

Charitable Giving and Retirement Assets

Individuals who save for retirement likely own an Individual Retirement Account (IRA), one or more qualified retirement plan accounts (e.g., a 401(k) plan) or both. However, there are rules and limitations on how much one can save for retirement using these accounts, and on how distributions from these accounts during retirement are taxed.

The deferral of taxation for qualified retirement plans and IRAs is a clear benefit, but also a potential tax problem when it is time to make distributions. For philanthropically inclined individuals, the use of these assets for charitable gifts may be an excellent, tax-efficient option. A gift made during the donor's lifetime or a gift using a beneficiary designation to a charity or to a charitable remainder trust can be a rewarding and practical solution. Here are several approaches for integrating these assets into charitable giving plans.

Strategies for Creating Lifetime Charitable Gifts with Retirement Assets

Qualified Charitable Distribution from an IRA

Also known as an IRA Charitable Rollover, the Qualified Charitable Distribution from an Individual Retirement Account (IRA) permits a person over age 70½ to direct a charitable gift directly to a qualified charity from an IRA [IRC Sec. 408(d)(8)]. The charity must be a public charity or private foundation that may receive general contributions (except not a Donor Advised Fund, nor a Sec. 509(a) Supporting Organization) and must otherwise qualify as a charitable income tax deduction [IRC Sec. 408(d)(8)(B)(i)]. A person may direct up to \$100,000 per year in this manner. The distributed amount is excluded from income so the taxpayer does not need to report the distribution as taxable income for federal tax purposes. Furthermore, the distribution counts toward the taxpayer's annual required minimum distribution for tax-deferred accounts. However, the distribution does not qualify for a charitable deduction [IRC Sec. 408(d)(8)(E)].

Loan from an IRA to a Charity

One instance of the creative use of an IRA to benefit a charity (though without any charitable deduction) is the CHIRA or Charitable IRA plan. Note that a Private Letter Ruling (PLR) cannot be relied upon by any person except the taxpayer to whom it was issued, but it does provide an illustration of how an IRA and a life insurance arrangement might work in tandem.

In PLR 200741016, the donor proposed directing his IRA to lend a sum of money to a qualified charity in return for a twenty year promissory note that pays 5% annually. The note would be accelerated upon the death of the owner. A life

insurance policy owned by the charity on the life of the donor would provide the collateral for the note. Under the terms of the note, in the event of the donor's death prior to the full payment of the note, the death benefit would pay off the remaining payments owing under the note and the excess benefit would go to the charity.

The loan payments from the charity to the IRA would provide the needed cash for the donor to take required minimum distributions from the IRA.

The loan itself was an investment permitted under IRC Sec. 408 and not a prohibited transaction. Nor did the purchase of a life insurance policy by the charity as collateral on the note violate the prohibition on an IRA investing in life insurance. Furthermore, the charity needs to establish an insurable interest in the donor's life under state law in order to meet the note requirements.

Regular Charitable Gifts Made with Lifetime Distributions from Retirement Assets

Lifetime plan withdrawals by a donor may be used to fund charitable gifts. Such withdrawals may be used for direct cash gifts, or to establish a charitable life income gift such as a charitable remainder trust (CRT) or charitable gift annuity (CGA). The charitable deduction created by an outright gift or by the creation of the CRT or CGA can reduce the income tax liability occasioned by the withdrawal. If the charitable gift is a life income gift, the donor (or someone selected by the donor) may receive payments during his or her lifetime(s).

The benefits of a charitable gift using the distribution from a retirement asset would be to reduce the donor's taxable estate by the value of the property transferred, and to create an immediate income tax deduction for the present value of the gift to the charity [IRC Sec. 170].

Strategies for Creating Testamentary Charitable Gifts with Retirement Assets

Because of the difficulty posed by both its estate and income tax liability, property within an estate that contains Income in Respect of a Decedent (IRD) can be an appropriate choice for charitable giving. In general, retirement assets such as an IRA or 401(k) are IRD. And by properly donating this income as a bequest through the estate, an individual generates both an estate tax charitable deduction as well as an income tax charitable deduction for the estate. Non-IRD assets may be better to bequeath to non-charitable heirs.

Naming a Charitable Beneficiary

Under the old RMD rules, the beneficiary's life expectancy was important because it could stretch out the distribution period for the payments under an IRA or

qualified plan, and thereby allow a living owner to take smaller RMDs each year. Since a charity has no life expectancy, naming a charitable beneficiary did not stretch out the distribution period at all. A donor was essentially penalized for naming a charitable beneficiary by being forced to take larger distributions than would have been required if an individual beneficiary had been named.

The current regulations eliminated this treatment of charitable beneficiaries and charitably inclined account owners. The lifetime RMDs for account owners are now determined under the Uniform Lifetime Table regardless of the life expectancy of the designated beneficiary (not forgetting the exception for a spouse who is more than 10 years younger than the owner). This should encourage more frequent use of IRAs and retirement plan assets for charitable giving purposes – especially since the IRD advantage enjoyed by charitable beneficiaries was unaffected by the RMD changes.

There are effective ways to make a charitable bequest of an IRA or qualified retirement plan asset:

One, the owner could designate the charity as the beneficiary for the retirement plan or IRA. This designation controls the distribution of the account (instructions left in a will or trust have no effect if the asset is not left to the estate or the trust). The plan or account administrator will have a beneficiary designation form for the owner to complete. This is the straightforward way to do it.

Two, the owner could leave the retirement plan or IRA to his estate or trust and include language within the will or trust that permits the executor or trustee to make income distributions and effectively claim the income tax charitable deduction for the IRD asset that goes to charity.

Qualified Terminal Interest Property Trust with a Charity as the Remainder Beneficiary

Qualified Terminable Interest Property (QTIP) trusts qualify for the marital deduction for federal estate tax purposes. A QTIP trust requires that all trust income generated during the spouse's life be paid to the spouse; no other beneficiary may benefit from the trust during the lifetime of the spouse [IRC Sec. 2056(b)(7)]. To use an IRA to fund a QTIP trust would provide that the greater of the IRA required minimum distribution or the income created by the IRA account must be paid to the spouse at least annually during the life of the spouse.

Under the QTIP charitable trust arrangement, the first spouse to die (as grantor) would mandate that the undistributed principal remain in the account. After the death of the surviving spouse, the trust assets would go to charity as the first spouse had directed by the terms of the trust. The value of such principal would be taxed in the estate of the surviving spouse, but the value of assets passing to charity would qualify for an estate tax charitable deduction.

If it is desirable to provide the surviving spouse with access to the principal of the trust prior to the eventual transfer to the charity, the QTIP can be drafted to permit such access. The value of the QTIP remaining at the spouse's death will be included in his or her estate; however, that value which is transferred to the charity will give rise to an estate tax charitable deduction.

Charitable Remainder Trust with a Spouse as the Non-Charitable Beneficiary

Individuals wishing for the charity to have an interest that is clearly vested might prefer to establish a Charitable Remainder Trust rather than a QTIP. When the account balance is transferred to the CRT upon the account holder's death, there will be the estate tax charitable deduction for the value of the portion bequeathed to the charity. The account holder's estate will also be entitled to an estate tax marital deduction with respect to the spouse's income interest in the assets transferred to the CRT. Since the charity is income tax-exempt, there will be no income tax liability as a result of the transfer of the qualified retirement plan or IRA assets to the CRT.

If a Charitable Remainder Trust (CRT) is used, either a fixed dollar amount (Charitable Remainder Annuity Trust) or a specified percentage (Charitable Remainder Unitrust) will be received at least annually by the non-charitable beneficiary or beneficiaries [IRC Sec. 664 (d)]. After their interest terminates, the remaining assets will be paid to the charitable beneficiaries named in the trust [Reg. Sec. 1.664-1(a)(1)(i)].

At the time the original account holder dies and assets pass to the CRT, the value of the interest going to the surviving spouse as beneficiary will qualify for the estate tax marital deduction and the value of the charitable remainder interest will qualify for the estate tax charitable deduction. Any value of the IRA remaining inside the CRT at the death of the surviving spouse will not be taxable in his or her estate.

However, there may be a problem due to the inflexible nature of the CRT distributions to the surviving spouse. But this inflexibility may not be troublesome if the surviving spouse has other available wealth.

Charitable Remainder Trust with a Child as the Non-Charitable Beneficiary

When an account holder wishes to provide for his or her children through an IRA or qualified retirement plan, the use of a CRT may be in some cases more advantageous than an outright bequest of an asset to the child.

There are several reasons why. One is that a bequest to a CRT will create an estate tax charitable deduction, which could reduce estate taxes. Further, the transfer of the IRA or qualified retirement plan to the CRT will not trigger immediate income taxation. Income generally will be taxed to the beneficiary of the

CRT as it is received by him or her. A bequest to a CRT benefiting a child may be limited or impractical, however, because of the requirement that at least 10 percent of the value transferred to the CRT must represent the charity's remainder interest [IRC Sec. 664(d)(1)(D), 664(d)(2)(D)].

When the IRA asset eventually passes to the charity following death of the non-charitable beneficiaries or the expiration of the trust term, the asset is essentially "lost" to the family. However, the reduced income and estate taxes occasioned by the transfer of the IRA to the CRT may have preserved additional principal in the IRA which will have generated additional income for the non-charitable beneficiary. And using part of this income to replace the IRA wealth by obtaining insurance on the lives of the beneficiaries is a possibility.

Note that the Sec. 691 income tax deduction attributable to the estate tax paid on IRD does not pass through the charitable remainder trust to the non-charitable beneficiaries.

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