reports a charitable contribution. Rev. Rul. 2004-5, 2004-3 IRB 295.

b. Satisfying A Pecuniary Bequest With Retirement Assets -- Triggers income to an estate or trust and there is no offsetting charitable income tax deduction unless there are instructions in the document to leave income to charity. The IRS Chief Counsel memorandum. ILM 200644020 (Dec. 15, 2005). See PLR 9507008 (Nov. 10, 1994) (above) for a comparable rule for savings bonds.

c. Taxable proceeds received by estate but given to charitable beneficiaries qualifies for offsetting charitable income tax deduction - PLR 200537019 (May 25, 2005)