Charity2017.wpd 8/9/16

Charitable Giving with Retirement Benefits

Why, How, and When to Donate Retirement Benefits to Which Type of Charity
2017 Edition

Natalie B. Choate, Esq.
Nutter McClennen & Fish LLP
Boston, Massachusetts
www.ataxplan.com

Abbreviations and Symbols

¶ Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011); see www.ataxplan.com. Unless the section number begins with a "7," the referenced section is not reproduced in this seminar handout/Special Report.

§ Refers to a section of the Code unless otherwise indicated.

ADP	Applicable Distribution Period. See ¶ 7.2.02(B).
AGI	Adjusted gross income. § 62.
Code	Internal Revenue Code of 1986, as amended through July 31, 2016
DB	Designated Beneficiary. § 401(a)(9); see ¶ 7.2.02(A).
DNI	Distributable net income. See ¶ 7.4.01.
IRA	Individual retirement account or individual retirement trust under § 408 or § 408A.
IRD	Income in respect of a decedent. § 691; see ¶ 7.1.02(B).
IRS	Internal Revenue Service.
NII, NIIT	Net investment income, net investment income tax. § 1411.
NUA	Net unrealized appreciation of employer securities. See ¶ 7.7.04.
QCD	Qualified charitable distribution. See ¶ 7.6.
PLR	IRS private letter ruling.
Reg.	Treasury Regulation.
RMD	Required minimum distribution. See § 401(a)(9) and ¶ 7.6.02.
UBTI	Unrelated business taxable income. ¶ 8.2.

This Special Report discusses charitable gifts of retirement benefits under traditional IRAs, qualified retirement plans, and 403(b) plans. At-death gifts from traditional (non-Roth) retirement plans are discussed, as well as lifetime gifts from traditional and Roth IRAs.

Income and transfer tax rates, brackets, thresholds, and exemptions in this Special Report are as of 2016. All are subject to change due to legislative action, and many are subject to inflation adjustments for post-2016 years.

7.1 Three "Whys": Reasons to Leave Benefits to Charity

Leaving traditional retirement benefits to charity can be an ideal way to fulfill a client's charitable intent. Because the charity is income tax-exempt, it receives the benefits free of income tax. Thus the benefits may be worth more to the charity than to the client's other beneficiaries.

7.1.01 ***What practitioners must know***

Estate planning practitioners need to know:

✓ The reasons to leave retirement benefits to charity. ¶ 7.1.02.

✓ The seven ways to leave retirement plan death benefits to charity, and the advantages and pitfalls of each. ¶ 7.2.

✓ Minimum distribution problems that occur when benefits are paid to a charity under a trust that also has individual beneficiaries. ¶ 7.3.

✓ Income tax issues that arise when benefits pass through a trust or estate on their way to the charitable beneficiary. ¶ 7.4.

✓ Which types of charitable entities are suitable to be named as beneficiaries of retirement benefits. ¶ 7.5.

✓ Obstacles and planning opportunities in lifetime charitable giving with retirement benefits. ¶ 7.6, ¶ 7.7.

This Special Report assumes the reader is generally familiar with the tax rules of charitable giving. For sources of information about tax aspects of charitable giving, see the Bibliography.

7.1.02 ***Reasons to leave retirement benefits to charity***

There are three reasons a client should consider leaving his retirement benefits to charity.

A. **To benefit charity.** The main reason to leave retirement benefits (or any other asset) to charity is to help the charitable organization achieve its goals. There is no advantage to giving retirement benefits to charity if the donor does not want to benefit that charity!

This Special Report explains how tax savings can reduce the cost of passing retirement benefits to charity, but the "cost" is never zero. In all the ideas discussed here, a substantial financial benefit is provided to the charity. Unfortunately, some promoters try to take advantage of the tax-exempt status of a charity to reap gains for private individuals. They devise schemes that provide only a token or speculative benefit to the charity, while profiting individuals who have no charitable intent. This Special Report does not discuss that type of "planning idea."

The ideas here are for *charitably-minded clients only*. If an individual's only estate planning goal is to maximize the value of his estate for his family (or other noncharitable beneficiaries), these ideas will not help that individual. If that is your situation, simply leaving your retirement benefits to your chosen individual beneficiaries is normally the best way to achieve your goal; though taxes will be higher, your family will end up with more money.

On the other hand, if you are interested in helping one or more charities, especially if you would like Uncle Sam to subsidize your charitable gift, read on…

B. Most tax-efficient use of retirement plan dollars. If a client wishes to leave some of his estate to charity and some to noncharitable beneficiaries, the most tax-efficient allocation of his assets generally is to fund the charitable gifts with retirement benefits and leave other assets to the noncharitable beneficiaries. Generally, retirement plan assets are *worth more* to the charity than to individual beneficiaries, while other types of assets are *worth the same* to a charity as to an individual, for the following reason:

Retirement plan distributions to a beneficiary generally are "income in respect of a decedent" (IRD). § 691; Rev. Rul. 92-47, 1992-1 C.B. 198; Reg. § 1.663(c)-5, Example 9. IRD does not get a "stepped-up basis" at the donor's death, and accordingly will generally constitute taxable income to the beneficiary when received after the participant's death. § 1014; for more detail on IRD, see ¶ 4.6 of *Life and Death Planning for Retirement Benefits*. For a family member or other individual beneficiary, the income tax reduces the value of the inherited benefits. A charity is income tax-exempt, and thus does not lose any part of the inherited benefits to income taxes.

In contrast to retirement benefits and other "IRD" assets, other types of inherited assets generally do not come with an income tax bill, even for a noncharitable beneficiary, because of two tax rules:

- **An inheritance is not income.** An inheritance, as such, is not considered "income." Thus, when a beneficiary inherits cash, retirement benefits, or any other type of asset from a decedent, the beneficiary does not owe any income tax on the value of that inheritance. Income tax liability, if any, will arise only when the beneficiary sells the inherited asset, or (in the case of an inherited retirement plan) withdraws from, or transfers, the plan.

- **Stepped-up basis at death for non-IRD assets.** Most assets (such as a house, car,

> business, stocks, bonds, mutual funds, etc.) receive a new basis (for income tax purposes) when they pass from a decedent to an heir, equal to the date-of-death value. Because of this new-basis-at-death rule applicable to most inherited assets, the beneficiary (when he later sells the inherited asset) pays no income tax on any built-in capital gain that accumulated in the asset through the date of death. Compared with that treatment, a retirement plan is a less favorable asset for an individual beneficiary to inherit, because (as "IRD") it does not get a new basis at death.

See § 1014(c) for the new-basis-at-death rule (also called "stepped-up basis," on the assumption that assets always appreciate). (§ 1014(c) does not apply with respect to property inherited from certain decedents who died in the year 2010.)

Neil Example: Neil's mother dies, leaving Neil her house (worth $500,000) and her IRA (also worth $500,000). There is no estate tax, because the estate is under the federal estate tax exemption; Neil's mother had not used up any of her exemption through lifetime gifts. The house is transferred to Neil. The receipt of this asset is not an income-taxable event, because an inheritance is not considered income. The IRA is registered in Neil's name as beneficiary of his mother, but no money is taken out of it immediately; so far there is no tax he must pay on the IRA.

Now he sells the house for $500,000 and withdraws $500,000 from the IRA.

He pays no income tax on the house sale. His basis in the house is $500,000 (the date-of-death value), just as if he had paid $500,000 to buy the house, so there is no gain on the sale and thus nothing to pay income tax on—even though Neil's mother originally bought the house for just $100,000. The $400,000 of capital gain that built up in the house during Neil's mother's life is never taxed, because of the new-basis-at-death rule.

However, Neil does have taxable income as a result of cashing in the IRA. The $500,000 distribution is included in his gross income for the year of the distribution. The IRA, unlike the house, does not get a new basis upon the owner's death.

Suppose Neil's mother had wanted to leave only half her estate to Neil, and half to her favorite charity. She has a choice of assets. She could leave half of each asset to each beneficiary; she could leave the IRA to Neil and the house to the charity; or she could leave the house to Neil and the IRA to charity.

It makes no difference to the *charity* which asset it receives. Whether the charity receives the IRA, the house, or half of each, the charity will receive $500,000 of value from Neil's mother's estate, because it will not have to pay any income tax on either asset.

For Neil, however, it makes a substantial difference which asset he receives. If he receives the IRA, he will have to pay income tax of up to 39.6 percent, or $198,000 (2016 rates; plus state income tax, if applicable), on the $500,000 when he withdraws the money from the IRA. While his withdrawals could be deferred over a long period of time, and deferral reduces the impact of the income taxes, he might realistically conclude that the IRA is worth less than $500,000 to him. Thus he is probably better off receiving the house, from which he can immediately realize $500,000 of value, without a haircut for income taxes.

C. **Accomplish other estate planning goals.** Judicious use of charitable giving with retirement benefits can help the client accomplish other estate planning goals at the same time as he fulfills his charitable intentions. See ¶ 7.5.06.

D. **Drawbacks, limitations.** Leaving taxable retirement plan benefits to charity is not a "perfect" estate planning idea:

- For one thing, it is not *always* true that an individual beneficiary will have more money at the end of the line if he inherits after-tax assets rather than the same nominal amount of retirement plan assets. A young individual who inherits a retirement plan and makes maximum use of the life-expectancy-of-the-beneficiary payout method to "stretch" the distributions over his life expectancy may end up with more dollars than if he had inherited the same amount of after-tax assets, due to the power of income tax deferral. For explanation of the stretch payout of retirement benefits, see ¶ 1.1.03 of *Life and Death Planning for Retirement Benefits*.

- The minimum distribution rules make this planning idea self-limiting. If a participant who has named a charity as beneficiary of his retirement plan lives long enough, the minimum distribution rules (see Chapter 1 of *Life and Death Planning for Retirement Benefits*) will have forced out most of the plan's value, and there will be little left for the charitable beneficiary. A retirement plan's value tends to start shrinking significantly due to required distributions in the participant's mid-90s. A long-lived charitably inclined participant should consider giving his RMDs to charity each year (see ¶ 7.7.02), and/or revising his estate plan to leave other assets to the charity to make up for the diminished retirement plan.

7.1.03 ***Charitable pledges (and other debts)***

If the client names a creditor as beneficiary of his retirement benefits, so that the benefits will be used to satisfy the client's debt to that creditor, paying the benefits to the creditor would generate taxable income *to the client's estate*. Although generally retirement benefits are taxed to the person who receives them (§ 402(a); see ¶ 2.1.03 of *Life and Death Planning for Retirement Benefits*), the IRS would say that the estate "received" the IRD, because the estate's debt was canceled when the benefits passed to the creditor.

A charitable pledge that remains unfulfilled at death may, depending on applicable state law, constitute a debt enforceable against the estate. See, *e.g.*, *Robinson v. Nutt*, 185 Mass. 345, 70 N.E. 198 (1904) (unpaid written charitable subscription enforced as a debt against the estate due to charity's reliance), and *King v. Trustees of Boston University*, 420 Mass. 52, 647 N.E. 2d 1196 (1995). However, even if the charitable pledge is enforceable against the estate under state law, it is not deductible as a debt for federal estate tax purposes except to the extent it either was given in exchange for full consideration (rare) or would have been deductible anyway as a charitable bequest under § 2055. Reg. § 20.2053-5, effective for estates of decedents dying on or after October 20, 2009.