Using Retirement Benefits for Charitable Contributions and Bequests

Estate Planning Section of the Utah State Bar

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I. The Pending Financial Impact of Required Distributions of Retirement Benefits.

A. **75 million baby boomers**: At its peak, "the largest generation in U.S. history." Now exceeded by millennials.

B. **Who Are They?** In general, baby boomers include those born during the years 1946 through 1964 (some definitions use the second half of 1946).

C. **How Much is Involved?** Of an estimated $25 trillion in total retirement benefits, about $15 trillion may be related to baby boomers.

D. **The Role of Defined Contribution Plans:** Defined contribution plans have in large part replaced defined benefit plans.

E. **What is the Required Beginning Date?** In general, the required beginning date (the "RBD") is April 1 of the year after turning 70 ½.

F. **What is the Significance of April 1, 2017?** For those born in the first half of 1946, the RBD is April 1, 2017, less than three weeks away. For those born in the second half of 1946, 2017 is their first distribution year, but the RBD is April 1, 2018.

G. **How Much Will be Distributed?** The remaining life expectancy for a 65-year old man is around 19 years and for a 65-year old woman, it is about 21.5 years. For minimum distribution purposes, the published LE for a 70-year old of either gender is 17. Therefore, depending upon who the designated beneficiaries are, and other factors, *trillions* of dollars could be distributed in the next twenty years.

II. Traditional Approach to Lifetime Distributions of Retirement Benefits to Charity.

A. **Withdrawal First, Gift Second.** The traditional approach for using retirement benefits to fund charitable gifting during life is to first withdraw the funds from the retirement account and to then make a charitable contribution with those funds. This typically results in ordinary income that will hopefully be offset by a charitable deduction. However, there are a number of charitable deduction problems, as discussed below.

B. **Charitable Deduction Strategies.** There are a number of charitable planning strategies that can be used in connection with lifetime withdrawals of retirement benefits.

a. **Donating the RMD**. For those over 70½, the required minimum distribution can be donated to charity each year.

b. **SOSEPP.** A taxpayer under the age of 59 ½ can avoid the ten percent penalty by electing to take a series of substantially equal periodic payments. These amounts can then be donated to charity subject to the normal rules.

c. **Net Unrealized Appreciation.** Appreciated employer stock distributed from a qualified plan can be donated to charity. Result should be that basis only is subject to income tax.

d. **Use of ESOP.** Somewhat similar to a tax-free exchange under § 1031, if appreciated stock in a company is sold to an ESOP, the proceeds can be invested without capital gains tax in qualified replacement property having a transfer basis. If the replacement property is donated to charity, the capital gain can be avoided. (This strategy differs from the others in that it does not involve an actual withdrawal of retirement benefits.)

e. **Making Qualified Charitable Distributions.** Most of the charitable deduction problems mentioned below in II C can be avoided by making Qualified Charitable Distributions (see discussion in III, below).

C. **Charitable Deduction Problems.** Although using retirement benefits to fund lifetime gifts does provide the benefit of offsetting ordinary income with an income tax deduction, the traditional approach has a number of potential problems, some familiar and some unfamiliar:

a. **AGI Limitations.** The charitable deduction is limited to a certain percentage of adjusted gross income for the year in question. Although excess amounts can be carried forward, that requires tracking through multiple tax years.

b. **Reduction of the Deduction.** Because the charitable deduction is an itemized deduction, individual taxpayers with a substantial amount of income may have their deduction reduced under § 68. The reduction of the deduction is made worse by the distribution itself, which constitutes additional AGI.

c. **Standard Deduction Problem.** Because the charitable deduction is an itemized deduction, there is no benefit to those who use the standard deduction.

d. **Personal Exemption Phase Out.** An increase in AGI may result in the phase-out of the personal exemption under § 151(d).

e. **Increased AGI Floor.** Because the distribution increases AGI, it also increases the floor for taking certain deductions other than the charitable deduction.

f. **State Law Deduction?** Some states do not provide for a charitable income tax deduction.

g. **Other Consequences.** It is also possible that the additional income from the distribution could increase Medicare premiums, the tax on Social Security benefits, and the net investment tax.

D. **Inherited IRAs.** In general, the same issues that apply to withdrawals by participants and owners from qualified plans and IRAs also apply to withdrawals by beneficiaries of inherited IRAs. **Double Deduction?** Following the death of the participant or owner, retirement benefits distributed to the beneficiaries constitute income in respect of a decedent. If those retirement benefits were included in the decedent's gross estate and an estate tax was paid, pursuant to § 691(c), a proportionate amount of the estate tax paid can be taken by the beneficiary as an income tax deduction (this is an often overlooked deduction), with the deduction being spread out over the time period in which the retirement benefits are taken into income (this appears to be true even if no estate tax was actually apportioned to the IRD). If the beneficiary contributes the amounts to charity, there is both a deduction for IRD <u>and</u> a charitable deduction for income tax purposes.

III. Making Qualified Charitable Distributions During Lifetime. Many of the problems associated with the traditional approach to using retirement benefits to fund lifetime charitable contributions can be avoided by making qualified charitable distributions under § 408(d)(8) ("QCDs"), which are a relatively new form of contributions that recently became permanent under the law. QCDs have the following characteristics and advantages:

A. **Exclusion from Income.** QCDs are excluded from gross income. As a result, no deduction is allowed under § 170. Also, there is no increase in AGI and no need to itemize deductions.

B. **Age Requirement.** Only those who are 70 ½ or over can make a QCD. The 70 ½ requirement raises some interesting timing issues and creates some uncertainty. In the first year open to a QCD, someone born on June 30 won't have much time to get a transaction completed on December 30th or 31st (because counting is apparently by day of the month (e.g., April 1 to October 1), presumably no one turns 70½ on December 31st). Query: When does someone with a birthday of August 29th (or 30th or 31st) turn 70½?

C. **Maximum Annual Amount.** The maximum amount that can be contributed each year as a QCD is $100,000 per person ($200,000 for spouses, but no "portability").

D. **Relationship to RMD.** The QCD satisfies the RMD but is otherwise unrelated. For those with charitable inclinations, contributing the RMD to charity using a QCD is a good planning strategy. However, for charitable contributions in excess of the RMD, using other strategies such as gifting appreciated stock should be considered as alternatives (e.g., so that the IRA "stretch" is not lost). If the RMD exceeds $100,000 and the full amount is donated, the excess will not be a QCD, but should still qualify for a deduction under § 170.

E. **Types of Retirement Accounts.** QCDs can only come from IRAs, including Roth IRAs, but not including SEPs or SIMPLEs.

F. **Permitted Charities.** In general, QCDs can be given to charities qualifying under § 170(b)(1)(A) (i.e., charities subject to the 50% of AGI limitation), which includes public charities and private operating foundations. However, donor advised funds, private non-operating foundations, support organizations, and split interest trusts (such as charitable remainder trusts and charitable lead trusts) are not permitted recipients.

G. **After Tax Amounts in IRA.** The normal rule is that distributions from an IRA carry out after-tax amounts (i.e., non-deductible contributions, or IRA amounts having tax "basis") on a proportionate basis. However, for QCDs, there is a special "income first" rule. In other words, after-tax contributions will come last. **Planning Opportunity:** Make a QCD to the extent of the taxable amount (relying on the income first rule), then convert the after-tax balance tax free to a Roth.

H. **Mechanics of Distribution**. Wire transfer or check to charity. However, the custodian may prefer to deliver the check to charity to the IRA owner for delivery, which is fine.

I. **Other Requirements.** Except for AGI limitations, the entire distribution must be otherwise deductible (e.g., meeting requirements of substantiation, no receipt of benefits from charity) and must otherwise have been included in gross income. **Warning:** If even a small benefit is received in exchange, the entire exclusion could be lost. Presumably, in that case, a deduction could still be claimed for the balance under § 170.

J. **Reporting.** The custodian will issue a 1099-R (use Code 7, not Code F). According to the instructions for Form 1040, the taxpayer lists the gross amount of the distribution on line 15a (i.e., including QCDs), but only the net amount on line 15b (i.e., excluding QCDs). Apparently, "QCD" should be written in the margin of the 1040. **Trap for the Unwary**: If the return preparer just looks at the 1099-R, there is nothing to indicate that a QCD is involved. Therefore, without proper communication, the exclusion may be overlooked.

K. **Inherited IRAs.** Beneficiaries of inherited IRAs can also make QCDs if they have attained the age of 70 ½. Similar to the discussion in II D, above, a beneficiary making a QCD should be able to claim both the § 691(c) deduction for IRD with respect to estate taxes paid and still exclude the amounts from gross income.

IV. Charitable Bequests of Retirement Benefits at Death. Notwithstanding the significant amount of required minimum distributions that will be made to participants and owners of qualified plans and IRAs during the next twenty years, a substantial amount of those benefits will still be payable to beneficiaries at death. Although those who live into their 90s will be forced to distribute most of their retirement benefits during lifetime, many others will die well before their life expectancies, leaving behind large accumulations of retirement benefits. Although the total amount of this accumulation and the identity of the beneficiaries are purely speculative, it seems reasonable to assume that many billions of dollars will flow from these accounts into the hands of charity. However, what is not speculative is the fact that the manner in which these charitable bequests are made will make a huge difference for income tax purposes to both charitable and non-charitable beneficiaries alike. The following discussion assumes a basic understanding of the rules governing required minimum distributions in a non-charitable context.

A. **Default Approach for Non-Charitable Use of Retirement Benefits.** With respect to retirement benefits such as IRAs and 401(k)s, a good default approach is to name the spouse of the owner as the primary beneficiary and the children as contingent beneficiaries on a per stirpes basis. This approach generally provides the greatest flexibility and deferral for income tax purposes and also provides some protection against the premature death of beneficiaries. For example, a surviving spouse can roll over benefits to his or her own IRA and designate new beneficiaries. Also, if there is no surviving spouse, the children can create separate inherited IRAs and take minimum distributions over their individual life expectancies. If there is no surviving spouse, and a child dies before the owner or participant, using the per stirpes approach will protect against disinheriting the issue of that deceased child. However, this default approach may also have some disadvantages, such as when taking care of minor beneficiaries or making charitable bequests is involved.

B. **Advantages of Using Retirement Benefits to Make Charitable Bequests.** If a decedent intends to leave assets to charity, using retirement benefits to fund the charitable bequests can be one of the most tax-efficient methods for doing this. This is because the charity is tax exempt and can receive the amounts free of any income tax. In contrast, because retirement benefits constitute income in respect of a decedent under IRC § 691, individual beneficiaries of retirement benefits will be subject to income tax as those benefits are received.

> **Example:** Jane dies in 2017 at the age of 82 with an estate of $1,500,000, consisting of a $750,000 IRA and appreciated real estate having a value of $750,000. The real estate qualifies for a step-up in basis. No estate tax is payable because of the exemption. Jane leaves one-half of her estate to her 62-year old son John, who is in a 40% state and federal combined income tax bracket, and the other half to charity. Because of the income tax charitable deduction, the charity receives one-half of each asset free of tax. However, John pays an income tax of $150,000 ($750,000 x .5 x .4) with respect to the IRA benefits. Jane should have named the charity as sole beneficiary directly on her IRA beneficiary designation form and

provided in her Will or Trust for the distribution of the real property to John, thereby saving her son $150,000.

Caution: <u>There can be drawbacks to using the approach in the Example</u>. For example, if John were only 42 when his mother died and was named instead of the charity, the income tax savings obtained from naming the charity might be more than offset by the benefit of having forty years of income tax deferral based on his life expectancy of 41.7 years. On the other hand, if Jane died at age 92, the combination of the minimum distribution rules and her greatly decreased life expectancy over the last few years of her life will probably leave the charitable bequest from the IRA greatly reduced. Finally, it almost never makes sense to leave Roth IRA benefits to charity because those benefits can generally be received by the beneficiaries tax free, regardless of who they are.

C. **Methods for Using Retirement Benefits to Make Charitable Bequests.** There are a number of methods for leaving retirement benefits to charity, each with its own advantages and disadvantages. For simplicity, this outline will refer to IRAs from this point on. Although the planning for qualified plans is generally the same, it is important to note that there are important differences.

   a. **Simplest Approach—100% to Charity**. The simplest approach is to name the charitable organization(s) as primary or contingent beneficiary of 100% of the IRA directly on the beneficiary designation form. If there is a desire to leave a specific amount to the charity, the owner can create multiple IRAs and monitor the amount intended for charity through the use of rollovers from one account to another or by taking required minimum distributions only from certain IRAs. <u>A potential downside to this approach is that someone has to follow through with monitoring the account, which may become increasingly difficult as the owner ages and/or becomes incapacitated</u>.

   b. **Next Simplest Approach—Fractional or Percentage Interests in IRA to Charity and Individuals**. The next simplest approach is to name the charitable organization and an individual or individuals as primary or contingent beneficiaries of fractional interests in the IRA directly on the beneficiary designation form. **Caution:** <u>If this combined approach is used, the life expectancy payout method may not be available to the non-charitable beneficiaries</u>. This is because the life expectancy method is only available if **all** beneficiaries are individuals with life expectancies. <u>However, although some risk is involved because of potential non-action by the beneficiaries, two fairly simple solutions to this problem are: (i) to create "separate accounts" (within the meaning of Regs. § 1.401(a)(9)-8) by the end of the year following the year of death; and (ii) to pay out the full benefit to charity by September 30 of the year following the year of death, which is the date for finalizing the IRA beneficiaries</u>. Alternatively, the charitable bequest could be made contingent on the September 30 payout deadline with a back-up charitable distribution in the Will or Trust (to ensure an estate tax deduction, if needed). Also, please note that because of the availability of a spousal rollover, the loss of the life expectancy payout method should not be a problem if the surviving spouse is the sole non-charitable beneficiary.

c. **More Complicated—Identify Pecuniary Amounts in Beneficiary Designation.** If the beneficiary designation lists a pecuniary amount for charity (e.g., $100,000) and the balance to the non-charitable beneficiaries, it is not clear whether the life expectancy payout method will be available. If the amount is a fixed sum with no adjustments for post-death appreciation and depreciation, then it would not qualify for separate account treatment, although the payment to charity before September 30 of the year following the year of death option would still be available. If the charitable and non-charitable portions do share pro rata in future gains and losses, then the separate account option should be available. Whichever approach is intended should be spelled out in the beneficiary designation form, possibly through an attachment.

d. **Complicated—Use of Formulas in the Beneficiary Designation.** Because assets fluctuate in value, an IRA owner will frequently not know what portion of the IRA should be left to charity or even a particular dollar amount that should be left. It is not uncommon for individuals to leave a stated percentage of their entire estate or of some portion of their estate to charity (e.g., 10% or 50%). Also, the beneficiary designation may allocate between a spouse, children, grandchildren, and charity, which can add to the complexity, or there may even be formulas for allocating estate tax exemption or generation-skipping exemption. The more complicated the beneficiary designation becomes, the more customized drafting that will be needed and the less likely that a custodian will be willing to accept the designation. A possible solution to this issue is to authorize the custodian to rely on a representation from the decedent's fiduciaries with respect to the amounts to be paid out.

e. **Most Complicated--Naming Trusts as Beneficiaries.** Although the mechanics of naming a trust as an IRA beneficiary are easily handled, the consequences of that simple choice can be extremely complicated. These complications arise from the interplay between the required minimum distribution rules, the income in respect of a decedent rules, and the income tax rules governing trusts.

    i. **Required Minimum Distribution Complications.** The first challenge of naming a trust as beneficiary of an IRA is making sure that the trust qualifies as a "see-through trust" for required minimum distribution purposes, which is important if non-charitable beneficiaries will be using the life expectancy payout method. In order to qualify for this treatment, only individuals can be beneficiaries of the trust. If that is not the case, the life expectancy payout method may be lost for all beneficiaries. For example, if a trust is named as beneficiary of a $1 Million Dollar IRA, and the trust contains a relatively small charitable bequest of $10,000, the life expectancy payout method could be lost, even if other assets are used to fund the charitable bequest. A possible solution to this problem is to remove the charity as a trust beneficiary by satisfying the charitable bequest by the September 30 deadline. <u>If the charity is successfully removed by the deadline and certain other administrative-type requirements are satisfied, then the trust can be treated as the designated beneficiary (i.e., as a see-through trust) and the life expectancy of the oldest trust beneficiary should be available for purposes of determining required minimum distributions</u>.

However, this approach won't work if the charity is a remainder beneficiary or the charitable distribution is otherwise delayed. Possible solutions to the charitable remainder or delay problem include the following: (1) create a conduit trust that automatically passes out all IRA distributions to the individual beneficiaries during their lifetimes; and (2) create a charitable remainder trust to be the beneficiary of the IRA. On the other hand, a conduit trust may not be a good alternative for a disabled beneficiary if the automatic distributions of the retirement benefits disqualify that beneficiary from receiving government assistance.

ii. **Distributable Net Income Problems**. The second challenge of naming a trust as beneficiary of an IRA is dealing with the "distributable net income" or "DNI" rules that apply for trust income tax purposes. DNI measures the amount of the deduction that will be available to the trust, sometimes called the "DNI Deduction." Although this is an oversimplification, these complex rules help determine who will pay the tax on trust income—the trust itself or the trust beneficiaries at presumably lower rates. Because post-death distributions of retirement benefits constitute income in respect of a decedent, they will also be included in distributable net income under either IRC § 651 or § 661. <u>However, in what could be considered a worst-case scenario, the problem is that no DNI deduction is allowed with respect to distributions to charity (unless a charitable remainder trust is a beneficiary of the trust)</u>. <u>As a result, the taxable income of the trust may be correspondingly increased, with an income tax payable by either the trust or the non-charitable beneficiaries with respect to benefits that were distributed to charity</u>. In a world of acronyms, the problem can be stated this way: **Although RMDs are IRD which is DNI, no DNI Deduction is available for distributions to charity.** Retirement plan distributions also have an effect on the extremely complicated IRS rules for carrying out Net Investment Income ("NII") from the trust to its beneficiaries for purposes of determining who pays that tax (although retirement benefits themselves are exempt from the NII tax).

iii. **Section 642(c) Charitable Deduction Issues.** Because no DNI Deduction is available with respect to retirement benefits distributed to charity, the third challenge of naming a trust as beneficiary is making sure that the distribution qualifies for a charitable deduction under § 642(c). <u>This deduction is very different from the charitable deduction available to individuals pursuant to § 170</u> (e.g., there are no AGI limitations). In general, § 642(c) requires that the distribution be made for a charitable purpose from the trust's "gross income . . . pursuant to the terms of the governing instrument," which requires some tracing. <u>In other words, the trust must not only authorize the trustee to distribute gross income to charity, but the distribution must actually be made from that gross income</u>. Although retirement benefits typically constitute principal for trust accounting purposes, as income in respect of a decedent, they are considered gross income for income tax purposes. <u>For purposes of § 642(c), it is possible to specify in the governing instrument that charitable bequests **shall** first be made from gross income, even if the allocation does not have any independent economic effect</u>. In other words, even if the amount to be received by the charitable beneficiary is the same regardless of the amount of gross income involved, a § 642(c) deduction will still be available. However, a problem may arise if the trust gross income includes tax-exempt income because notwithstanding any provision to the contrary in the governing instrument, the payment to charity will be deemed to be made proportionately from all classes of gross income, so it is not possible to allocate all of the otherwise taxable gross income to the charitable beneficiary and the tax-exempt income to the non-charitable beneficiary unless the allocation has independent economic effect, which may be hard to accomplish. <u>Section 642(c) also provides a special timing rule, in which the trustee can elect to have a charitable contribution paid in one tax year treated as if it were paid in the previous tax year</u>. A similar treatment is available under § 663(b) with respect to the DNI deduction, but only if the payment is made within the first sixty-five days of the second tax year.

iv. **The Separate Share Rules of Section 663.** The income tax separate share rules, which are different than the separate account rules for purposes of required minimum distributions, determine whether "substantially separate and independent shares" of different beneficiaries will be "treated as separate trusts." The separate share rules will determine the amount of DNI that will be allocated to a particular trust beneficiary's share. If the trust instrument doesn't specifically allocate the retirement benefits to the charitable share, the gross income that arises from distributing the retirement benefits to the trust will be allocated proportionately to all of the beneficiaries. <u>Therefore, the trust instrument should not only provide that the charitable share is to be satisfied using the trust's gross income, but should also provide that the retirement benefits are to be allocated to the charitable share</u>.

v. **Assignment of the Right to Receive IRD.** So far, this analysis has focused on distributions of retirement benefits that are actually received by the trust pursuant to the IRA beneficiary designation which are included in trust gross income as income in respect of a decedent and then distributed from the trust to the trust beneficiaries. <u>However, another option is for the trust to assign *the right to receive* the retirement benefits to the charity</u>. This can be done if the trust instrument gives the trustee authority to distribute trust assets in kind to the beneficiaries and to pick and choose which assets will be distributed to which beneficiaries. <u>In that case, the benefits will be paid directly to the charity instead of to the trust, and the trust will therefore not have any gross income arising from the benefits</u>. The assignment approach can avoid problems with both the separate share rules and the § 642(c) governing instrument requirement discussed above. **Warning:** <u>If the right to receive retirement benefits is assigned in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount), the IRS may treat that as a sale of the benefits that triggers income to the trust for the full amount that is assigned</u>. This issue can be avoided by using fractional or percentage bequests.

vi. **A Flexible Approach for Trusts and Retirement Benefits.** A flexible approach for potentially using trusts as beneficiaries of retirement benefits would be for the IRA owner to name the spouse as primary beneficiary (thereby allowing for a rollover) and naming the owner's trust as the contingent beneficiary. If the IRA is rolled over to the surviving spouse, the survivor's trust would be named as primary beneficiary. If a joint trust is being used, that trust could be used in place of either separate trust. Whichever trust becomes the beneficiary, any formula provisions for determining the value of the charitable share can easily be included there and the trustees will then have the responsibility to determine the appropriate amount for the charity.

The trust document could also provide that the amount of the charitable distribution to be made pursuant to the trust is to be reduced by any amounts paid directly to the charity pursuant to any beneficiary designation, which will avoid doubling up the amounts. If the trust does not become the beneficiary of any retirement benefits, then any short fall in the charitable contributions would be made up from the Trust using non-retirement benefits.

If the trust is actually named as the beneficiary of the retirement benefits, the trustees could be authorized to either take distributions of the benefits or assign the right to receive them, depending upon which approach they feel is the best at the time. This flexibility is important because the tax laws are always changing and there may be reasons to follow a certain approach in the future that are not yet apparent. As noted above, the trustees should not assign the right to receive the retirement benefits in satisfaction of a pecuniary bequest. Assuming that the charitable bequest is satisfied by September 30 of the year following the year of death and the other requirements for creating a see-through trust are met, the life expectancy method should be available for the non-charitable distributions, based on the life expectancy of the oldest trust beneficiary.

V. **Conclusion.** Because of the many complex tax issues involved, planning for charitable contributions during lifetime and charitable bequests at death is not an easy undertaking. However, the easiest part of this process may be to learn all of the different rules that are involved. Much harder is explaining all of this to clients and helping them understand the different options that are involved. Harder still may be actually advising them which option is best under all the circumstances and then implementing that option in the most effective way possible. Most importantly, the success of this undertaking will help many owners of retirement benefits leave a legacy earned through hard work to their intended charitable and non-charitable beneficiaries in the most tax efficient and effective manner possible.

Sources:

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