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STACEY N. KNOX

* Certified Specialist Estate Planning, Trust And Probate Law State Bar of California, Board of Legal Specialization

1875 CENTURY PARK EAST
SUITE 1500
LOS ANGELES, CALIFORNIA 90067-2516

TELEPHONE - (310) 575-0800
FACSIMILE - (310) 575-0170

WRITER'S E-MAIL ADDRESS
bill@stone.net

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USE OF RETIREMENT BENEFITS IN CHARITABLE PLANNING

By

WILLIAM FINESTONE, ESQ.
Certified Specialist*
Estate Planning, Trust & Probate Law

Northern California Planned Giving Council

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USE OF RETIREMENT BENEFITS IN CHARITABLE PLANNING

1. Introduction: Goals

1.1 To benefit charity.

Tax savings can help finance the cost of passing retirement benefits to charity, but the "cost" is never zero, and of course there is always a substantial financial benefit provided to the charitable organization. Providing those benefits to charity will prevent the donor from maximizing the value of the donor's estate for family members; that can be accomplished by leaving all retirement benefits to family members. Taxes will be higher, but the donor's family will have more money. But charitable gifts via retirement plans can help donors who are interested in helping a charity with maximum tax "subsidies."

1.2 To save taxes.

To benefit both charitable and non-charitable beneficiaries, the most tax-efficient method generally is to fund the charitable gifts with retirement benefits and leave other assets to the non-charitable beneficiaries. Retirement plan assets are worth more to a charity than to a non-charitable beneficiary, while most other assets are worth the same to both types of beneficiaries. This is because retirement plan distributions to a beneficiary are generally considered "income in respect of a decedent" ("IRD") under IRC §691 and are subject to income taxes. Because a charity is tax-exempt, no part of the inherited benefits received by charity are lost to income taxes. The foregoing is also true with other forms of IRD that allow a beneficiary designation, such as an interest in a non-qualified deferred compensation plan and a taxable death benefit under an annuity contract. See LTRs 200618023, 200452004, and 200425027.

1.2.1 **Example 1**

Decedent leaves her house (worth $500,000) and her IRA (also worth $500,000) to child. There is no estate tax, because the estate is under the federal estate tax exemption. Child receives the house tax-free (no income tax either), and if child sells the house for $500,000, no capital gains tax either, regardless of what the decedent paid for the house ("stepped-up basis").

Child will have taxable income, however, as a result of receiving IRA distributions. The $500,000 distribution is included in the child's gross income for the year of the distribution. The IRA, unlike the house, does not get a new basis upon the owner's death.

If decedent wanted to leave only half her estate to child and half to charity, she could leave half of each asset to each beneficiary; she could leave the IRA to child and the house to charity; or she could leave the house to child and the IRA to charity. Would it make any difference to child? To charity?

1.2.2 **Example 2**

1.2.2.1 Assumptions. Mrs. Smith, a California resident widow, has accumulated $2,000,000 in a pension plan. She dies in 2013 at age 65, survived by children and a grandchild. She has designated her grandchild as the recipient of the plan benefits, which are to be paid in a lump sum.

Mrs. Smith's gross estate is $6,000,000, and therefore the marginal federal estate tax rate is 45 percent. The GST rate is also 45 percent. The grandchild's marginal combined U.S. and California income tax rate is 40 percent. Mrs. Smith had used her entire GST exemption before her death. Mrs. Smith's Will contains a tax apportionment clause that allocates estate taxes to the recipients of the transfers subject to estate tax.

1.2.2.2 Calculation of applicable taxes

Gross amount to Grandchild before any taxes			$2,000,000
Estate tax rate			45%
U.S. estate tax (no California estate tax)			**$ 900,000**
Because the GST in the case of a direct skip is tax-exclusive (i.e., it is determined by applying the 45% GST rate to the amount passing after the GST), the GST can be determined by applying the following formula:			
	Amount passing to the recipient before the GST	($2,000,000-$900,000)	$1,100,000
minus	Amount passing to the recipient before the GST / 1+ GST rate	($1,100,000) / (1.45)	758,621
GST			**$ 341,379**

Amount subject to income tax [$2,000,000 less the IRD deduction of $1,241,379, which is the sum of the federal estate tax ($900,000) and the GST ($341,379)]		$ 758,621
Combined U.S. and California income tax rate		40%
Combined U.S. and California income taxes		**$ 303,448**

1.2.2.3 Net result (after-tax amount passing to Grandchild)

Original Amount		$2,000,000
U.S. estate tax	$900,000	
GST	341,379	
Combined U.S. and California income taxes	303,448	1,544,827
Balance (about 23 cents per dollar)		**$ 455,173**

1.3 Estate planning.

A donor can accomplish other estate planning goals while at the same time fulfilling the donor's charitable intentions. For example, charitable gifts of retirement benefits via charitable remainder trusts can help solve some of the estate planning problems that arise in connection with disposing of retirement funds (see paragraph 4 on pages 11-13).

2. Examples of Charitable Designations

2.1 Sole beneficiary.

Designating a charity as sole beneficiary of the plan death benefit involves the fewest difficulties. Because the benefits are paid directly to charity, all tax on the benefits is avoided (the charity's income tax exemption eliminates income tax and the estate tax charitable deduction eliminates estate tax). The same result obtains if multiple charities are named.

2.2 Fractional share.

A charity can receive a fractional share of the retirement plan (tax-free), with other fractional shares passing to non-charitable beneficiaries (taxable). **This**

approach risks losing the option of a "life-expectancy payout" for the non-charitable beneficiaries.

2.2.1 Multiple Beneficiary Rule: All beneficiaries must be individuals.

Retirement benefits generally can be distributed after the owner's death as slowly as "in annual installments over the life-expectancy of the designated beneficiary." This method ("life-expectancy payout method" or "stretch IRA" method) can provide considerable income tax deferral, depending on the beneficiary's age. *The life-expectancy payout method is not available to a beneficiary who is not an individual.* A "designated beneficiary" must be either an individual or a qualifying "see-through trust." *Individual beneficiaries can use the life-expectancy payout method for an inherited retirement plan only if ALL beneficiaries of the plan are individuals.* A charity is not an individual (and therefore cannot be a "designated beneficiary"). Thus, unless an exception applies, naming charities and individuals jointly as beneficiaries precludes a life-expectancy payout for the individual beneficiaries. This could be a very unfavorable tax result for the individual beneficiaries, especially any beneficiary who is young and has a long life-expectancy. Fortunately, there are two exceptions to this rule that make it possible to name both charities and individuals as beneficiaries of the same account.

2.2.2 First exception: "Separate accounts."

The first exception is the "separate accounts" rule. If the beneficiaries' interests in the retirement plan are expressed as fractional or percentage shares, and the beneficiaries "establish" separate accounts for their respective shares by December 31 of the year after the year of the donor's death, then each separate account is treated as a separate retirement plan for purposes of the multiple beneficiary rule, and each individual beneficiary can use the life-expectancy payout method for that beneficiary's separate "account." If the beneficiaries fail to meet the deadline, however, they will be limited to taking benefits under the five-year rule* (if the participant died before his or her required beginning date or "RBD"), or over what would have been the participant's remaining single life-expectancy (if the participant died after his RBD). RBD is April 1 of the year after the year in which the participant reaches age 70½.

2.2.3 Second exception: Distribution prior to September 30.

The second exception is that a beneficiary is "disregarded" if its interest is entirely distributed by September 30 of the year after the year of the participant's death. Thus, the charity's (and all other non-individuals') share(s) can be distributed at any time prior to the September 30 deadline, and the remaining individual

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* By December 31 of the calendar year in which occurs the fifth anniversary of the participant's death.

beneficiaries are entitled to use the life-expectancy payout method. If for any reason the charity's interest is not entirely distributed by the deadline, the charity would still be considered to be a beneficiary and the individuals would **not** be able to use the life-expectancy payout method. (See LTR 200740018)

2.2.4 Exception problems.

Relying entirely on the exceptions makes sense only in some cases. If use of the life-expectancy payout method would be very advantageous, consider establishing separate IRAs: One payable to the charitable beneficiaries and one payable to the individual beneficiaries. In this way, there is no risk of failing to divide the IRA after death in a timely manner, or of failing to distribute the charity's share in a timely manner. But dividing an IRA now into separate IRAs for the charity and the individual beneficiaries will create an annoyance and extra chores [e.g., keeping values of the separate IRAs in the right proportions; MRDs can be taken from any one IRA or any combination of IRAs for this purpose (IRS Notice 88-38)]. See paragraph 2.3.2 on page 6.

2.2.5 Spouse is sole noncharitable beneficiary.

If the participant's surviving spouse is the sole noncharitable beneficiary, he or she can roll over his or her share to the spouse's own retirement plan, so there is no need to comply with the "life-expectancy payout" rules.

2.3 Specific amount.

A charity can receive a "pecuniary" (fixed-dollar) portion of the account, with the balance (residue) going to individual beneficiaries. This presents some of the same problems as leaving benefits to charitable and individual beneficiaries in fractional shares, and some additional problems.

2.3.1 Problems with the plan administrator.

Some plan administrators will not accept "pecuniary" gifts in a beneficiary designation form; they will accept only fractional share gifts. If this is not a problem, verify how the plan administrator will interpret the form: As a "pecuniary bequest" or as an instruction to divide the plan into two separate accounts as of the date of death, one worth the pecuniary amount and the other containing the balance of the plan. If the plan administrator interprets the beneficiary designation as establishing two separate accounts as of the date of death, with the charity's "account" sharing proportionately in gains and losses that occur after death, then the same options will be available as discussed in paragraphs 2.2.2 and 2.2.3 on page 4 (establish the separate accounts by December 31 of the year after the year of death, or fully distribute the charity's share by September 30 of the year after the year of death). But if the plan

administrator's policy is that the charity should receive the pecuniary amount regardless of any post-death fluctuations in the account value, then the option of "establishing separate accounts" will not be available, because the beneficiaries' respective interests must share pro rata in post-death gains and losses in order to qualify for separate accounts treatment. The option of fully distributing the charity's entire share by September 30 of the year after the year of death is available either way. If the charity receives its full share of the account by that date, it will not be considered to be a beneficiary, and the individuals can use the life-expectancy payout method.

2.3.2 Separate IRAs for large pecuniary bequests.

Because a charitable bequest jeopardizes availability of the life-expectancy payout option for the individual beneficiaries' shares, a separate IRA can be established for the pecuniary bequest(s). For example, a donor desiring to provide a $100,000 gift to charity at death might divide a $1,000,000 IRA into two separate IRAs, one containing something more than $100,000 (perhaps $200,000) of which the beneficiary designation reads "$100,000 to charity, balance to individual(s)," and the other IRA payable only to the individual(s) containing the $800,000 balance of the original $1,000,000 IRA. The separate $800,000 IRA payable to the individual(s) is not subject to any risk of losing the life-expectancy payout method, and the separate $200,000 IRA can take advantage of one of the two exceptions discussed in paragraphs 2.2.2 and 2.2.3 on page 4 to qualify the individuals for the life-expectancy payout method.

2.3.3 Small testamentary bequests.

If the pecuniary bequest to charity is modest, the usual rule ("use retirement benefits to fund charitable bequests") might be ignored by putting the charitable bequest in the donor's other testamentary documents. Although it is generally more tax-advantageous to fund the charitable bequest from the retirement plan, the advantage (if the bequest is very small) may not be worth incurring the risk of jeopardizing the life-expectancy payout for the individual beneficiaries.

2.3.3.1 If income is recognized by the donor's estate (or trust), however, an offsetting deduction for the payment of the charitable bequest under IRC §642(c) may be possible. LTR 200526010 (March 22, 2005).

2.3.3.2 The fiduciary beneficiary might assign its interest in the plan to charity to avoid income inclusion (see paragraph 2.5.2 on pages 8-9).

2.3.3.3 If only **part** of the plan is passing to charity, designating a trust rather than an estate as beneficiary of the balance of the plan may allow the non-charitable beneficiary (trust) to be a "designated beneficiary" if the trust meets certain qualifications ("see-through" trust) and if all charitable interests are distributed by September 30 of the year following the participant's death. An "estate" cannot be a