Charitable Giving with Retirement Benefits

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

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Charitable Giving with Retirement Benefits

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This Outline is excerpted from the author's book *Life and Death Planning for Retirement Benefits* (8th ed. 2019), updated for post-publication developments. Cross references may refer to portions of the book that are not contained in this Outline.

The Outline 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 used in this Outline are subject to change due to cost of living adjustments and/or legislative action.

Abbreviations and Symbols Used in this Outline

¶	Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (8th ed. 2019); 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, 2020.
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.

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 arise 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 Outline assumes the reader is generally familiar with the tax rules of charitable giving.

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 Outline explains how tax savings can reduce the cost of passing retirement benefits to charity, but the "cost" is never zero. In all ideas discussed here, a substantial financial benefit is provided to the charity, so they 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. Leaving the retirement benefits directly to the client's intended beneficiaries is normally the best way to achieve that goal.

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). IRD does not get a "stepped-up basis" at the donor's death, and accordingly will generally constitute gross income to the beneficiary when received after the participant's death. § 1014(c); see ¶ 4.6 of *Life and Death Planning for Retirement Benefits*. For any individual beneficiary, the income tax reduces the value of the inherited benefits. A charity is income tax-exempt, so it does not lose any 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 a built-in income tax bill, even for a noncharitable beneficiary, because of two tax rules:

- **An inheritance is not income.** An inheritance, as such, is generally not "income." § 102(a). 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 as such. 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. § 1014(c). This should be called the "new-basis-at-death rule," but is commonly referred to as "stepped-up-basis," presumably based on the assumption that all assets appreciate, even though the rule could step an asset's basis either "down" or "up" depending on whether the asset depreciated or appreciated during the owner's life. Because of the stepped-up basis applicable to most inherited assets, the beneficiary (when he later sells the inherited asset) pays no income tax on any built-in 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. § 1041(c).

Neil Example: Neil's mother dies, leaving Neil her house (worth $500,000) and her IRA (also worth $500,000). Assume there is no estate tax. The house is transferred to Neil. Neil's 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. Because of § 1014(c), 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 stepped-up-basis 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 stepped up 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. Which is best tax-wise?

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 (being income tax-exempt) it will not have to pay any income tax on either asset.

For Neil, however, it makes a big difference which asset he receives. If he receives the IRA, he will have to pay federal income tax (plus state income tax, if applicable) on the $500,000 when he withdraws the money from the IRA. While his withdrawals could be deferrable over some period of time, and deferral may reduce the impact of the income taxes (see Chapter 1), 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 reduction 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. 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 (§ 401(a)(9) and related regulations; see Chapter 1 of *Life and Death Planning for Retirement Benefits*) will have forced out most of the plan's value during his lifetime, 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. See also ¶ 7.7.02.

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

If the client names one of his creditors 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 presumably generate taxable income *to the client's estate*. Although generally retirement benefits are taxed to the person who receives them (see ¶ 2.1.05 of *Life and Death Planning for Retirement Benefits*), the IRS would presumably say the estate "received" the IRD, because the estate's debt was canceled when the benefits passed to the creditor. See § 61(a)(12), § 691(a)(2), Reg. § 1.677(a)-1(d).

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 (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 (1995). However, a charitable pledge is *not* considered a debt for federal income tax purposes. Rev. Ruls. 55-410, 1955-1 CB 297, 64-240, 1964-2 CB 172. Therefore, leaving retirement benefits to a charity in fulfillment of the decedent's lifetime charitable pledge will not cause the estate to realize income when the charity collects the benefits, even if the pledge was enforceable as a debt against the participant's estate, and even if paying other kinds of debts directly from the IRA at death *would* generate taxable income to the estate.

7.2 Seven "Hows": Ways to Leave Benefits to Charity

Here are the seven ways retirement benefits can pass, upon the participant's death, to a charitable beneficiary.

7.2.01 ***Name charity as sole plan beneficiary***

The method of leaving retirement plan benefits to charity that *should* involve the fewest difficulties is simply to name the charity directly as the beneficiary of the death benefit payable under the particular retirement plan. Because the benefits are paid directly to the charity under the beneficiary designation form, income tax on the benefits is easily avoided. § 691(a) causes the benefits to be included directly in the income of the charitable recipient as named beneficiary, and the charity's income tax exemption (§ 501(a)) makes the distribution nontaxable. The estate tax charitable deduction (§ 2055(a)) is available for the full value of the charity's interest.

This format works equally well for gifts to multiple charitable beneficiaries: If all beneficiaries of the plan are charities, the problems discussed in ¶ 7.2.02–¶ 7.2.06 do not arise.

But no approach is problem-free. Based on anecdotal evidence, there can be problems with IRA providers and plan administrators when a charity named as beneficiary tries to collect its inheritance. Some IRA providers require a beneficiary to officially become a "customer" of the firm before they will accept instructions from such beneficiary. Becoming a customer involves opening an "inherited IRA" account, which in turn requires the charity to provide extensive documentation (such as articles of incorporation, corporate resolutions, etc.) and/or background information about its governing body before the charity can collect the benefits it is entitled to. A small charity may lack staff to carry out these demands; a large charity may face burdensome information-gathering about (for example) its far-flung board of trustees to collect even a small gift from an IRA.

To avoid this new-but-possibly-growing problem, the client could consider leaving the retirement plan to a donor advised fund (DAF; ¶ 7.5.03) she sets up for the purpose, and list her charitable beneficiaries with the DAF provider. The DAF firm should be experienced and capable in carrying out the paperwork demands of IRA providers and plan administrators, so the ultimate charitable beneficiaries are spared these problems. If the client does not already have a DAF, this approach might require a lifetime charitable gift if the DAF sponsor's has a minimum funding amount requirement to establish the DAF, but some DAF sponsors accept "distribute-at-death-only" DAF accounts without current funding. An important consideration: The DAF sponsor is not required to follow the donor's directions regarding which charity(ies) to distribute to; the client who funds the DAF is merely an "advisor" regarding the choice of recipients. However, normally the DAF sponsor will follow the donor's advice. The donor can amend her schedule of at-death DAF beneficiaries from time to time, a process that may be easier than (1) changing the list of beneficiaries on an IRA beneficiary designation form or (2) amending a list of beneficiaries in the donor's will or trust.

7.2.02 ***Leave benefits to charity, others, in fractional shares***

From the mid-1980s through 2019, estate planning for retirement benefits centered around the "life expectancy payout" whereby an individual could take distributions from an inherited retirement plan over his or her life expectancy, thus enjoying a potentially long deferral of income taxation of those benefits. A trust named as beneficiary could also use this life expectancy or "stretch" payout of inherited retirement benefits (based on the life expectancy of the oldest trust beneficiary) provided the trust complied with strict and somewhat abstruse rules promulgated by the Treasury in 2002 (the "see-through trust" rules). Under the SECURE Act, enacted in late 2019 effective for deaths after 2019, the life expectancy payout has been eliminated for most beneficiaries. Most "designated beneficiaries" from now are entitled to no more than a 10-year payout period rather than a life expectancy payout. Only a few categories (called "eligible designated beneficiaries") are still entitled to a variation of the life expectancy payout. References in this outline to "designated beneficiary treatment" refer to the 10-year payout or (in the case of an "eligible designated beneficiary") the post-SECURE modified version of the life expectancy payout.

A charity can be named as one of several beneficiaries receiving fractional shares of the retirement plan, with other fractional shares passing to noncharitable beneficiaries, as in "I name as beneficiary of my IRA My Favorite Charity and my son Junior in equal shares."

A. The problem: The IRS's multi-beneficiary rule. This approach risks losing the option of designated beneficiary treatment for the noncharitable beneficiary(ies). Under the "minimum distribution rules" a Designated Beneficiary can withdraw inherited retirement benefits in annual instalments over 10 years (or over his life expectancy, in the case of an "eligible designated beneficiary") thus achieving income tax deferral which in some cases can be significant. However, this favorable designated beneficiary treatment for determining Required Minimum Distributions (RMDs) is available only to *individual beneficiaries* (and qualifying "see-through trusts"); a charity, as a nonindividual, cannot be a Designated Beneficiary.

If there are multiple beneficiaries, the regulations' general rule is that all of them must be individuals or none of them is entitled to designated beneficiary treatment. Reg. § 1.401(a)(9)-4, A-3. Thus, if Junior and the charity are both named as beneficiary, the IRS's "opening bid" is that there is "no designated beneficiary" (and therefore no 10-year payout or life expectancy payout). There are two exceptions to this harsh rule. Because of these exceptions, it is still feasible to name both charities and humans as beneficiaries of the same account without sacrificing tax benefits (though it may still not be advisable to do so; see "D").

B. **First exception: separate accounts.** If there are multiple beneficiaries, but the respective beneficiaries' interests in the retirement plan constitute "separate accounts," each separate account is treated as a separate retirement plan for purposes of the minimum distribution rules. Thus, each individual beneficiary can use the most favorable payout option available to him as the Applicable Distribution Period ("ADP") for his "separate account." He is considered the sole beneficiary of that separate account. Reg. § 1.401(a)(9)-8, A-2(a)(2).

The drawback of relying on this exception is that the beneficiaries may not meet the deadline for establishing separate accounts, which is December 31 of the year after the year of the participant's death. If they miss the deadline, the beneficiaries will be limited to taking benefits under whichever "no-Designated Beneficiary" (no-DB) rule applies: The benefits will have to be distributed by the end of the year that contains the fifth anniversary of the participant's death, if he died before his Required Beginning Date (RBD). or (if he died after his RBD) over what would have been the participant's remaining life expectancy had he lived.

C. **Second exception: distribution by Sept. 30.** The other exception is that a beneficiary is "disregarded" (doesn't count as a beneficiary for purposes of determining the ADP) if such beneficiary ceases to have any interest in the benefits by September 30 of the year after the year of the participant's death (called the "Beneficiary Finalization Date" or BFD). Reg. § 1.401(a)(9)-4, A-4(a). Thus, the charity's share can be paid out after the participant's death at any time up to the BFD, and the remaining beneficiaries (assuming they are all individuals) will be entitled to designated beneficiary treatment. As of the magic date there is no nonindividual beneficiary on the account, so the plan complies with the "all-beneficiaries-must-be-individuals" rule.

Frank Example: Frank dies in Year 1. The beneficiary designation for his $1 million IRA provides that "10 percent of the account shall be paid to Charity X and the balance shall be paid to my son." Charity X takes full distribution of its share of the account shortly after Frank's death. As of the BFD (September 30, Year 2), the son is the sole remaining beneficiary of the IRA, because the charity's interest has been terminated by distribution. As an individual, the son is a Designated Beneficiary, and RMDs to him will be determined based on the whatever designated beneficiary treatment he is entitled to.

Other notes about this approach: A qualified disclaimer by the charity would have the same effect (though it would be rare for a charity to disclaim). Also, there is no executor or other fiduciary in charge of the IRA—the individual beneficiary, charity, and IRA provider must manage together to get the bequest distributed by the applicable deadline.

The drawback of relying on the distribute-by-the-BFD exception is that time passes quickly and people miss deadlines. If the charity's interest is not entirely distributed (or disclaimed) by the deadline, the charity still "counts" as a beneficiary and the individual beneficiary(ies) would lose out on the 10-year or life-expectancy-of-the-beneficiary payout method.

D. **When to rely (or not rely) on the exceptions.** As explained at "B" and "C," it is possible to name both individuals and charities as co-beneficiaries of one IRA, without necessarily losing the option for the individual beneficiaries to use the life-expectancy-of-the-beneficiary payout method, because of the two exceptions to the multiple-beneficiaries rule. The next question is whether it is advisable to rely on these exceptions, or to avoid the whole problem by not using this approach.

Relying on the exceptions makes sense in some cases but not others. If designated-beneficiary treatment would be advantageous for the individual beneficiary(ies), it may not be wise to rely on the exceptions. Instead, consider establishing separate IRAs during the participant's life, one payable to the charitable beneficiary(ies) and one payable to the individual beneficiary(ies), though this approach has other drawbacks—particularly the difficulty of keeping the values of the separate accounts in the same constant proportions, making distributions always pro rata, etc.

E. **If the spouse is the only noncharitable beneficiary.** The concern about multiple beneficiaries does not arise if the only beneficiaries are the participant's spouse and one or more charities, if *the spouse in fact survives the participant*, because the spouse does not need to take an installment payout of the benefits over her life expectancy in order to defer income taxes; she can simply roll over her share of the benefits to her own retirement plan. See ¶ 3.2 of *Life and Death Planning for Retirement Benefits*.

However, even when the spouse is named as the sole noncharitable primary beneficiary, consider the possibility of the spouse's disclaimer, simultaneous death, or predeceasing the participant *if* the contingent beneficiary in that case would be another individual, because in that case you are right back in the situation of having both individual and nonindividual beneficiaries.

7.2.03 ***Leave pecuniary gift to charity, residue to individuals***

Another way to leave part of the benefits to charity is to name the charity as beneficiary of a pecuniary (fixed-dollar amount) portion of the account, with the balance (residue) going to individual beneficiaries.

Some (most?) IRA providers will not accept pecuniary gifts in a beneficiary designation form. Assuming the IRA provider will accept it, the pecuniary gift presents some of the same problems as leaving benefits to charitable and individual beneficiaries in fractional shares (¶ 7.2.02), and some additional problems:

Nora Example: Nora's beneficiary designation for her $1 million IRA reads as follows: "Pay $100,000 to the Topeka Maritime Museum and pay the balance to my daughter Diana."

A. **Pecuniary gift may not qualify as a "separate account."** Under one approach to funding a pecuniary gift, the IRA provider would create two shares as of the date of Nora's death, one with $100,000 and the other containing the rest of the account's assets. Then both shares would share pro rata in gains and losses occurring after the date of death. This treatment could be required by the beneficiary designation form, or (if the beneficiary designation form does not address this question) this treatment might be required as part of the IRA provider's standard procedures.

On the other hand, the beneficiary designation form, or the IRA provider's documents, might indicate that the charity is to receive a flat $100,000, regardless of what appreciation or depreciation occurs in the IRA after the date of death. The planner needs to determine what the client's wishes are and spell out the desired result in the beneficiary designation form.

The interpretation of the pecuniary gift will affect not only how much each beneficiary receives, but also what options will be available for preserving designated beneficiary treatment for Diana. If the beneficiary designation creates two separate accounts as of the date of death, with the Museum's portion sharing pro rata in gains and losses that occur after Nora's death, then the same options will be available as discussed under ¶ 7.2.02(B) and (C) above (establish separate accounts by 12/31 of the year after the year of Nora's death, or pay out the charity's share in full by 9/30 of the year after the year of Nora's death).

If the Museum is to receive a flat $100,000, regardless of post-death fluctuations in the account value, then the option of establishing separate accounts will not be available, because the gift "flunks" the requirement of pro rata sharing gains and losses. However, the option of paying out the charity's entire share by 9/30 of the year after the year of Nora's death is available either way. If the Museum receives its full share of the account by that date, the Museum does not count as a beneficiary of the account for RMD purposes, and Diana can use designated beneficiary treatment for her share of the IRA.

B. Consider separate IRAs for large pecuniary bequests. Alternatively, Nora could divide her IRA into two separate IRAs while she is still living, one containing something more than $100,000 (perhaps $200,000?) of which the beneficiary is "$100,000 to the Topeka Maritime Museum, residue to Diana," and the other containing the balance of the IRA ($800,000?) payable solely to Diana. That way, she can have her pecuniary bequest to the charity just as she wants it in the smaller IRA. Meanwhile, the bulk of the assets are in a separate IRA payable solely to the individual beneficiary, and *this* IRA is not subject to any risk of losing designated beneficiary treatment due to failure to meet the post-death deadlines.

C. Put small pecuniary bequest in will? If the pecuniary bequest to charity is modest, consider putting the charitable bequest in the client's will. Though it is more tax-advantageous to fund the charitable bequest by designating the charity as a beneficiary of the retirement plan, the advantage (if the bequest is very small) may not be worth incurring the risk of jeopardizing designated beneficiary treatment for the individual beneficiaries.

D. Make charity's gift conditional on payment by 9/30? The pecuniary charitable gift could be placed in the beneficiary designation form, but made conditional on the charity's taking its entire share of the IRA prior to the Beneficiary Finalization Date. If the charity misses the deadline, the entire account passes to individual beneficiaries, thus preserving designated beneficiary treatment. It may be difficult to find an IRA provider that would allow this. Also, a conditional IRA gift to charity may not entitle the estate to an estate tax charitable deduction. To cover the gap, repeat the bequest in the client's will or trust, bequeathing the charity the desired pecuniary amount "reduced by any amounts paid to the said Charity from my IRA." Thus, the estate tax deduction is assured, because the charity is guaranteed to receive its bequest either from the IRA or from the estate (or trust). This is a rather complicated approach, but tax minimization is rarely simple.

7.2.04 ***Formula bequest in beneficiary designation***

Often, the amount a client wants to leave to charity is neither a fixed dollar amount nor a fractional share of the retirement plan, but rather is derived from a formula based on the size of the client's estate and/or adjustments for other amounts passing to the charity.

The first problem with a formula beneficiary designation is that the IRA provider may not accept it. The IRA provider normally does not have the information needed to apply the formula. For example, the IRA provider has no way to determine what assets are in the participant's estate; all it knows is what is in the IRA. Also, the IRA provider typically charges a nominal fee for providing custodial duties, and its services do not include calculating elaborate formula amounts.

Both these problems can be overcome, with some IRA providers, by specifying that the participant's executor or some other fiduciary will provide the formula amount to the IRA provider, and that the IRA provider has no duty to verify that the fiduciary's figures are correct. For example, one IRA provider requires any IRA holder who files a "customized beneficiary designation" to supply, along with the beneficiary designation, an authorization that allows the IRA provider to rely on representations by the participant's executor.

If using this approach, make sure that the related trust document or will specifies that this task is part of the duties the fiduciary undertakes by agreeing to be executor or trustee.

7.2.05 ***Leave benefits to charity through a trust***

In many cases it is not feasible to name the intended charitable recipient directly as beneficiary of the retirement benefits. The most common reason for this is that some additional actions must be taken, after the client's death, to carry out the charitable gift. For example:

- The intended charitable recipient may be a charitable foundation that has not been created yet; or

- The amount going to the charity may be based on a formula that depends on facts that cannot be determined until after the client's death; or

- The client may want the charities to be selected after his death, with a designation such as "The benefits shall be distributed to such one or more art museums located in Indiana as my executor shall select from among those that are exempt from federal income taxes under § 501, and gifts to which qualify for the federal estate tax charitable deduction under § 2055."

In all of these cases, the plan administrator may not be willing to accept a beneficiary designation under which the administrator would not be able to tell, at the participant's death, who is entitled to the benefits.

If the only problem is that the actual charitable recipients are to be selected after the participant's death, consider leaving the retirement benefits to a "donor-advised fund" (¶ 7.5.03). The participant should set up the fund prior to death, name it as beneficiary, designate who will be responsible for allocating the fund's assets to charities after his death, and provide the allocators with the guidelines they are to follow. Because the donor-advised fund is itself tax-exempt, the problems discussed in the rest of this section do not arise—and the plan administrator is happy because it knows to whom it must make the check payable.

In some situations, however, the benefits may have to be made payable to the participant's estate (or trust) as beneficiary of the retirement plan, with the Will (or trust instrument) specifying that the benefits are to be paid to the not-yet-created (or not-yet-selected) charitable beneficiaries. The executor or trustee is then responsible for carrying out the post-death actions (such as forming the charitable foundation, calculating the formula distributions, or selecting the charities), and the plan administrator can then simply follow the fiduciary's instructions in distributing or transferring the benefits.

Unfortunately, this approach involves additional complexity with respect to required minimum distributions (see ¶ 7.3) and fiduciary income taxes (see ¶ 7.4).

7.2.06 ***Leave benefits to charity through an estate***

When it is not feasible to name a charity directly as beneficiary, there is an advantage to leaving the benefits to the charity through the participant's estate, rather than through a trust. An estate is entitled to an income tax deduction for amounts either paid to or "set aside" for charity, whereas generally a trust is entitled to an income tax deduction only for amounts "paid" to charity. See ¶ 7.4.04(B), (C). Thus, an estate may have a slight edge; but otherwise the income tax complications of passing retirement benefits through an estate on their way to the charity are the same as for a trust, and require expert knowledge, both at the drafting and administration stages. See ¶ 7.4.

7.2.07 ***Disclaimer-activated gift***

This approach may appeal to a client who would like to encourage his individual beneficiary to be philanthropic. The participant names an individual (such as a son or daughter) as primary beneficiary of the plan, and names a charity as contingent beneficiary, specifying that the charity is to receive any benefits disclaimed by the primary beneficiary. See PLR 2001-49015 for an example of this type of planning (though this ruling did not involve retirement benefits). For detail on disclaimers of retirement benefits, see ¶ 4.4 of *Life and Death Planning for Retirement Benefits* .

The participant might express a wish (preferably in a separate letter, to avoid the necessity of getting the plan administrator to deal with a nonstandard beneficiary designation form) that the child disclaim all or part of the benefits.

Why not just leave the benefits to the child, along with a letter expressing the parent's wish that the child give the funds to charity? The disclaimer route is preferable because of the income tax consequences. If the child is the beneficiary of the account and does not disclaim it, the child cannot later assign the benefits to a charity without first paying income tax on them. The child may not be able to eliminate the income tax on the distribution through the charitable deduction; see ¶ 7.7.01. In contrast, if the charity receives the benefits as the result of the child's qualified disclaimer, the income associated with the benefits is shifted to the tax-exempt charity. GCM 39858.

The contingent beneficiary that will receive the benefits upon the primary beneficiary's disclaimer can be any type of charity that is suitable to receive retirement benefits (¶ 7.5.01–¶ 7.5.08), except:

1. A private foundation (¶ 7.5.02) of which the disclaimant is a trustee or manager having power to choose recipients of the foundation's funds, unless the foundation is legally required to hold the disclaimed assets in a separate fund over which the disclaimant does not have such powers. This is because of the requirement that disclaimed assets must pass "without any direction on the part of" the disclaimant. § 2518(b)(4). In PLR 2005-18012, the IRS ruled that proposed disclaimers in favor of a donor-advised fund (DAF; ¶ 7.5.03) did not violate this requirement since each proposed disclaimant was merely an "advisor" to the DAF that would receive the disclaimed property.

2. A charitable remainder trust (CRT; ¶ 7.5.04) or gift annuity (¶ 7.5.08) of which the disclaimant is an income beneficiary (unless the disclaimant is the participant's surviving spouse), because of the requirement that disclaimed property must pass, as a result of the disclaimer, either to the participant's surviving spouse or to someone other than the disclaimant. § 2518(b)(4). See *Christiansen*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009), in which a disclaimer was held not to be qualified under § 2518 for this reason (the disclaimed asset passed to a charitable lead trust (¶ 7.5.09) of which the disclaimant was the remainder beneficiary).

Even if you don't care about the *gift tax* effects, a nonqualified disclaimer is not within the safe harbor of GCM 39858 for *income tax* purposes. If the disclaimer is treated as an assignment of the right to receive income in respect of a decedent, the disclaimant would be liable for income taxes on the full value of the IRA. § 691(a)(2).

7.3 RMDs and Charitable Gifts Under Trusts

This ¶ 7.3 explains how the minimum distribution rules work with respect to a trust that is named as beneficiary of a retirement plan, when one or more charities are beneficiaries of the trust. For explanation of the minimum distribution rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits*; for how the minimum distribution rules apply to trusts, see ¶ 6.2–¶ 6.3.

7.3.01 ***Trust with charitable and human beneficiaries***

Suppose a client wants to name a trust as beneficiary of his retirement plan. His children are intended to be the primary beneficiaries of the trust, but the trust also has one or more charitable beneficiaries. He wants the plan benefits that pass to this trust to be paid out over 10 years. To achieve the desired result, the Treasury's "RMD trust rules" must be complied with so the trust qualifies as a "see-through trust" for minimum distribution purposes. One of these rules is that all trust beneficiaries must be individuals. § 401(a)(9)(E); Reg. § 1.401(a)(9)-4, A-1, A-3, A-5. This rule creates two problems in common estate planning situations involving charities:

- First, *any* charitable gift to be paid from the trust at the participant's death, no matter how small, would cause the trust to flunk this requirement. The only *possible* exception to this rule would be if the trustee is forbidden to use the retirement benefits to fund the charitable bequest. Even the normally innocuous statement "this trust shall pay any bequests under my will, if my estate is not adequate to pay the same," could make the trust "flunk" if the will contains charitable bequests. However, the problem of such payable-at-death charitable gifts can be cured by distributing the charitable bequests prior to the Beneficiary Finalization Date. See ¶ 7.3.02.

- The second problem is that, generally, remainder beneficiaries of the trust are considered "beneficiaries" for this purpose. Thus, if a trust is the beneficiary of the retirement plan, and any part of the remainder interest in the trust passes to charity (or could be appointed to charity under a power of appointment), the trust will flunk (unless the charitable remainder beneficiary can be disregarded under the IRS's RMD trust rules; see ¶ 6.3 of *Life and Death Planning for Retirement Benefits*). This is not a problem with a CRT (¶ 7.5.04), because such trusts are income tax-exempt. The problem is with a trust that is primarily for individual beneficiaries but which definitely or even possibly has charitable gifts that will be made after the individuals' deaths; see ¶ 7.3.03.

Thus, when drafting a trust that is to make charitable gifts, or that may be used to fund charitable bequests under the client's will, it is important to determine whether any retirement benefits may be payable to that trust, and, if so, to either:

A. In the beneficiary designation form and in the trust, make the benefits payable directly to the trust shares that benefit only individuals, if qualifying for designated beneficiary treatment is an important goal; or

B. Match the retirement benefits to the charitable gifts, if the goal is to have the benefits pass to the charity free of income taxes (see ¶ 7.4). Under this approach you are giving up on using designated beneficiary treatment for the benefits.

If the trust has both charitable and noncharitable beneficiaries, but the instrument does not take one of the above two approaches, the trustee may have to accept undesirable tax results (such as no designated beneficiary treatment) unless the trustee can use one of the corrective measures described below in ¶ 7.3.02 or in ¶ 7.3.04.

7.3.02 ***If charitable gift occurs at the participant's death***

This section describes a post-death corrective measure that may be available for a trust that has charitable gifts occurring upon the participant's death, and where the trustee wants to preserve designated beneficiary treatment for the human beneficiary(ies).

Russ Example: Russ leaves his $3 million IRA to a trust. The trust provides that, upon Russ's death, the trustee is to pay $10,000 to Russ's favorite charity, and hold the rest of the funds in trust for the life of Russ's wife with remainder to Russ's issue upon the wife's death.

The IRS's "opening bid" is that this trust does not qualify as a see-through trust because it has a noncharitable beneficiary as of the date of Russ's death. If that is the trust's only defect under the RMD trust rules, it can be fixed: The trustee can "eliminate" the charitable beneficiary by paying to the charity its $10,000 bequest before the Beneficiary Finalization Date (BFD); see ¶ 7.2.02(C).

If the charity is paid in full prior to the BFD, it is no longer counted as a "beneficiary" of the trust or the IRA as of that date, so the trust has only individual beneficiaries and qualifies as a see-through trust. See PLR 2006-08032, in which shares of the decedent's IRA were transferred (from the trust named as beneficiary) to the trust's charitable beneficiaries, prior to the BFD, in fulfillment of their pre-residuary bequests. The IRS ruled the charities were accordingly to be "disregarded" and (since only individual beneficiaries remained) the trust was thereby enabled to qualify as a see-through trust.

If the trust does not contain a prohibition against paying retirement benefits to charity, and the trustee has authority to pay any asset to any beneficiary, the trustee could choose whether to use the IRA proceeds or other assets to pay the $10,000 bequest. It would make no difference, under the minimum distribution rules, which assets were used, as long as the charity has no further interest in the benefits after the BFD.

7.3.03 ***If charitable gift occurs later: Drafting solutions***

If the charitable gift(s) will not occur until after the death(s) of one or more individual beneficiary(ies), the problem of "fixing" the trust so that the retirement benefits can be paid out using designated beneficiary treatment becomes much more complex.

This section describes an estate planning problem, and its less-than-perfect solutions, where a client is trying to benefit both individuals and charities through her trust which is to be named as beneficiary of her retirement benefits. (A)–(D) provide alternative planning solutions; ¶ 7.3.04 lists post-mortem "cleanup" ideas.

Heather Example: Heather's trust provides that, upon Heather's death, the trust is divided into equal shares for her four children. Each child receives income for life from his or her share, plus principal in the trustee's discretion for the child's health, education and support. At death, each child can appoint the principal of such child's share among Heather's issue and any charity. If the child fails to exercise this power, such child's share is paid to such child's issue if any, otherwise to the other children. The assets coming to this trust at Heather's death are Heather's $1 million IRA and $1 million of other assets. The existence of potential charitable remainder beneficiaries (as appointees under the children's powers of appointment) could mean this trust would flunk the RMD trust rules. (Note: It is not certain that this power causes the trust to "flunk": Some argue that potential appointees under a power of appointment should not be counted as "beneficiaries" unless and until the power is exercised and something is actually appointed to them, citing regulations issued in connection with Qualifying Subchapter S Trusts.)

Could this trust have been written in a better way, to avoid this problem?

Some trust-writers think they eliminate this type of problem by including in the trust a blanket prohibition against paying retirement benefits to nonindividual beneficiaries. However, adding such a blanket prohibition is *not* the best way to solve the problem in Heather's trust. Because the potential charitable gifts do not occur until each child dies, the trustee, in order to carry out a blanket prohibition against using retirement benefits to fund any charitable gift, would have to segregate the IRA (and all distributions from it) from the other assets of the trust immediately upon Heather's death and keep them segregated for the duration of the trust. So instead of administering four trusts (one for each child) the trustee would end up administering eight trusts (one trust for each child's share of the IRA and IRA distributions, which could not be appointed to charity on the child's death, plus a separate trust for each child's share of the non-IRA assets, which *could* be appointed to charity on the child's death). That is the only way the trustee will be able to tell, when the child dies many years from now, which assets can be appointed to charity and which assets cannot be. If the trust instrument or local law does not clearly give the trustee authority to establish two separate trusts for each beneficiary, the trustee might have to go to court to get such authority.

Suppose the trustee sets up the eight separate trust shares. Now Child A needs a discretionary distribution of principal. Does it come out of the retirement assets trust for Child A? or the nonretirement assets trust for Child A? Again, this is a question that must be covered in the trust instrument (or, if it is not, the trustee might have to go to court for authority to pay out of one share or the other).

If there may be charitable remainder interests in a trust that is being created primarily for individual beneficiaries, and the trust may receive retirement benefits at the trust-creator's death, here are preferable options to consider *instead of* a catchall clause prohibiting payment of retirement benefits to nonindividuals:

A. Jettison the less important goal. Determine which is a more important goal to the client, the charitable remainders or designated beneficiary treatment for the retirement benefits, then give up whichever one is less important. If the charitable gifts are high priority, consider giving up designated beneficiary treatment. In the Heather Example, if the total value of Heather's retirement plan had been $100,000 out of her total estate of $2 million, she might decide designated beneficiary treatment was not of significant value, and therefore not bother taking steps to try to preserve it.

B. **Create separate trusts.** Consider creating separate trusts to receive the retirement benefits and the nonretirement assets. If Heather places high priority on *both* the deferred payout of her $1 million IRA over 10 years, *and* on allowing the children to appoint their shares of the other $1 million of assets to charity, she could direct the trustee to establish two separate trusts for each child, one for the child's share of the IRA and one for the child's share of the other assets. The power to appoint to charity would apply only to the trusts that held no retirement benefits. The drawback of this approach is the administrative inconvenience and cost of extra trust bookkeeping.

C. **Use a Charitable Remainder Trust.** Consider leaving the benefits to an income tax-exempt Charitable Remainder Trust (CRT; ¶ 7.5.04–¶ 7.5.07) rather than to the client's regular taxable family trust.

D. **Use a Conduit Trust.** Under a Conduit Trust, each time the trust receives a distribution from the retirement plan, the trustee must immediately pass that distribution out to the life beneficiary. For RMD purposes, the remainder beneficiary of a Conduit Trust does not "count" as a beneficiary; thus, having a charity as remainder beneficiary of a Conduit Trust does not violate the "all trust beneficiaries must be individuals" rule. See ¶ 6.3.05 of *Life and Death Planning for Retirement Benefits*. Thus the remainder of a Conduit Trust can pass to charity without causing loss of the trust's "see-through" status. However, this may not benefit the charity much, since there will be nothing left for the charity if the individual lives more than 10 years (since, post-SECURE, most benefits payable to individuals must be paid out within 10 years after the participant's death) or if the individual lives to his IRS-defined life expectancy (if the individual is an "eligible designated beneficiary" so the trust is entitled to a life expectancy payout).

7.3.04 ***If charitable gift occurs later: "Cleanup" solutions***

If the participant has already died, leaving her retirement benefits to a trust like "Heather's" trust (¶ 7.3.03), where there are or may be charitable gifts occurring after the deaths of the primary (individual) beneficiaries, and the survivors would like to be sure the trust qualifies as a see-through trust (so they can have a life-expectancy payout), the children could disclaim their powers of appointment.

7.4 Income Tax Treatment of Charitable Gifts of Retirement Benefits From a Trust or Estate

Chapter 2 of *Life and Death Planning for Retirement Benefits* explained the income tax treatment of retirement benefits generally. Chapter 6 explained the additional rules applicable when retirement benefits are paid to a trust or estate with individual beneficiaries (¶ 6.5, "DNI Meets IRD"). This ¶ 7.4 will look at the further complications arising when the retirement benefits are payable to a trust or estate that has *charitable* beneficiaries.

¶ 7.4.01–¶ 7.4.03 assume that the fiduciary receives a distribution from the retirement plan and, in the same year, funds a gift to a "public" charity (¶ 7.5.01) or private foundation (¶ 7.5.02). If the charitable gift is not funded in the same year the distribution is received from the retirement plan, see ¶ 7.4.04. If, instead of taking a distribution from the plan and passing the distribution out to the charity, the fiduciary transfers the retirement plan itself to the charity, see ¶ 7.4.05.

For ease of reading, this ¶ 7.4 will sometimes refer only to trusts; the same rules apply to estates unless otherwise specified.

7.4.01 ***Trust income tax rules, "DNI," and the NIIT***

A trust or estate can deduct, from its gross income, certain distributions made to the trust's or estate's noncharitable beneficiaries to arrive at its taxable income. § 651(a), § 661(a). The beneficiaries then pay the income tax on these distributions. § 652(a), § 662(a). The amount the trust or estate can deduct is limited to the amount of its "distributable net income" or "DNI." § 651(b), § 661(a). Because of this limitation, the deduction is often called the "DNI deduction." See ¶ 6.5.01 of *Life and Death Planning for Retirement Benefits* for full explanation. Here are the DNI rules that particularly affect retirement benefits payable to a trust with one or more charitable beneficiaries:

- There is no DNI deduction allowed for a distribution from an estate or trust *to a charity*, although a distribution to a *charitable remainder trust* may be eligible for the DNI deduction. See ¶ 7.4.02.

- A distribution to a charity from an estate or trust is deductible, if at all, only if it meets the stringent requirements for a charitable deduction. See ¶ 7.4.03.

- Under the "separate share" rule of § 663(c), the gross income that results when a trust receives a distribution from a retirement plan might have to be allocated among all of the trust's residuary beneficiaries, even if the trust instrument gives the trustee the power to pick and choose which beneficiary receives which asset. See ¶ 6.5.05.

A trust must also contend with the 3.8 percent additional income tax on the trust's undistributed net investment income (NII), sometimes called the net investment income tax (NIIT). § 1411; see ¶ 2.1.02, ¶ 6.5.09, and ¶ 7.4.02.

7.4.02 ***DNI deduction, retirement benefits, and charity***

A retirement plan distribution received by a trust becomes part of the trust's "distributable net income" (DNI) to the extent the distribution is includible in the trust's gross income. See Reg. § 1.663(c)-5, Examples 6, 9, 10. If the trust has more than one beneficiary, the extent, if any, to which the trustee can allocate this DNI to the beneficiary(ies) of the trustee's choice may be determined under the separate share regulations; see ¶ 6.5.05–¶ 6.5.06.

There is no DNI deduction allowed for a distribution from an estate or trust *to a charity*. § 651(a)(2), § 663(a)(2). Although the Code could be interpreted to mean that a trust can take a DNI deduction for distributions to charity that do not qualify for the charitable deduction, the IRS has not interpreted it that way. See Rev. Rul. 68-667, 1968-2 CB 289. The courts have supported the IRS; see Boyle, F.L., and Blattmachr, J.G., *Blattmachr on Income Taxation of Estates and Trusts*, 16th Ed. (2017), Practicing Law Institute, New York, NY 10036, www.pli.edu, § 3:2.1[J][7]; and Ferguson, M. Carr, and Ascher, Mark L., *Federal Income Taxation of Estates, Trusts, & Beneficiaries*, CCH/Wolters Kluwer (4TH Ed. 2017), § 6.10, in which the authors argue that the IRS regulation may be invalid; and Zaritsky, Lane, and Danforth, *Federal Income Taxation of Estates and Trusts*, ("Checkpoint" On-line Edition; Warren, Gorham & Lamont), ¶ 2.04[6]. Accordingly, if the distribution to charity does not qualify for the charitable deduction under § 642(c) it will not be deductible at all.

A distribution to a *charitable remainder trust* (¶ 7.5.04) is eligible for the DNI deduction, to the extent it meets the other requirements of that deduction. Reg. § 1.664-1(a)(5)(iii).

The 3.8 percent additional tax on the trust's undistributed net investment income ("NII"; § 1411; ¶ 2.1.02, ¶ 6.5.09) adds a further complication. Unlike individuals, trusts and estates can reduce their taxable NII by the amount of any NII distributed to charity—provided the distribution qualifies for the fiduciary charitable deduction under § 642(c) (¶ 7.4.03). Reg. § 1.1411-3(e). If the trust or estate has both NII and excluded income (such as an IRA distribution; retirement benefits are not "investment income") in its gross income, and distributes some but not all of its income to charity, how do you know whether the charity received the NII or the excluded income? The deduction must be allocated between the two classes "as if" NII were gross income and excluded income constituted amounts not includible in gross income; see ¶ 7.4.03(E). Reg. § 1.1411-3(e)(4).

7.4.03 ***Charitable deduction under § 642(c)***

Since a distribution to a charity is not eligible for the DNI deduction (¶ 7.4.02), a distribution to a charity from an estate or trust is deductible, if at all, *only* if it qualifies as a charitable deduction under § 642(c). As the following discussions will reveal, it is quite possible to have a distribution to charity that qualifies for *neither* deduction.

§ 642(c) allows an estate or trust "a deduction in computing its taxable income…[for] any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a" charitable purpose (as defined in § 170(c)).

A distribution from an estate or trust to a Charitable Remainder Trust is *not* eligible for the income tax charitable deduction; it is deductible, if at all, only as DNI (¶ 7.4.02). Reg. § 1.642(c)-2(d); § 1.664-1(a)(5)(iii).

A. Introduction to § 642(c): the fiduciary charitable deduction. Like an individual taxpayer, a trust is entitled to an income tax deduction for certain payments to charity. There are differences between the *individual* income tax charitable deduction under § 170 and the *fiduciary* income tax deduction under § 642(c): For example, the fiduciary charitable deduction is unlimited in amount. Also, none of the requirements discussed in sections B–F below that apply to the fiduciary income tax charitable deduction apply to the individual version. For discussion of all the differences between the individual and the fiduciary income tax charitable deductions, see *Ferguson/Ascher*, op. cit., § 6.01, or *Zaritsky*, op. cit., ¶ 2.04[1].)

Suppose a trustee receives a $10,000 distribution from an IRA that is payable to the trust, and then distributes $10,000 from the trust to a charity. To determine whether the trust can take a charitable deduction for the $10,000 payment to the charity, the trustee must answer the following five questions:

First, the trustee must determine whether the "separate share" rule (see "Appendix A") applies, and if so what its effect is. If it does apply, the trustee may not be able to allocate all the gross income resulting from the retirement plan distribution to the charity's share—even if he paid the entire plan distribution to that charity. See § 663(c).

Second, there is the matter of timing. In what taxable year was the plan distribution received by the trust, and in what taxable year did the trust make a distribution out to the charity? There is some flexibility regarding the year in which the deduction can be taken relative to these two events; see ¶ 7.4.04.

Third, was the payment to the charity made "pursuant to the terms of the governing instrument?" See "B" below. If it was not, there is no deduction. If the answer is yes, then:

Fourth, was the payment paid out of "income?" See "C" and "D." If not, there is no deduction. If the answer is yes, then:

Finally, out of what *class* of income was the payment made? The deduction will be allowable to the extent the payment was made out of gross income that is neither tax-exempt income (*e.g.*, municipal bond interest) nor unrelated business taxable income (UBTI). See "E."

As this list of requirements shows, taking a charitable deduction for a retirement plan distribution that is paid to a charity through a trust or estate is not a simple matter. A trustee can *sometimes* avoid having to meet all these technical requirements by transferring the retirement plan account itself to the charity (though that step itself is not necessarily a simple matter), rather than taking a distribution from the plan and then paying funds to the charity; see ¶ 7.4.05.

B. "Pursuant to the governing instrument." A trust is entitled to an income tax deduction for amounts that are paid to charity out of its gross income "pursuant to the terms of the governing instrument." § 642(c)(1).

A treatise could be written about the meaning of the phrase "pursuant to the terms of the governing instrument," starting with the question of which document is "the governing instrument." For example, if a trust instrument grants a beneficiary a testamentary power of appointment, and the beneficiary appoints the property to charity, the beneficiary's will exercising the power is not "the governing instrument," according to *Brownstone v. U.S.*, 465 F. 3rd 525 (2d Cir. 2006), disallowing the charitable deduction in these circumstances. The court ruled that the *trust* was the governing instrument, and since the charitable gift was made under the trust-beneficiary's *will* the gift was not "pursuant to the governing instrument."

In CCA 2008-48020, a trust (of which the only asset was an IRA payable to the trust as beneficiary) provided for ongoing distributions to individuals and charities. The trust was reformed by court order, after the participant's death, to provide for (among other changes) immediate distributions to the charities, so that the ongoing trust would be solely for the benefit of individuals and qualify as a see-through trust. The IRS Chief Counsel advised that the immediate payments made to the charities under the reformed trust were not made "pursuant to the governing instrument," because the trust reformation was done to achieve a tax goal (acquire see-through trust status) rather than to compromise a dispute, and accordingly were not income tax-deductible. Compare PLR 2006-52028 (discussed at ¶ 7.4.05) and PLR 2003-36020.

For our purposes, suffice it to say that "pursuant to the terms of the governing instrument" means that the trustee is explicitly authorized or required by the trust instrument to make the payment to the charity. *If there is more than one instrument involved, or if there is any other ambiguity regarding whether this requirement is met, please refer to the treatises cited in ¶ 7.4.01, not this Outline*.

C. Out of gross income, Part I: Tracing. The Code requires that the payment to charity must come from the trust's *gross income* in order to be deductible. This requires tracing the origin of the item that is distributed to the charity. Rev. Rul. 2003-123, 2003-2 CB 1200. This is in contrast to the "DNI" system for deducting distributions to noncharitable beneficiaries (¶ 7.4.01), which was explicitly designed to eliminate the need for tracing, according to *Ferguson/Ascher*, op. cit., § 6.09, Note 2.

Distributions from an inherited IRA or other inherited retirement plan are generally includible in the gross income of the recipient as "income in respect of a decedent" (IRD; § 691). IRD that is includible in the gross income of a trust is "gross income" for purposes of the charitable deduction. Reg. § 1.642(c)-3(a). This regulation clarifies that even if this asset is "principal" for trust accounting purposes it is "gross income" for income tax purposes, including for purposes of the fiduciary income tax charitable deduction under § 642(c).

Retirement plan death benefits (up to the amount of the date of death value of such benefits) are IRD to the extent they are includible in the recipient's gross income. Rev. Rul. 92-47, 1992-1 CB 198; Reg. § 1.663(c)-5, Example 9. Retirement plan death benefits generally are entirely includible in gross income when received by the beneficiary (for exceptions see ¶ 2.1.06 of *Life and Death Planning for Retirement Benefits*).

D. Out of gross income, Part II: Source specified by instrument or law. Suppose the trust instrument directs the trustee to pay $x to charity (so the payment is "pursuant to the governing instrument"), and the trustee actually makes the payment out of the trust's gross income (so the "tracing requirement" is met). There is one more hurdle: Either the governing instrument or applicable state law must indicate that the gross income can (or must) be the source of such payment.

Here the rule is a little more lenient than the rule with regard to which *class* of income the payment comes from (see "E" below): If the instrument specifies that the payment comes from income, or the instrument is silent on that point but state law specifies the payment comes out of income, that direction is respected for federal income tax purposes—regardless of whether it has "independent economic effect."

Local law provision: In Rev. Rul. 68-667, 1968-2 CB 289, the decedent's Will left a formula pecuniary bequest to a charity and left the residue of the estate to a noncharitable trust. The will was "silent as to the disposition of income of the estate during the period of administration." The estate made distributions to the charity and to the trust during the year. The IRS held that the payments to the charity were not deductible under § 642(c) because applicable state law required that "all income earned by an estate during the period of administration be distributed to the residuary legatee." Thus, the estate's "income" belonged to the noncharitable residuary trust, and the estate could not under applicable law have used such "income" as the source of the payments to the charity.

In contrast, in Rev. Rul. 71-285, 1971-2 CB 248, a trust was required to make an annual annuity payment to charity. On termination, the trust would pass to daughter. The trust was silent regarding the source of the charitable annuity payments. Applicable local law indicated that, absent a contrary provision in the trust, payments would be made first from the trust's income. Accordingly, the IRS allowed the charitable deduction for the charitable annuity payments in this case, unlike in Rev. Rul. 68-667.

Governing instrument provision: If the governing instrument specifies that the payment to charity shall be made first from income, that provision will be honored for purposes of § 642(c), regardless of whether it has any economic effect independent of its income tax consequences. Nongrantor charitable lead trusts, for example, are allowed an income tax charitable deduction for charitable annuity payments paid out of gross income, even though there is no economic effect of designating income as the first source for such payments—the charity is entitled to the same annuity amount regardless of whether the trust even has any income. Rev. Proc. 2007-45, 2007-2 CB 89, Section 4 (IRS sample charitable lead annuity trust), Article 2, 6th sentence, and Section 5.01(3); see PLRs 2003-39018, 2005-16005, 2005-36013.

This is consistent with the rules for allocation of DNI, where a governing instrument provision that a particular beneficiary's "separate share" is to be funded "first" with retirement benefit proceeds will be respected for purposes of allocation of DNI among beneficiaries' shares even though the provision has no economic effect independent of income taxes. Reg. § 1.663(c)-5, Example 9; see Appendix A.

Note: A pecuniary gift is eligible for the income tax charitable deduction to the extent it is paid out of gross income pursuant to the governing instrument; see Reg. § 1.642(c)-(3)(b)(2), Example 1, and Rev. Rul. 71-285, *op. cit.* This is in contrast to the DNI rules, under which the DNI deduction is *not* available for distributions in fulfillment of a bequest of a specific sum of money unless (1) the governing instrument requires that such distribution is to be paid in more than three installments (which would be unusual) [§ 663(a)(1), Reg. § 1.663(a)-1] or (2) the amount of the pecuniary bequest is to be determined by a formula where the amount of the bequest cannot be determined as of the date of death—for example because the amount will depend on such things as whether the executor elects to deduct administrative expenses on the estate tax return or on the income tax return. Reg. § 1.663(a)-1(b)(1).

E. **Out of WHICH income?** The charitable deduction under § 642(c) is limited to amounts paid out of gross income *other than tax-exempt income* (*e.g.*, municipal bond interest) and *unrelated business taxable income* (UBTI). § 681(a); Reg. § 1.642(c)-3(b)(1), (d).

If a trustee has received both ordinary taxable income and tax-exempt income in a particular year, and then makes a distribution to charity out of the trust's income account (pursuant to the governing instrument), how does the trustee know whether what he paid the charity came from the trust's taxable income (deductible) or from its tax-exempt income (nondeductible)?

The Code does not answer this question. Treasury regulations do: If a provision in the governing instrument (or applicable state law) "specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose," that provision "controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences." Otherwise, the distribution is deemed to come proportionately from each class of such income. Reg. § 1.642(c)-3(b)(2); § 1.643(a)-5(b).

For the meaning of "economic effect independent of income tax consequences," see Reg. § 1.652(b)-2(b), which deals with the allocation of classes of DNI among beneficiaries. Generally it means that the direction must potentially affect the *amount* the beneficiary receives, not just the tax characteristics of such amount. However the boundaries of this rule are not clear in all cases.

Laurie Example: Laurie's trust specifies that the income of the trust shall be paid equally to her sister Piper and her favorite charity, but that Piper's share shall be funded to the maximum extent possible with tax-exempt municipal bond interest and the charity's share shall be funded to the maximum extent possible with other types of income. Since this provision assigning one class of income to one beneficiary has no independent economic effect (each beneficiary receives the same dollar amount it would have received without this clause) it is disregarded. The muni bond interest and the "other income" will be deemed paid equally to the two beneficiaries. In contrast, if the trust said "Pay all muni bond interest to Piper and pay all other types of income equally to the two beneficiaries," the provision has economic effect—the amount of muni bond interest affects the amount Laurie will receive—so the provision will be honored for income tax purposes.

F. **Directing payment to charity out of retirement benefits.** Although Reg. § 1.642(c)-3(b)(2) first refers to "the source out of which amounts are to be paid [etc.]," all subsequent references and the two examples provided treat "source" as meaning "class of income." Directing that a particular beneficiary's share be paid out of retirement plan proceeds is *not* considered directing that the share be paid out of a particular "source" for purposes of allocating the resulting gross income among beneficiaries, because that particular direction will be respected even if it does not have independent economic effect. See Reg. § 1.663(c)-5, Example 9.

PLR 2016-11002 provides an example of one successful way to leave retirement benefits to charity through a trust. The decedent's IRAs were left to a trust as sole beneficiary. The trust stated "that Decedent's IRAs shall be distributed to" a particular charity ("Foundation"). The trust proposed to cash out each IRA in a lump sum in cash, "then pay that cash to Foundation within the same taxable year." The IRS ruled that the trust would be entitled to a § 642(c)(1) fiduciary income tax charitable deduction for the distributions to charity, equal to the amount of income caused by the IRA distributions.

Another approach is for the trust instrument to direct that the charity's share shall be funded "first" with traditional (nonRoth) retirement plan accounts or benefits or the proceeds thereof. This should work as an effective way to sidestep the separate share rule [see Appendix A] and also, presumably (if the plan is cashed out at the trust or estate level), to constitute a direction to pay the charity out of gross income.

Some drafters direct that the charity's share shall be paid first out of income in respect of a decedent (IRD). That formulation (as opposed to referring to traditional retirement accounts and proceeds thereof—even though such accounts constitute entirely or mostly IRD) does not track the language of Example 9 and conceivably could be taken as directing fulfillment with a "class" of income. If IRD is considered a "class" of income within the meaning of Reg. § 1.642(c)-3, and the trust has other "classes" of income in addition to IRD, it could become necessary to allocate the "classes" proportionately among multiple beneficiaries. The author has found no instance of IRD's being characterized by the IRS as a "class of income" for purposes of Reg. § 1.642(c)-3.

7.4.04 ***Timing of charitable deduction for trust or estate***

This ¶ 7.4.04 deals with when (in what year) a trust or estate may take an income tax charitable deduction under § 642(c) relative to the timing of (1) receipt of a distribution from a retirement plan and (2) the estate's or trust's payment to the charity of the income resulting from that plan distribution. The rules for an estate are slightly different from the trust rules.

¶ 7.4.03 dealt with retirement plan distributions that are paid to a trust and distributed by the trustee to the trust beneficiaries, where the plan-to-trust distribution and the trust-to-beneficiary distribution both occur *in the same taxable year of the trust*. The exact same rules apply when a retirement plan distribution is paid to an estate, and is then in turn distributed by the executor to the estate beneficiaries, where the plan-to-estate distribution and the estate-to-beneficiary distribution occur *in the same taxable year of the estate.*

If the plan distribution is received in one year, but not distributed to the charity until a later year, then different rules apply (and the results may differ depending on whether the plan distribution was received by a trust or by an estate). The following subparagraphs A–C assume that the distribution to the charity meets the other applicable requirements of the charitable deduction (see ¶ 7.4.03).

A. **Distribution to charity in the next year.** If the amount is distributed to the charity in the year (Year 2) *following* the year the income was received (Year 1), the fiduciary can elect to treat the payment to the charity as if it had been made in Year 1 (and so can deduct it in Year 1). § 642(c)(1). This rule applies to both estates and trusts. See PLR 2004-18040, in which a trust was allowed to make this election late.

B. **Estate gets a set-aside deduction.** If the distribution to the charity does not occur until even later than that, things get tougher. An *estate* can take a charitable deduction for amounts "permanently set aside for" charity as well as for amounts "paid to" charity. § 642(c)(2). A trust generally is not entitled to this deduction (see "C"). However, even the set-aside deduction is not a slam dunk: See *Estate of Eileen S. Belmont*, 144 TC 84 (2/19/15) (no set-aside deduction for income that the estate *could have been* required to use to pay a contestor's claim if other assets had not proved sufficient).

Note: There is generally no set-aside deduction, even for an estate, for amounts set aside for future distribution to a Charitable Remainder Trust. Reg. § 1.642(c)-2(d).

C. **Trust may or may not get set-aside deduction.** Trusts, unlike estates, generally *cannot* take a deduction for amounts that are merely "set aside for" charity; a trust generally gets a deduction only for amounts *paid* to charity. There are up to three exceptions to this general rule: A trust may take a set-aside deduction if the trust is treated as part of the estate pursuant to a § 645 election (see Reg. § 1.645-1(e)(2)(i)), or if the trust is eligible for a grandfather exception for certain pre-10/9/69 instruments (see § 642(c)(2)). Finally, if at the time the income is set aside all remaining beneficiaries of the trust are charities the deduction is presumably allowed; this situation is beyond the scope of this book.

7.4.05 ***Transfer benefits to charity to sidestep some rules***

This ¶ 7.4.05 discusses transferring an IRA, intact, from an estate or trust to one or more charitable beneficiaries of the estate or trust. Such a transfer may help the fiduciary sidestep the "separate share rule" [see Appendix A] as well as some technical requirements of § 642(c).

For how to do these transfers, see Appendix B. For the income tax treatment of such transfers, see ¶ 6.5.07–¶ 6.5.08 of *Life and Death Planning for Retirement Benefits*.

Transferring part of a retirement plan to a charitable beneficiary prior to the Beneficiary Finalization Date (BFD; see ¶ 7.2.02(C)) may also enable the trust to qualify as a see-through trust for minimum distribution purposes with respect to the rest of the plan (or other retirement benefits); see ¶ 7.3.02. Other than this deadline established under the minimum distribution rules, there is no particular date by which the transfer must occur to fulfill the income tax purposes discussed here.

Avoid some 642(c) technicalities. For an example of using such transfers in a charitable giving context, see PLR 2006-52028, in which the participant's IRAs were payable to a trust. The IRS ruled favorably on the trustee's transfer of the IRAs to charitable beneficiaries as a nontaxable event. Since the fiduciaries were simply transferring the IRAs to the residuary beneficiary-charities, there was no realization of gross income (as there would have been if the IRAs had been cashed out) and therefore there was no need to claim a § 642(c) deduction (and tangle with the "pursuant to the governing instrument" requirement). Compare CCA 2008-48020, discussed at ¶ 7.4.03(B). This approach also sidesteps the requirement that the instrument must specify that the payment to charity must come out of gross income (¶ 7.4.03(D)).

Avoid separate share rule. When the separate share rule of § 663(c) applies, if a fiduciary distributes money to a beneficiary, that distribution will carry out DNI only to the extent there is DNI that is properly allocable to that particular beneficiary's "separate share." See Appendix A. Although § 663(c) states that it applies for the *sole* purpose of determining the amount of DNI "in the application of sections 661 and 662," it appears that the separate share rules also apply to determine allocation of DNI to the share of a *charitable* beneficiary, even though, after all the allocating is done, there will be no DNI deduction under sections 661–662 for distributions to charity. See Regs. § 1.663(c)-1(a) and § 1.663(c)-5, Example 11. See also *Ferguson/Ascher,* op. cit., § 6.10, where the authors assume this result.

If the participant has already died, leaving retirement benefits to a trust that has "separate shares" within the meaning of § 663(c); and the beneficiary(ies) of one or more shares is (are) charities, while one or more other shares have noncharitable beneficiaries; and the trust does not include a provision mandating allocation of the retirement benefits to the share(s) of the charitable beneficiary(ies); the deemed allocation (under the separate share rule) to noncharitable beneficiaries' shares of gross income arising from retirement plan distributions can still be avoided, in the trust administration phase, if:

1. The trust instrument (or applicable state law) gives the trustee authority to distribute assets in kind to beneficiaries in satisfaction of their shares; and

2. The trust instrument (or applicable state law) gives the trustee authority to pick and choose which asset will be used to fund the charity's share; and

3. The trustee, instead of taking distribution of the retirement benefits, transfers the retirement plan account, intact, to the charity [see Appendix B for how to do this].

Following the assignment, the charity can take distributions directly from the retirement plan. The distributions do not have to be included in the gross income *of the trust* because the benefits are never paid to the trust. The problem of Reg. § 1.663(c)-2(b)(3) is avoided.

Why this works. Here is the reasoning behind this approach. Retirement plan death benefits paid to a beneficiary are generally taxable to the beneficiary as income in respect of a decedent (IRD) under § 691 (except to the extent such benefits are nontaxable as return of basis or under some special provision of the Tax Code). See Chapter 4 of *Life and Death Planning for Retirement Benefits* for detail on IRD.

The retirement plan itself (i.e., once inherited by the beneficiary, but prior to distribution of the benefits out of the plan) is a "right to receive IRD." See PLRs 2002-34019, 2005-20004, 2005-

26010, 2006-17020, 2006-20025, 2006-44020, 2006-52028, and 2013-30011. Generally, the transfer of a right to receive IRD, whether by gift or by sale, triggers immediate taxation of the IRD to the transferor. § 691(a)(2). However, this general rule does not apply to a transfer to the person or entity (including a charity) entitled to receive the asset by inheritance from the decedent. § 691(a)(2).

In PLR 2002-34019, IRAs were payable to the deceased participant's estate. The residuary beneficiaries of the estate were charities and individuals. The executor (pursuant to power granted in the will to make disproportionate distributions in kind) distributed cash to the individual beneficiaries in satisfaction of their shares, and proposed to transfer the IRA to the charities in payment of their shares. The IRS ruled that transfer of the IRAs to the charities would not be a taxable assignment of IRD under § 691, or create taxable income to the estate or individual beneficiaries. PLRs 2005-20004, 2005-26010, 2006-17020, 2006-33009, 2008-26028, 2010-13033, and 2013-30011 are similar.

PLR 2004-52004 is similar except that it does not mention § 691. PLR 2006-18023 is similar but involved a nonqualified deferred annuity rather than an IRA. For an IRS-blessed transfer of an IRA to a charity from an estate where the will was reformed after the decedent's death to specify that the IRAs would be the source of funding the charitable gifts, see PLR 2008-50004.

Limitations of this approach. For limitations and problems in connection with this type of transfer see Appendix B. Also, use of this type of transfer to fulfill a pecuniary bequest would not achieve the objective: It would be treated as a "sale" of the right to receive IRD according to CCA 2006-44020, causing income to be realized at the trust or estate level.

7.4.06 ***How to name a charity as beneficiary through a trust***

Here are guidelines to follow if retirement benefits are to be paid to a trust at the client's death, and the trust is to make distributions to charities, and you want the gross income resulting from the retirement plan distributions not to be taxable to the trust, and you also want the maximum estate tax benefit for making the charitable gifts.

These guidelines assume that all or most of the retirement benefits will pass to charity, so that there is no need to be concerned about preserving designated beneficiary status for the trust (¶ 7.3.01).

- **Specify that no estate taxes are to be charged against or paid out of the charity's share.** This is required if you do not want the estate tax charitable deduction to be reduced by the amount of the estate taxes paid out of the charity's share.

- **Specify that the retirement plan benefits must be used first to fund the charitable bequests**, and that nonretirement assets are to be used for this purpose only if there are no other assets available. This assures that the trustee will not be required (by state law equitable apportionment principles, the "separate share rule" of § 663(c), or otherwise) to assign proportionate shares of the retirement benefits and other assets to all beneficiaries; see ¶ 7.4.03(F).

- **Specify that the trustee has authority to distribute assets in kind.** This will assure that the trustee can transfer IRAs directly to the charities to fulfill their shares, rather than being compelled to withdraw funds from the IRAs and then distribute funds to the charities.

- **Use fractional rather than pecuniary formulas to define the charitable gifts**, if possible. This allows the fiduciary to fulfill the gift by transferring the retirement account intact to the charity, as described in ¶ 7.4.05, without being subject to "sale" treatment.

7.5 Seven "Whiches": Types of Charitable Entities

The Tax Code recognizes various types of charities and "split-interest" partially-charitable entities, not all of which are income tax-exempt. This ¶ 7.5 explains which charitable entities are and are not suitable to be named as beneficiaries of traditional (taxable) retirement plan death benefits.

7.5.01 ***Suitable: Public charity***

§ 501 provides an income tax exemption for a lengthy list of organizations, including clubs, burial societies, employee benefit plans and, in § 501(c)(3), the type of organization people usually mean when they refer to "charities": "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, ...or educational purposes [etc.], no part of the net earnings of which inures to the benefit of any private shareholder or individual," and which does not engage in certain proscribed political activities. The definition is similar, though not identical, for § 2055(a)(2) (estate tax deduction for bequests to charity). These organizations are referred to in this Outline as "public charities," meaning 501(c)(3) organizations that are not private foundations (¶ 7.5.02).

A public charity is exempt from income tax (except for the tax on "unrelated business taxable income" or "UBTI"). § 501(a), (b). Bequests to public charities qualify for the estate tax deduction, up to the value of such property included in the gross estate. § 2055(a).

Lifetime gifts to such charities are deductible for gift tax purposes (§ 2522(a)). Lifetime gifts to *domestic* charities qualify for the income tax charitable deduction. § 170(a), (c)(2)(A). Gifts to some charities qualify for a larger deduction (as a percentage of gross income) than others, but this distinction is irrelevant to at-death gifts.

The planner needs to verify that the organization is an exempt organization under § 501(c)(3).

7.5.02 ***Suitable: Private foundation***

In general, a private foundation is a "501(c)(3) organization" (¶ 7.5.01) primarily supported by contributions of one donor or family. The definition of a private foundation is notoriously convoluted (see § 509); there are several different types and not all are subject to the same restrictions. Untangling the various definitions and subsets of private foundations is beyond the scope of this book.

Certain private foundations, although exempt from "regular" income taxes (except the tax on UBTI), are subject to a two percent excise tax on net investment income. § 4940. The § 4940 tax "is a limited excise tax that applies only to the specific types of income listed in that section. Amounts from retirement accounts are deferred compensation income," not part of "the gross investment income" of a foundation, and therefore are *not* subject to this tax, according to PLRs 9838028 and 2000-03055.

7.5.03 ***Suitable: Donor-advised fund***

A donor-advised fund (DAF) is a "public" (501(c)(3)) charity that receives contributions from many individual donors, invests those contributions as separate accounts (one per donor), and distributes the account funds at a later time to "real" charities such as schools, museums, and aid organizations. See § 4966(d)(2). The donor of the gift (or other person appointed by the donor) "advises" the DAF which charities to distribute the funds to. The DAF is not obligated to follow the advisor's suggestions but normally does so.

First offered by some large charities, DAFs are now run also by mutual fund firms and (unfortunately) some questionable organizations as well. Some problems led Congress to impose regulations and penalties on DAF abuses; see § 4966. However, most use of DAFs is entirely benign and DAFs are very useful for donors, so hopefully they will continue to exist and donors will abjure abusive transactions.

Because a DAF is an income tax-exempt 501(c)(3) charity, funding it with retirement plan death benefits is highly suitable. Leaving retirement benefits to a DAF, where the participant-DAF donor has specified which charities are to receive gifts upon his death (or at least how they will be selected), is a recommended way to avoid problems that arise with some IRA providers when benefits are left directly to charities; see ¶ 7.2.01. Funneling IRA death benefits through a DAF may also make it easier for the donor to change his list of charitable beneficiaries (or their respective shares), a convenience for the donor compared with the usually more cumbersome task of changing beneficiaries of an IRA or retirement plan.

Regarding disclaimers to a DAF, see ¶ 7.2.07, #1.

7.5.04 ***Suitable: Charitable remainder trust***

A Charitable Remainder Trust (CRT), as that term is used here, means a charitable remainder trust that meets the requirements of § 664 and accordingly is income tax-exempt. § 664(c)(1). The general idea of a CRT is that the trust pays out an annual income to one or more human beneficiaries (such as the donor's spouse or children) (referred to here as "the human beneficiary," though there might be more than one) either for life or for a term of not more than 20 years. At the end of the life (or term) interest, the remaining trust assets are paid to charity.

A CRT must meet rigid requirements set forth in § 664 and its related regulations: The annual payout to the human beneficiary is specified in the trust instrument and must be either a fixed dollar amount, in which case the trust is a "charitable remainder annuity trust" or CRAT, or a fixed percentage of the annually-determined value of the trust, in which case the trust is a "charitable remainder unitrust" or CRUT. The annual payout rate of a CRUT must be at least five percent (but not more than 50%). A CRUT is more flexible than a CRAT because it can provide that the annual payout to the human beneficiary is the unitrust percentage or the net income of the trust if less, and can provide for "makeup" distributions to the noncharitable beneficiary if in later years the trust's income exceeds the unitrust percentage. However, neither type of CRT can permit the human beneficiary to receive anything other than the unitrust or annuity payout amount.

The attraction of leaving retirement plan death benefits to a CRT is that the benefits are distributed to the trust with no income tax. Thus, the client's human beneficiary can receive a life income from reinvestment of the *entire amount* of the retirement benefit. In contrast, if the individual inherited the benefits as named beneficiary under the plan, he would have to pay income taxes on the benefits as those were distributed, meaning that (once distribution of the benefits is complete) the amount left over for the human beneficiary to invest is substantially reduced. Thus the human beneficiary can expect a larger annual income from the CRT than he would receive by investing the after-tax value of any retirement benefits distributed to him directly.

Another attraction is that the decedent's estate is entitled to an estate tax charitable deduction for the value of the charitable remainder gift. This value is determined using IRS-prescribed actuarial tables and interest rates, and must be at least 10 percent of the date-of-death value of the trust. § 664(d)(1)(D), (d)(2)(D); § 7520.

This is not to suggest that the client's human beneficiaries will receive more money as life beneficiaries of a CRT than they would receive if they were named directly as beneficiaries of the plan. Normally the opposite is true, because an individual named directly as beneficiary of a retirement plan receives the *entire* benefit, not just the income from the benefit. The income beneficiary of a CRT receives only the income from the reinvested plan proceeds; the proceeds themselves (the principal of the CRT) eventually go to the charity. Also, the economic advantage of deferral of distributions over, if designated beneficiary treatment is available, reduces the negative effects of the fact that the distributions are taxable income to the beneficiary; see ¶ 1.1.03 of *Life and Death Planning for Retirement Benefits*.

7.5.05 ***Income tax rules for CRTs; IRD deduction***

A CRT generally pays no income tax itself (see ¶ 7.5.04), but:

A. **Retirement benefits and UBTI.** There is a 100 percent tax on the unrelated business taxable income (UBTI) of a CRT (but its other income for the year is tax-exempt). § 664(c)(2). PLRs 9237020 and 9253038 involved CRTs that were to be named as beneficiaries of retirement benefits. The IRS ruled that the trusts in question qualified as CRTs (and thus were tax-exempt as long as they did not have UBTI), and that retirement plan death benefits payable to the trusts would be income in respect of a decedent (IRD; § 691) and have the same character as the income would have had if it had been paid to the deceased participant. These rulings thus imply that retirement plan distributions are *not* UBTI. In PLR 2002-30018 the IRS ruled that a charity's receipt of IRA death benefits, in exchange for paying a charitable gift annuity to the decedent's human beneficiary, did not generate UBTI.

B. **The multi-tier CRT accounting system.** A CRT has a unique accounting system, under which every dollar that the CRT receives is allocated to one of several "tiers" based on its federal income tax character (such as ordinary income, capital gain, tax-exempt income, or principal). § 664(b).

In effect, the CRT "remembers" what types of income it has received. Then, when the CRT makes a distribution to the human beneficiary, the distribution is deemed to come out of one of these tiers, and the federal income tax character of the amount is revived. For example, if the distribution to the human beneficiary is deemed to come out of the ordinary income tier, the beneficiary will have to include that distribution in his gross income as ordinary income.

Distributions to the human beneficiary are generally assigned to tiers on a "worst-first" basis, so (for example) the human beneficiary cannot receive any capital gain income from the CRT until the CRT has distributed everything it held in its ordinary income tier.

Some people mistakenly believe that, if they leave a retirement plan to a CRT, the CRT could take a distribution of the entire plan tax-free (correct so far), reinvest the proceeds in municipal bonds, and then pay the tax-exempt municipal bond interest annually to the human beneficiary. This maneuver does not work, because the retirement plan distribution to the CRT (to the extent it is ordinary income) all goes into the "ordinary income" tier. (Most retirement plan distributions are ordinary income.) Even if the trustee *did* invest the proceeds in municipal bonds, no distribution to the human beneficiary would be treated as coming from the tax-exempt bond interest "tier" until the ordinary income "tier" had been used up.

So, although the CRT pays no income tax when it receives a distribution from a retirement plan, the beneficiary of the CRT will have to pay income tax on the distributions *from* the CRT, to the extent those are deemed to represent the CRT's regurgitation of the retirement plan benefit (or other taxable income) under the tier system. Regs. § 1.664-1(d). For how the 3.8% additional tax on net investment income applies to CRTs, see Reg. § 1.1411-3(d).

C. **CRTs and the IRD deduction.** Generally, when the beneficiary of a retirement plan receives a distribution from the plan, he must include it in his gross income as income in respect of a decedent (IRD), but he is entitled to an income tax deduction for the federal estate taxes that were paid on those benefits. § 691(c); see ¶ 4.6.04 of *Life and Death Planning for Retirement Benefits* for details. If retirement benefits are paid to a Charitable Remainder Trust, that deduction for practical purposes disappears—nobody gets to use it. There is no mechanism by which a CRT can pass out the IRD deduction to the CRT's human beneficiaries.

The § 691(c) deduction reduces the taxable income of the CRT (i.e., income assigned to the trust's "first tier") in the year the distribution is received from the plan. Reg. § 1.664-1(d)(2). Distributions to the individual beneficiary would be deemed to come out of the "net taxable income" of the CRT (first tier) until it had all been used up. The income of the CRT that was sheltered by the 691(c) deduction would become "principal" that could eventually be distributed to the individual beneficiary tax-free as part of the last tier. However, the tax-free principal of the CRT is not deemed distributed until after all net *taxable* income has been distributed. *This point would never be reached in most CRTs funded with retirement benefits.* Accordingly, under this interpretation, the § 691(c) deduction is essentially "wasted" when retirement benefits are left to a CRT.

The IRS confirmed this interpretation in PLR 1999-01023. Some practitioners disagree with this ruling and argue that the unitrust distributions from the CRT should retain their character as IRD and therefore carry out the IRD deduction to the human beneficiary along with the taxable income, citing Reg. § 1.691(c)-1.

7.5.06 ***Solving planning problems with a CRT***

For a client wishing to benefit charity as part of her estate plan, naming a charitable remainder trust (CRT) as beneficiary of retirement benefits can help solve estate planning problems in addition to satisfying the charitable intent. For example, it can be a good way to benefit charity while also benefitting an older individual (see "A" below), multiple adults ("B"), the surviving spouse ("C"), or a disabled individual ("D"), or to dispose of a lump-sum-only plan ("E"). But caution is required: See ¶ 7.5.07 for drawbacks, risks, and other reasons NOT to leave benefits to a CRT.

A. **To benefit an older individual.** Naming an older nonspouse individual outright as beneficiary of retirement benefits has the effect of dumping the benefits out of the plan and into the beneficiary's gross income rapidly (over the beneficiary's short life expectancy) [beneficiaries close in age to the participant qualify as "eligible designated beneficiaries," and so are still entitled to the life expectancy payout; § 401(a)(9)(E)(ii)(IV)], so the income taxes get paid up front and the elderly person will have less money available in his later years. In contrast, if the benefits are left to a CRT for the life benefit of that person, he will enjoy a more-or-less steady income from the CRT that will last for his entire life, not run out at the end of his IRS-defined life expectancy.

In addition, the participant's estate will get an estate tax charitable deduction which may free up some other funds that can be given to the same or other beneficiaries. A charitable gift annuity could also be used in this situation; ¶ 7.5.08. The downside is that the individual beneficiary cannot take out more than the pre-set income stream from the CRT (or gift annuity) regardless of need.

B. **Provide life income for multiple adults.** Naming a noncharitable trust for multiple adult beneficiaries of varying ages produces a nightmare from the point of view of required minimum distributions (RMDs): Either the trust must use the 10-year payout rule to measure RMDs, or (if some beneficiaries qualify as "eligible designated beneficiaries" entitled to the life expectancy payout method) the participant must name multiple separate trusts, one for each beneficiary, which could have the effect of chopping up the assets into too many too-small pots.

By naming as beneficiary, instead, one CRT that pays a unitrust payout for life to several adult beneficiaries, the participant avoids all RMD problems (because the tax-exempt CRT can cash out the plan benefits immediately upon the participant's death, with no income taxes). The trust produces a more-or-less steady income which can be split among the human beneficiaries. As each individual beneficiary dies, his income share passes to the surviving members of the group, thus providing a crude form of inflation protection. Because the value of the charity's remainder interest (determined actuarially using IRS tables) must exceed 10 percent of the total trust value as of the date of the participant's death, this approach will only work with a small group of adult beneficiaries (*e.g.*, a group of 50-something siblings or friends and 80-something parents); see ¶ 7.5.07(B). § 664(d)(1)(D).

C. For spouse, as a QTIP alternative. For a charitably inclined participant, leaving retirement benefits to a CRT for the life benefit of his surviving spouse can sidestep the drawbacks and risks involved in leaving such benefits outright to the spouse or to a noncharitable trust for her benefit (but see ¶ 7.5.07(C) regarding spousal consent).

Leaving benefits outright to the spouse has major tax advantages (primarily the spousal rollover), but only if the spouse rolls the benefits over to her own retirement plan after the participant's death, and there is no way to guarantee that she will actually do that. If the surviving spouse fails to carry out the rollover all the tax advantages are usually lost. Even if the spouse does roll over the benefits left to her outright, she might dissipate the money on expenditures the participant wouldn't approve of, and/or leave what's left of it at her death to a beneficiary the participant wouldn't approve of. If the participant leaves the benefit to a QTIP trust to head off these outcomes, there are major income tax drawbacks (see discussion at ¶ 3.3.02(B) and ¶ 6.4.06 of *Life and Death Planning for Retirement Benefits*).

In contrast, if benefits are left to a CRT for the spouse's life benefit, the spouse will get an income stream for life, without the drawbacks of leaving benefits to a QTIP trust. There will be no need for the spouse to roll benefits over (or take any other steps) on the participant's death—the benefits pass directly to the CRT. The participant can choose the ultimate beneficiary (which has to be a charity of course). If the spouse is the only human beneficiary of the CRT (recommended), there will be no estate tax on the benefits either at the participant's death or at the spouse's death (due to the combination of the charitable and marital deductions). § 2056(b)(8).

D. Disabled beneficiary. If a person is receiving means-tested disability benefits, naming such person as outright beneficiary of a retirement plan would typically cause him to lose such benefits until the inherited plan had been spent down. If the benefits are left to a see-through trust under which the disabled individual is the sole life beneficiary (no distributions can be made to anyone else during his/her lifetime), the trust would qualify for a life expectancy payout (see § 401(a)(9)(H)(iv))—but distributions not passed out to the disabled individual (or applied for his/her benefit) in the same taxable year received would be taxable at trust tax rates. One alternative to explore, not further discussed here, is naming, as beneficiary of the retirement plan, a charitable remainder trust for the life benefit of the disabled individual and then providing (in the CRT) that the CRT's annuity or unitrust payments will be made to a "self-settled-type" ((d)(4)(A)) supplemental needs trust for the benefit of the disabled beneficiary rather than outright to the disabled beneficiary, as permitted by Rev. Rul. 2002-20, 2002-1 CB 794.

E. **Lump sum distribution-only plan.** Many qualified retirement plans offer a lump sum distribution (LSD) as the only permitted form of death benefit. A CRT is a good choice of beneficiary for a LSD-only plan. By receiving the LSD tax-free, then paying a unitrust payout for life to the participant's human beneficiary(ies), the CRT approximates the life expectancy payout that is not available under the retirement plan.

A "Designated Beneficiary" of a lump-sum-distribution-only plan (including a "see-through trust" named as beneficiary) can instruct the plan to transfer the lump sum, by direct rollover, to an "inherited IRA" (created for the purpose of receiving the distribution) in the name of the deceased participant and payable to the same beneficiary, thus enabling the beneficiary to receive the deferral advantages of designated beneficiary treatment (from the "inherited" IRA) even though that is not an option offered by the plan he actually inherited. § 402(c)(11). Despite the existence of this option, there are still factors that make the CRT an attractive alternative compared with naming a see-through trust as beneficiary of a lump-sum-only plan and expecting that trust to have the benefits transferred to an inherited IRA:

- Drafting a see-through trust can be challenging, in view of the IRS's problematic RMD trust rules. See ¶ 6.2–¶ 6.3 of *Life and Death Planning for Retirement Benefits*. If the trust for some reason does not qualify as a see-through the nonspouse beneficiary rollover to an inherited IRA will not be available.

- There is the risk that the lump sum benefits, instead of being transferred by direct rollover to an inherited IRA as instructed by the Designated Beneficiary after the participant's death, will by mistake (either of the plan trustee or the IRA provider) be transferred to a taxable account, causing immediate income taxation of the entire lump sum. Transferring intended rollover distributions into a taxable account is a regularly-occurring mistake. See, *e.g.*, PLRs 2007-03036, 2007-04038, 2007-27027, 2007-09068, and 2007-17027. When this mistake happens after the participant's death it cannot be corrected (unless the beneficiary happens to be the participant's surviving spouse); see ¶ 4.2.02(A) of *Life and Death Planning for Retirement Benefits*.

7.5.07 ***Reasons NOT to leave benefits to a CRT***

Though it is a great planning tool, there are limitations on leaving retirement benefits to a CRT. Beware of leaving too much money to a CRT with individual beneficiaries other than the surviving spouse (see "**A**"), or with individual beneficiaries who are "too young" ("**B**"), or for a nonconsenting surviving spouse ("**C**").

A. **Do not overfund CRT with nonspouse beneficiary.** When retirement benefits are left to a CRT, the entire value of the benefits is included in the decedent's gross estate for estate tax purposes. The estate tax charitable deduction for a bequest to a CRT will not shelter the entire value from estate taxes. Rather, only the actuarial value of the charitable remainder is allowed as a charitable deduction.

Accordingly, unless the surviving spouse is the sole human beneficiary of the CRT (in which case her interest is nontaxable because it qualifies for the marital deduction; § 2056(b)(8)), the human beneficiary's interest in the CRT will in effect be subject to estate tax, if (combined with the decedent's other assets) the amount is large enough to attract estate tax. The question of who is going to pay that tax and with what funds needs to be settled as part of the estate plan. Leaving too much money to a CRT could cause a tax meltdown.

B. **CRT does not work if beneficiaries are too young**. In order to be a qualifying charitable remainder trust, the value of the charitable remainder (as of the date of the gift to the trust, or, in the case of a CRT funded at death, as of the date of death) must be at least 10 percent of the total value of the trust. § 664(d)(1)(D), (d)(2)(D). If the CRT beneficiaries are "too young," and have a life interest, the trust will not meet the 10 percent requirement and it will not qualify as a CRT. This could be overcome by limiting their income interest to a term of 20 years or less, rather than life.

C. **Spousal consent may be required.** Qualified plan benefits are subject to certain federal-law rights held by the spouse of the worker; accordingly, as to either all or part of a married client's benefit under a qualified plan, it will not be possible to leave it to a CRT without the spouse's consent. See ¶ 3.4 of *Life and Death Planning for Retirement Benefits*. State law marital property rights may affect the participant's ability to freely choose a beneficiary for an IRA.

7.5.08 ***Suitable: Charitable gift annuity***

Under a charitable gift annuity, a sum is left to a charity and the charity agrees to pay a fixed income to a human beneficiary for life. Leaving a retirement plan to a charity subject to the obligation to pay an annuity to the participant's chosen human beneficiary could be a good way to provide an income for an older beneficiary. The participant's estate gets an estate tax deduction for the value of the retirement benefits left to the charity minus the value of the annuity (determined using IRS tables). The benefits are paid to the charity free of income tax. See § 170(f)(10)(D), § 501(m)(5), PLR 2002-30018.

This approach has several advantages compared with the charitable remainder trust (¶ 7.5.06(A)) or a long term payout directly from the retirement plan: The human beneficiary would receive a fixed predictable income (which a beneficiary might prefer to the fluctuating income provided by a charitable remainder unitrust or a gradual payout from a retirement plan). There is no need to draft a CRT. The income is guaranteed to last for the beneficiary's life. However, for a given dollar amount of retirement benefits, the amount of life income that could be provided for the human beneficiary is potentially higher with a CRT than is usually possible with a gift annuity.

For an excellent explanation of charitable gift annuities, including discussion of funding them with retirement benefits, see "Charitable Gift Annuities" by William Finestone, 29 *ACTEC Journal* 37 (Vol. 29, No. 1), Summer 2003.

7.5.09 ***Usually unsuitable: Charitable lead trust***

A charitable lead trust (CLT) is the mirror image of a charitable remainder trust: A "unitrust" or "annuity" income stream is paid to a charity for a term of years, then the underlying property passes to the donor's individual beneficiaries at the end of the term. § 170(f)(2)(B).

Unlike a CRT, however, the CLT is not exempt from income taxes. Thus a CLT named as beneficiary must pay income tax on the benefits as they are distributed from the retirement plan. Because of this, leaving traditional retirement benefits to a CLT appears generally to be a disadvantageous way to fund such a trust.

Generally, the planning advantage of a CLT funded at death is that, in addition to satisfying the donor's charitable intentions, it may allow funds to pass to the donor's descendants free of gift or estate taxes. This phenomenon occurs if the investment performance of the trust "beats" the IRS's § 7520 rate. When the initial bequest is made to the CLT, the IRS § 7520 tables are used to value the charity's and family's respective interests in the trust. The decedent's estate then pays estate tax on the value of the interest passing to the family. If the trust's investments outperform the § 7520 rate, the amount by which the investments outperform the § 7520 rate eventually passes to the family beneficiaries. Since the IRS rates did not predict that this value would exist, the excess value is never subjected to estate tax.

If the CLT is funded with traditional retirement benefits, however, the CLT will generally start out at a disadvantage, since some of the principal that the IRS assumed the trust would have has been used to pay income taxes, making it *less* likely that the trust will "beat" the IRS's § 7520 rate. In effect the trust starts out with a loss; the client may well end up paying estate tax on *more* than the family beneficiaries eventually receive. The CLT thus appears generally an unattractive choice as beneficiary of traditional retirement benefits, though there could be some unique circumstances in which it would work.

7.5.10 ***Unsuitable: Pooled income fund***

With a pooled income fund (§ 642(c)(5)), the donor makes his gift to a fund maintained by the charitable organization that will ultimately receive the gift. The fund invests the gift collectively with gifts from other donors, and pays back to the donor (or to another beneficiary named by the donor) a share of the fund's income corresponding to the relative value of the donor's gift. When the donor (and/or the beneficiary he nominated) dies, the share of the fund attributable to that donor's gift is removed from the fund and transferred to the charity.

The pooled income fund provides approximately the same benefits as a CRT (irrevocable gift of remainder interest to charity generates an estate tax charitable deduction, while providing a life income to the donor's human beneficiaries), without the expense of creating and operating a stand-alone CRT. Unlike CRTs, however, pooled income funds are not exempt from income tax. Reg. § 1.642(c)-5(a)(2); compare § 664(c). Therefore, generally retirement plan death benefits paid to a pooled income fund will be subject to income tax in the year received by the fund to the same extent they would be taxable to an individual beneficiary. Accordingly a pooled income fund is not an attractive choice as beneficiary of traditional retirement benefits.

7.6 Qualified Charitable Distributions

The preceding sections have discussed leaving retirement benefits to charity *at death*. This and the following section discuss ways to transfer retirement benefits to charity *during life*.

Generally, lifetime gifts of retirement benefits are not a tax-favored way to deal with such benefits. ¶ 7.7.01. One minor but very popular exception is the "qualified charitable distribution" (QCD)—the ability of *some people* to transfer *a limited amount* of funds directly from *certain types of IRA* to *certain types of charities*. Specifically, an over-age-70½ IRA owner or beneficiary (¶ 7.6.02) can instruct the administrator of the IRA (¶ 7.6.03) to transfer up to $100,000 in any calendar year (¶ 7.6.04) to one or more eligible charities (¶ 7.6.05). The amount(s) so transferred is (generally) not includible in the gross income of the IRA owner-donor (¶ 7.6.07), even though it is a distribution from his or her IRA, and even though it may be used to satisfy the required minimum distribution (¶ 7.6.09(B)).

This ¶ 7.6 explains QCDs—the requirements, mechanics, limitations, benefits, and complications.

7.6.01 ***Where to find the law***

The QCD is created by § 408(d)(8), which has in effect been part of the Tax Code since 2006—"in effect" because it was enacted five times on a temporary and often retroactive basis before being made a permanent part of the Code in its sixth (!) enactment in December 2015.

Originally enacted as part of the Pension Protection Act of 2006 (P.L. 107-16, section 120(a)), § 408(d)(8) contained an expiration date in subparagraph (F); it was good for IRA distributions in 2006 and 2007 only (see § 408(d)(8)(F) as enacted). § 408(d)(8) was extended in late 2008 for two more taxable years (2008 and 2009). In December 2010, § 408(d)(8) was extended for two more years (2010–2011). The American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240, section 208(a)) extended § 408(d)(8) *again*, but only through 2013. QCDs were again allowed by late-in-the-year legislation for 2014 (P.L. 113-295, section 108(a)), but again as a temporary provision: Subsection (F) stated that the section would not apply to distributions after 2014. Finally, QCDs were re-authorized *and made permanent* for 2015 and later years by § 112(a) of the "Protecting Americans from Tax Hikes Act of 2015" (PATH, P.L. 114-113) enacted December 18, 2015, which struck the expiration date provision (subsection (F)) from the Code.

The Treasury's only authoritative pronouncement on QCDs to date is (still) Notice 2007-7, 2007-1 CB 395, Q&A 34 through 44.

7.6.02 ***Who can make QCDs: Individuals over age 70½***

Only individuals who are age 70½ or older can make QCDs. § 408(d)(8)(B)(ii).

The QCD donor can be either an IRA participant donating from his own IRA <u>or</u> a beneficiary donating from an inherited IRA. Notice 2007-7, A-37. The only requirement is that the donor (whether owner or beneficiary) must be a human being age 70½ or older.

Although the SECURE Act raised the age for starting required minimum distributions from 70½ to 72 (§ 401(a)(9)(C)(i)), the age for making QCDs was left at 70½.

This is the only Code provision to make the age 70½ "birthday" itself a significant event. Someone who reaches age 70½ on (say) December 30 could have a tough time getting his IRA provider to make the QCD on the last day of the year. It would have been easier for all concerned to allow QCDs to occur anytime during or after the calendar year the individual reaches age 70½—but that's not what the law says.

Example: In 2018, Jonathan inherited an IRA from his mother. He also has an IRA of his own. Jonathan's 70th birthday was April 1, 2019. He turns 70½ on October 1, 2019. He can make QCDs from either his own IRA or the inherited IRA he holds as beneficiary of his mother (or both) any time on or after October 1, 2019.

7.6.03 ***From IRAs only (other than "ongoing" SEPs or SIMPLEs)***

QCDs may be made *only* from IRAs. § 408(d)(8)(B). So, a QCD can not be made from a "qualified retirement plan," i.e., a plan qualified under § 401(a) of the Code, such as a pension, profit-sharing, Keogh, or 401(k) plan); or from a 403(b) plan; or from a 457 plan.

A QCD can be made from any type of IRA subject to the following exceptions/limitations:

- A QCD may not be made from "simplified employee pension" (SEP-IRA; § 408(k)) or "simple retirement account" (SIMPLE; § 408(p)). § 408(d)(8)(B). SEPs and SIMPLEs are IRAs funded directly by contributions from the individual's employer. The IRS has stated that this prohibition applies only to an "ongoing" SEP-IRA or SIMPLE IRA. A "SEP IRA or a SIMPLE IRA is treated as ongoing if it is maintained under an employer arrangement under which an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contributions would be made." Notice 2007-7, A-36.

- Though Roth IRAs are not "banned" from making QCDs, as a practical matter, QCDs cannot be made from a Roth IRA due to the requirement that the distribution must be one otherwise includible in gross income. See ¶ 7.6.07(A).

The fact that QCDs cannot be made from a qualified plan creates an insurmountable obstacle for retirees who choose to leave their benefits in their former employer's plan but would like to use QCDs to fulfill their RMDs from such plan: The employee cannot just transfer the RMD amount from the plan to the IRA and thence to the charity because any distribution from the QRP to the IRA will be a nonrollable RMD until the RMD has been paid in full. § 408(d)(3)(E). The only way someone in this position can use QCDs to reduce her taxable RMDs is to roll ALL of her QRP balance into an IRA (after taking the RMD for the rollover year)...but then she will lose whatever advantages she was seeking by staying in the employer plan.

7.6.04 ***How much? Up to $100,000 per year per IRA owner***

The QCD income exclusion is limited to $100,000 per year. § 408(d)(8)(A). The limit is per IRA owner, not per IRA. "For married individuals filing a joint return, the limit is $100,000 per individual IRA owner." Notice 2007-7, A-34. So, a husband and wife who are both over age 70½ and who both have IRAs can each transfer up to $100,000 to charity from their respective IRAs in the same year. But if (for example) wife has an IRA and husband does not, or husband has an IRA but does not want to make a gift, wife cannot "borrow" husband's limit and give $200,000 from her IRA.

The donor does not have to give that much. $100,000 per IRA owner per year is the maximum and there is no minimum (other than what the IRA provider may impose administratively).

7.6.05 ***Which charities can and cannot receive QCDs***

A QCD can be made to any charity described in § 170(b)(1)(A) *other than* a donor-advised fund (§ 4966(d)(2)) or a supporting organization (§ 509(a)(3)). § 408(d)(8)(B)(i).

§ 170(b)(1)(A) charities are those charities donations to which can generate the largest deduction for individuals as a percentage of their gross income—generally 50%, but 60% for certain donations in 2018–2025—such as churches, schools, nonprofit medical facilities, and publically-supported nonprofit organizations engaged in charitable work. Certain private foundations can also receive QCDs; consult the statute for details.

Although donor-advised funds (¶ 7.5.03) and "supporting organizations" are normally treated as full-fledged charities for purposes of the income tax charitable deduction, they are excluded by statute from receiving QCDs.

7.6.06 ***Requirements applicable to the gift***

The QCD gift must pass three tests: First, it must be an IRA distribution that would (but for the QCD exemption) be 100% includible in the donor's gross income. See ¶ 7.6.07 regarding that requirement. The other two tests are discussed in this ¶ 7.6.06:

Second, it must be a gift that would be 100% deductible as a charitable contribution under § 170 if made *outside* the IRA (except that, for this purpose, the percentage-of-income limits in § 170(b) are ignored). § 408(d)(8)(C). Finally, it must meet all the requirements applicable to non-QCD gifts for which an income tax charitable deduction is sought under § 170 (such as the "substantiation requirement" of § 170(f)(8) for gifts of $250 or more). Notice 2007-7, A-39. For the requirements of the income tax charitable deduction generally, see IRS Publication 526, "Charitable Contributions." Regarding the substantiation requirement in particular see ¶ 7.6.08.

The requirement that the gift must be of the "100% deductible"-type means that:

- A "split-interest gift" cannot qualify as a QCD. Thus, QCDs cannot be made to a charitable remainder trust (¶ 7.5.04), pooled income fund (¶ 7.5.10), or charitable gift annuity (¶ 7.5.08). The gift must go 100% directly to the charity.

- For taxable years after 2017, if the gift is made to an educational institution, and it entitles the donor to purchase tickets to an athletic event, the gift is totally nondeductible and accordingly cannot be made via QCD. § 170(l).

- The donor cannot receive from the charity, in exchange for his QCD, any "goods or services" except those that the IRS allows to be disregarded. Reg. § 1.170A-1(h)(i). "Goods or services" means "cash, property, services, benefits, or privileges." Reg. § §1.170A-13(f)(5).

Under the IRS's rules, the following goods or services can be disregarded even if received in exchange for the gift:

1. Goods or services that have insubstantial value under the guidelines provided in Revenue Procedures 90-12, 1990-1 CB 471, 92-49, 1992-1 CB 987, and any successor documents.

2. Certain "membership benefits" offered for dues of $75 per year or less. Disregardable membership benefits include such standard "percs" as free parking and gift shop discounts. Reg. § 1.170A-13(f)(8)(i)(B).

3. "Any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context." See § 170(f)(8)(B).

The no-consideration requirement can raise thorny questions. If the "goods or services" the donor receives exceed in value the de minimis amounts permitted by IRS rules, it may not be possible to make the gift using a QCD. For example, a coffee mug with the charity's logo on it may be disregardable based on its cost and fair market value and the amount of the donation relative to that cost and fair market value—but if the donor also received a calendar or a tote bag along with the mug, the combined value may mean the value she received is not "insubstantial." It is to be hoped that each charity would have its tax counsel review these IRS guidelines, and the goods and services the charity is providing, and then provide each donor with written confirmation that the full gift is tax-deductible (i.e., the membership or other benefits or token gifts can be disregarded as of insubstantial value). Unfortunately, charities (especially smaller ones) may not be well versed enough in these rules to know what is "disregardable" and what isn't.

A different problem arises when you get back something that definitely is not "disregardable," even if it has small value compared to the gift—for example, you buy a $10,000 ticket to a charity ball and your ticket entitles you to $100 worth of dinner. If you make the gift from your taxable, it's easy to handle the value you get back—just reduce the amount you deduct on Schedule A by the value of the goods or services received, for a net deduction (in this example) of $9,900. But with a QCD the existence of the "something valuable you get back" means the entire gift cannot be a QCD.

Could the charity-ball transaction be done as a "bifurcated" donation, under which the charity would accept two checks totaling $10,000, one for $100 (from the donor's taxable account) to pay for the dinner and one for $9,900 from the IRA as a QCD? The charity would give two separate receipts; the receipt for the $9,900 IRA distribution would show no goods or services received in exchange. There is no IRS pronouncement on this question.

Because of the muddy rules about "stuff you get back for your gift," you have three choices when seeking to make a QCD to an organization where you are a "member" or otherwise getting something "back" from the organization. Either you sit down with your and the organization's tax lawyers and prepare a written memorandum, with citations, about why what you are getting back is disregardable under IRS regulations (so your QCD qualifies as a "100% deductible gift"), or you find a way to sever your IRA-funded donation from your membership or event ticket—perhaps by making a bifurcated donation as above described (though there is as yet no authority that this "works" in the QCD context). Or, simply do not use QCDs to fund any charitable gift or membership where you will receive something back.

7.6.07 ***Income tax aspects: Exclusion, exceptions, and basis recovery***

A QCD has "gross income" aspects coming and going: A QCD is generally *excludible* from the donor's gross income...but one requirement of a QCD is that it must be a distribution that (but for § 408(d)(8)) *would have been includible* in the donor's gross income. § 408(d)(8)(B), last sentence.

The income tax exclusion of QCDs is straightforward. Generally, the QCD is excluded from the individual's gross income for all purposes**.** § 408(d)(8)(A). Thus it cannot be counted as part of the individual's gross income for purposes of applying the percentage-of-income limits in § 170(b) with respect to his other charitable gifts. Of course, there is no income tax charitable deduction for the QCD. Notice 2007-7, A-39.

But before we get to the exclusion, we first have to determine that the distribution *would have been includible in gross income* before we can exclude it from gross income. This makes QCDs from Roth IRAs impossible—see "A." It creates a problem if the IRA contains "after-tax money" (investment in the contract or "basis"); but the statute solves this problem; see "B." It may mean the QCD can be "erased" and converted to an "itemized deduction" by tax-free rollover; see "C."

And, even when you've cleared all those hurdles, there is an exception to the income exclusion for people who have made a tax-deductible IRA contribution after age 70½; see "D."

A. **QCDs from Roth IRAs almost impossible.** A qualified distribution from a Roth IRA cannot be a QCD because a qualified Roth IRA distribution is nontaxable. Thus, a QCD could be made from a Roth IRA only if the Roth IRA had not yet met the requirements for a "qualified distribution." Even then, however, since all distributions from a Roth IRA are deemed to come first from the account's contributions (distributions of which are not includible in gross income) the only way a QCD could occur from a Roth IRA would be for the over-age 70½ Roth IRA owner who had not held a Roth IRA for the required 5-year holding period of § 408A(d)(2)(B) to first to withdraw all of his contributions (tax-free), then make a QCD from the "earnings" still left in the account. There is no known reason why anyone would ever do this. Since the Roth IRA owner can expect that these funds eventually will qualify for income-tax free treatment and it would not be advantageous to throw away that future tax benefit just to make a QCD. For details of income tax treatment of Roth IRA distributions see ¶ 5.3 of *Life and Death Planning for Retirement Benefits*.

B. **Special basis recovery rule for QCDs.** If the IRA owner has any "basis" (after-tax money; also called "investment in the contract") in any of his IRA accounts, then the requirement that QCDs must be all pretax money could pose a problem. Under the rule nicknamed the "cream-in-the-coffee rule" of § 72 (see ¶ 2.2.08(A) of *Life and Death Planning for Retirement Benefits*), any distribution from an IRA normally carries out proportionate amounts of the pre- and after-tax money in the individual's IRAs (with all of his traditional IRAs being treated as single account for purposes of determining the proportions). If the cream-in-the-coffee rule applied to QCDs, an individual who had any after-tax money in his IRA(s) could never make a QCD. Accordingly, QCDs are one of the few exceptions to the cream-in-the-coffee rule:

To accommodate the entirely-includible-in-income requirement, there is a special "basis recovery rule" in the Code for QCDs: QCDs are deemed to come out of the IRA's pretax money first. § 408(d)(8)(D).

Note: A state's "basis recovery rule" for IRA distributions may or may not accommodate this special federal rule for QCDs. The client and preparer must determine the client's income tax basis both before and after the QCD, for both federal and (if applicable) state purposes.

C. **What happens if you "roll over" a QCD?** An IRA distribution is generally included in the recipient's gross income. § 408(d). This general rule does not apply to a distribution that is "rolled over" into the same or another IRA (or other eligible retirement plan) within 60 days after its distribution. § 408(d)(3)(A). Suppose Charlie, who is over age 70½, causes $100,000 to be transferred from his IRA to a public charity in a transfer that is intended to qualify as a QCD. Less than 60 days later Charlie deposits $100,000 back into his IRA from his taxable account (assume he has made no other IRA-to-IRA rollovers within the preceding 12 months). Because of this rollover, the original IRA distribution is now not includible in his gross income...which means it no longer qualifies as a QCD (since it is not a distribution that would have been includible in his income). The effect of making a nonqualifying QCD is that the amount transferred from the IRA to the charity is to be treated as taxable distribution followed by an itemized deduction, according to Notice 2007-7, Section IX, A-43.

Why would Charlie do this? Perhaps because at the time he made the QCD in early 2020 he intended it to satisfy his RMD requirement for the year. However, subsequently when RMDs were "suspended" for the year 2020 by the CARES Act, he decided he would be better off taking an itemized deduction for those charitable gifts. The IRS has not commented on this strategy for "erasing" a previously-distributed QCD.

D. **Limitation on the income exclusion!** Beginning with the year 2020, there is an exception to the income exclusion otherwise granted for QCDs. If an individual who is over age 70½ has made a tax-deductible IRA contribution, the income exclusion for his/her QCDs will be reduced dollar for dollar by the amount of the tax-deductible IRA contribution.

From the inception of IRAs in 1974 (year ERISA was passed, the law that among many other things created IRAs), an individual could not contribute to a traditional IRA in or after the year in which he/she reached age 70½. See § 219(d)(1) as it existed prior to 2020. Traditional IRAs were the only type of retirement plan that had an age cap on contributions. § 107(a) of the SECURE Act repealed § 219(d)(1). Starting in 2020, any worker can contribute to a traditional IRA regardless of age.

SECURE made a slight change in the QCD rules to avoid potential game-playing due to elimination of the age cap on IRA contributions. An individual's IRA contributions may or may not be tax deductible depending on such individual's gross income and participation in employer retirement plans (or on the income and plan participation of the individual and his or her spouse); see § 219 for details. With removal of the age cap on IRA contributions, an individual could (without the following SECURE-imposed change) make a tax-deductible IRA contribution and an income-excludable QCD with the same dollars. SECURE prevents this "double dipping" by modifying the income exclusion for QCDs.

A QCD is normally excludable from the IRA owner's gross income up to a maximum of $100,000 per year. SECURE reduces the individual's permitted exclusion by the amount of post-age-70½-year deductible IRA contributions. See § 408(d)(8)(A), as amended by SECURE effective for years after 2019:

> "The amount of distributions not includible in gross income by reason of the preceding sentence for a taxable year (determined without regard to this sentence) shall be reduced (but not below zero) by an amount equal to the excess of—
>
> > "(i) the aggregate amount of deductions allowed to the taxpayer under section 219 for all taxable years ending on or after the date the taxpayer attains age 70½, over
> >
> > "(ii) the aggregate amount of reductions under this sentence for all taxable years preceding the current taxable year."

The new income exclusion amount for a QCD therefore is: The individual's total QCDs for the year (up to a maximum of $100,000), minus "the aggregate amount of deductions allowed to the taxpayer under section 219 for all taxable years ending on or after the date the taxpayer attains age 70½." Once a deductible IRA contribution has been used by the Tax Code to offset/reduce the QCD income exclusion, it expires for that use and won't affect future QCDs.

Note: Contributions to a SEP-IRA (see § 408(k)) will NOT have this effect of reducing the QCD income exclusion cap. SEP-IRA contributions are deductible under § 404(h), not § 219.

Martin Example: In 2020, Martin, who is single, turns age 70½ and has compensation income of $50,000. He is not a participant in any employer retirement plan. He makes a tax-deductible contribution of $7,000 to his traditional IRA for 2020. In the same year, after his age 70½ "birthday," he transfers $100,000 (maximum QCD amount) from one of his traditional IRAs to his favorite charity. Only $93,000 of the contribution is excludable from his 2020 income. In 2021, Martin makes another traditional IRA contribution, but this one is not tax-deductible due to his new high-paying job and participation in an employer retirement plan. He again makes a $100,000 QCD. Because the SECURE-added limitation applied to him in 2020, and penalized him in 2020 to the full extent of his $7,000 tax deductible 2020 IRA contribution, his 2021 $100,000 QCD is fully excludable from his 2021 gross income.

Dorothy Example: In 2020, Dorothy, who is single, turns age 70½ and has compensation income of $60,000. She is not a participant in any employer retirement plan. She makes a tax-deductible contribution of $7,000 to her traditional IRA for 2020. In the same year, after her age 70½ "birthday," she transfers $30,000 from one of her traditional IRAs to her favorite charity. Her 2020 income-excludable QCD amount is only $23,000: Total QCD ($30,000) reduced by tax-deductible IRA contribution ($7,000). $7,000 of her QCD will be includible in her 2020 gross income.

Louise Example: In 2020, Louise, who is single, turns age 70½ and has compensation income of $60,000. She is not a participant in any employer retirement plan. She owns a substantial IRA. She makes a tax-deductible contribution of $7,000 to her traditional IRA for 2020. She makes no QCDs in 2020 or 2021 and no further traditional IRA contributions at all, ever. In 2022, the RMD from her IRA is $75,000. She satisfies this RMD by transferring $75,000 from her IRA to her favorite charities via QCDs. Unfortunately for her, SECURE "remembers" the $7,000 tax deduction she took in 2020 for a post-age-70½ IRA contribution. Accordingly, only $68,000 ($75,000 minus $7,000) of her 2022 QCD is excludable from her income. $7,000 of her normally-income-tax-free QCD is includible in her gross income. Once she has paid that debt to society, her future QCDs will be totally income-excludable (up to $100,000 per year) provided she is a good girl and does not make any more tax deductible IRA contributions.

7.6.08 ***How to do a QCD; how to report it***

To effect a QCD, the IRA owner directs the IRA provider to transfer funds from the IRA to the charity. One acceptable procedure is for the IRA provider to cut a check payable to the charity, send the check to the IRA owner-donor, and have the donor physically deliver the check to the charity. Notice 2007-7, A-41.

Another approach is available for a "checkbook IRA": Some IRA providers furnish the IRA owner (any IRA owner, or in some cases only IRA owners over a certain age) with a checkbook, whereby the IRA owner can write his/her own check(s) to the charity(ies), without having to file check requests with the IRA provider. This is certainly a simpler and more convenient way to make QCDs. One financial advisor (Bryce Schintzius, CFP), however, does not embrace the checkbook IRA; he points out that making IRA transactions "easy" for the IRA owner increases the risk of mistakes. He cites a client who blithely wrote QCD checks on her "checkbook" SEP-IRA account, overlooking the ban on QCDs from such accounts (¶ 7.6.03).

QCDs are allowed only for direct transfers from the IRA to a charitable recipient of a permitted type. If the money is first distributed to the individual, then donated to charity, it is not a QCD, and all the usual limits and drawbacks described at ¶ 7.7.01 will apply (there was an exception to this for certain charitable transfers in January 2013).

If the QCD is $250 or more, the IRA owner-donor must obtain from the charity a contemporaneous receipt that meets the requirements of § 170(f)(8). See Reg. § 1.170A-13 for these requirements (one of which is the charity must state that "no goods or services were provided" in exchange for the gift; ¶ 7.6.06). If this receipt is not obtained the gift is not a valid QCD and will be treated as an ordinary distribution to the IRA owner—even if the gift was in fact made to the charity and nothing was received in exchange for it.

The IRA custodian reports the QCD on Form 1099-R, just as if it had paid the distribution to the individual rather than to a charity. There is no special coding or other indication on Form 1099-R signaling that the distribution is a QCD. Thus, nothing in the 1099-R will reveal that the distribution is nontaxable! As the IRS put it in the Instructions for IRS Form 1099-R (2019), p. 1, "There's no special reporting" that IRA providers have to do for QCDs.

Instead, it's up to the IRA owner to report the nontaxable status. See Instructions for IRS Form 1040, 2018, line 4.

*7.6.09 **Advantages, planning uses, and pitfalls of the QCD***

The QCD will not save anyone millions of dollars, but it is nevertheless a safe legal somewhat tax-favored way for an over-age-70½ client to use his IRA to benefit charity— a low-tax way to fulfill the minimum distribution requirement for the charitably inclined client.

A. **Advantages of the QCD.** The QCD eliminates *some* of the problems that arise when making lifetime charitable gifts funded by IRA distributions (see ¶ 7.7.01). A QCD does not increase AGI and therefore does not: increase the individual's adjusted gross income for purposes of determining eligibility to contribute to a Roth IRA (§ 408A(c)(3)) or the extent to which his "net investment income" will be taxed (§ 1411); decrease the deductibility of medical expenses (§ 213(a), (f)); increase the taxability of Social Security benefits (§ 86); increase Medicare premiums (42 U.S. Code §1395r(i)); or increase state income taxes (in a state that uses federal AGI as the basis for computing state income tax but does not allow a charitable deduction). Since there is no itemized charitable deduction for the QCD gift, the gift does not "count" for purposes of the percentage-of-income limits on charitable deductions in § 170(b). Also, the QCD is in effect "deductible" even for someone who does not itemize deductions; the substantial increase in the standard deduction, and limitation on the deduction for state and local taxes, as a result of the TCJA 2017 will increase the attraction of QCDs for some individuals as more will now use the standard deduction.

B. **Use QCD to fulfill RMD.** A QCD will count as a distribution for purposes of determining whether an individual has fulfilled the RMD requirement. Notice 2007-7, A-42.

C. **Confusing QCDs and RMDs.** Someone who has already taken his RMD for a particular year cannot use a QCD later in the year to fulfill his RMD for that year; he cannot roll the already-taken RMD back into the IRA (to enable him to use a QCD instead) because RMDs are not eligible rollover distributions. He can still make a QCD from his IRA; it just will not be his RMD. People will get confused about the RMD/QCD relationship. The two things have nothing to do with each other (other than the fact that a QCD counts towards the RMD, to the extent the RMD has not already been taken).

D. **Using QCD to fulfill charitable pledge.** A QCD is considered a payment to the participant for purposes of the prohibited transaction rules. Thus, it is not a prohibited transaction even if it is used to fulfill a pledge to the charity. Notice 2007-7, A-44.

E. **When a QCD may not be best.** While it might appear desirable for an over-age 70½ individual to use QCDs to fund all of his charitable contributions, there will be practical limits on this—for one thing it is a cumbersome way to make small donations (unless the "checkbook IRA" is used—see ¶ 7.6.08). Also, an IRA owner who wants to give more to charity than just the amount of his RMD should determine whether another form of charitable gift would be more advantageous for such additional gifts (such as gifts of appreciated stock from a taxable account).

7.7 Other Lifetime Gifts of Retirement Benefits

This ¶ 7.7 discusses lifetime charitable giving options for individuals who have money in IRAs and other retirement plans. Most of the considerations discussed here apply to both living participants and beneficiaries (with respect to inherited benefits they hold).

7.7.01 ***Lifetime gifts from distributions***

A client who has more money in his retirement plan than he expects to need may wish to give some of it to charity. Generally, the only way he can do this is to first withdraw funds from the plan and then give the funds to the charity. For the exception to this general rule, see "Qualified Charitable Distributions" (¶ 7.6).

Withdrawing funds or other assets from a retirement plan generally causes the value of the withdrawn property to be included in the recipient's income. If the recipient then, in the same year, donates the withdrawn amounts to charity, it seems as though the income tax charitable deduction should eliminate the income tax on the retirement plan distribution. Unfortunately the following obstacles often prevent the income tax charitable deduction from wiping out the tax cost of the retirement plan distribution:

A. **Percent-of-income limit.** The income tax deduction for charitable contributions is limited (in most years) to a certain percentage (depending on the type of property given and the type of recipient charity) of the individual's gross income. § 170(b). If the person's donations exceed the deduction limit, the excess can be carried forward for a limited number of years. § 170(d).

B. **Reduction of itemized deductions.** Charitable deductions are itemized deductions, subject to the "reduction of itemized deductions" that applied or will apply to high-income individual taxpayers in certain years, though this tax section (§ 68) does not apply in the years 2018–2025.

C. **Personal exemption phaseout.** The personal exemption deduction is phased out under § 151(d) for high-income taxpayers, though not in the years 2018–2025. A retirement plan distribution, by increasing AGI, could cause loss of some or all of the taxpayer's personal exemption in such years. The charitable contribution does not offset this.

D. **Deduction decreases taxable income but not AGI.** Because the distribution is included in the individual's gross income, it may increase his taxes or costs in indirect ways not offset by the charitable deduction, because the distribution increases his adjusted gross income (AGI) and the charitable deduction does not decrease AGI. For example, the plan distribution could decrease his medical expense deduction (§ 213(f)); increase his Medicare premiums; or increase the taxability of his Social Security benefits (§ 86).

E. **Split-interest gifts are only partially deductible.** If the gift is made to a charitable remainder or lead trust, to a pooled income fund, or in the form of a charitable gift annuity, the amount of the deduction is only part of the total gift (since a portion of the gift is benefitting individuals), even though all of the plan distribution was includible in income.

F. **Penalty for pre-age 59½ distributions.** If the participant is under age 59½ at the time of the distribution, there is a 10 percent additional tax on the distribution unless an exception applies. § 72(t). The charitable deduction has no effect on this penalty. See ¶ 7.7.03 for a lifetime charitable giving strategy for under-age-59½ individuals.

G. **State income taxes.** In a state that allows no charitable deduction in computing its income tax, the participant would pay state tax on the distribution but get no offsetting deduction.

H. **Nonitemizers.** An individual who uses the "standard deduction" rather than itemizing his deductions would see no income tax benefit from the charitable contribution.

I. **Extra tax on net investment income.** An IRA distribution will normally increase the recipient's gross income for purposes of determining how much of his investment income is subject to the 3.8% net investment income tax (NIIT; § 1411), but an itemized charitable deduction will not reduce it.

In some cases QCDs can be used to avoid some of these drawbacks; see ¶ 7.6. Also, certain retirement plan distributions (¶ 7.7.04–¶ 7.7.06) are not subject to full normal income tax, and so may offer an opportunity for tax-effective charitable giving.

*7.7.02 **Give your RMD to charity***

A retirement plan participant generally must start taking required minimum distributions (RMDs) annually from his IRAs and other plans after age 70½ (or after later retirement in some cases). § 408(a)(6). If the participant does not need his RMDs for other purposes, this would be an appropriate source of charitable gifts. The first $100,000 of the RMD can be satisfied using QCDs (¶ 7.6). If the RMD exceeds the QCD limit of $100,000, the participant can simply take the excess as a regular distribution then donate it to charity. The drawbacks listed at ¶ 7.7.01 still apply, but since he has to take the unneeded RMD anyway, he might as well give it to charity; and in most cases he will receive *some* income tax benefit from the charitable gift.

A beneficiary who has inherited a retirement plan is also generally required to take annual RMDs from the plan. If a beneficiary does not need the distributions from an inherited retirement plan, he might consider giving them to charity. Ideally, the participant should have left the benefits directly to charity in the first place, rather than leaving them to a rich beneficiary who does not want them. However, if that did not happen, and the beneficiary is receiving a stream of unwanted RMDs, the beneficiary could reduce his income tax liability by giving the distributions to his favorite charity as he receives them. This approach is especially appropriate for a younger wealthy donor, who generally cannot take distributions from his *own* retirement plan without paying a 10 percent penalty; the penalty does not apply to distributions from an inherited plan. § 72(t)(2)(A)(ii).

If the beneficiary is over age 70½, the first $100,000 of the RMD can be satisfied with a QCD (see ¶ 7.6).

If the participant's estate was subject to federal estate taxes, the beneficiary is entitled to an income tax deduction (the "IRD deduction") as he takes distributions from the inherited plan, for the estate taxes attributable to that plan. See § 691(c). By giving the distribution to charity, he gets both deductions, though neither deduction would be available for gifts made using a QCD.

*7.7.03 **Gifts from a pre-age 59½ "SOSEPP"***

A 10 percent additional tax generally applies to retirement plan distributions taken before reaching age 59½. § 72(t). A young individual who wanted to give some of his retirement benefits to charity would be discouraged from doing so by this penalty. This penalty does not apply to death benefits (§ 72(t)(2)(A)(ii)), so it affects only participants, not beneficiaries.

One exception to this penalty is well suited for fulfilling a pledge of annual gifts to a charity. It is called the "series of substantially equal periodic payments" (SOSEPP). § 72(t)(2)(A)(iv). The series must meet extensive IRS requirements; see ¶ 9.2–¶ 9.3 of *Life and Death Planning for Retirement Benefits*.

*7.7.04 **Gift of NUA stock***

The Code gives special treatment to distributions of employer stock from a qualified plan. Any increase in value of such stock, occurring while the stock is in the plan, over the plan's "cost basis" in the stock is called "net unrealized appreciation" (NUA). Under certain circumstances, NUA is not taxed at the time of the distribution; rather, taxation is postponed until the stock is later sold. § 402(e)(4).

According to PLRs 1999-19039, 2000-38050, and 2002-15032, a retired employee who holds stock with not-yet-taxed NUA has the same options that other individuals owning appreciated stock have when they wish to diversify their investments and/or increase the income from their portfolios: Either sell the stock, pay the capital gain tax, and reinvest the net proceeds; or, contribute the stock to a Charitable Remainder Trust (¶ 7.5.04) reserving a life income, thus avoiding the capital gain tax and generating an income tax deduction besides.

7.7.05 ***Gift of other low-tax lump sum distribution***

"NUA" is not the only special tax deal available for qualifying lump sum distributions (LSDs). An LSD to a participant who was born before January 2, 1936 (or to the beneficiaries of such a participant) qualifies for a special tax treatment under which the distribution is excluded from the recipient's gross income and taxed under a separate rate schedule. This schedule would typically produce a lower-than-normal tax on LSDs up to a few hundred thousand dollars. See ¶ 2.4.06 of *Life and Death Planning for Retirement Benefits*.

The special tax treatment for LSDs has a mixed effect on charitable giving. The effect may be favorable: Since the LSD is excluded from the recipient's gross income, the recipient may be able to pay the low LSD rate on the distribution, give the distribution to charity, and deduct the gift from his other income, thus saving taxes at his regular income tax rate. Or the effect may be unfavorable: If the distribution is large enough, excluding it from gross income may cause a large charitable gift to exceed the percentage-of-AGI limits on charitable deductions (§ 170).

7.7.06 ***Give ESOP qualified replacement property to CRT***

The Code allows a business owner, if various requirements are met, to sell stock of his company to an "employee stock ownership plan" (ESOP), then reinvest the proceeds in marketable securities ("qualified replacement property"), without paying income tax on the sale. § 1042. The untaxed gain carries over to the qualified replacement property and the capital gain tax thus deferred will be paid when the taxpayer "disposes of" the qualified replacement property.

A disposition of the qualified replacement property "by gift" does not trigger this recapture provision, but since the Code doesn't define "gift," there is some question whether transferring qualified replacement property to a Charitable Remainder Trust (which is not 100% a gift if the donor retains an income interest) is considered a gift for this purpose. One PLR, No. 9732023, in limited and ambiguous language, answered this question favorably to the taxpayer, concluding that "the contribution of the qualified replacement property to the charitable remainder unitrust will not cause a recapture of the gain deferred by the Taxpayers under section 1042(a)...."

Appendix A
IRD and the "Separate Share Rule"

This excerpt from Chapter 6 of *Life and Death Planning for Retirement Benefits* (8th ed. 2019) is included to explain how the "separate share rule" applies to the allocation of a trust's "distributable net income" (DNI; § 663) among the various trust beneficiaries. Although there is no "DNI deduction" (§ 691(c)) for a trust's distributions to a charity, this separate share rule is nevertheless applicable in determining how much of a trust's DNI is "allocable" to the charity's share and therefore (once so allocated) available to be tested for deductibility under § 642(c) (see ¶ 7.4.03 of this Outline).

6.5.05 ***IRD and the separate share rule***

So far we have spoken of the trustee's receiving a retirement plan distribution, including it in the trust's gross income, then paying it out to the trust beneficiary and taking a DNI deduction. This simple pattern becomes more complex if the "separate share rule" of § 663(c) applies. Under this rule, "in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts."

When the separate share rule applies, if a fiduciary distributes money to a beneficiary, that distribution will carry out DNI only to the extent there is DNI that is properly allocable to that particular beneficiary's "separate share."

The separate share regulations have the following special rule regarding the allocation of IRD that is "corpus" (principal) for trust accounting purposes: "(3) Income in respect of a decedent. This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not…[trust accounting income]. Such gross income is allocated *among the separate shares that could potentially be funded with these amounts*.... based on the relative value of each share that could potentially be funded with such amounts." Reg. § 1.663(c)-2(b)(3). Emphasis added.

Here's how the separate share rule would apply to a retirement plan distribution that is corpus for trust accounting purposes:

Jody Example: Jody dies in Year 1, leaving his $1 million IRA and $2 million of other assets to a trust. At Jody's death, the trust is to be divided into two equal shares, one for each of Jody's children Brad and Angelina, so each child is to receive a total of $1.5 million. Each child's share is to be distributed outright to the child. In Year 1, the IRA administrator sends the trustee a check for the entire IRA balance of $1 million, creating $1 million of gross income to the trust. The trustee immediately distributes the $1 million it received from the IRA to Angelina in partial fulfillment of her 50 percent share. The trust has no other income, and makes no other distributions, in Year 1. What is the trust's DNI deduction for the distribution to Angelina?

Step 1: Does the separate share rule apply? The separate share rule applies here because distributions to Jody's children must be made "in substantially the same manner as if separate trusts had been created" for them. Reg. § 1.663(c)-3(a). If this had been a "spray" trust, with the trustee having discretion to pay income and/or principal of the entire fund to either child at any time (instead of having to give each child an equal amount) the separate share rule would not apply.

Step 2: Is the plan distribution corpus? The regulation next requires that we determine whether the IRA distribution is "corpus" for trust accounting purposes. Assume that it is; see ¶ 6.1.02.

Step 3: Does the trust instrument or state law dictate to which share(s) this plan distribution shall be allocated? If either the instrument or law mandates that the IRA be allocated to a particular share, that allocation will be followed for purposes of allocating the resulting DNI among the separate shares. To carry out Step 3, therefore, we must look at the terms of Jody's particular trust and/or state law:

Allocation Respected Despite No Economic Effect

A trust instrument's allocation of a retirement account or its proceeds to a particular share is given effect for income tax purposes even if such allocation has no independent economic effect. Contrast allocations of a "class" of income, ¶ 7.4.03(E).

<u>Scenario 1</u>: If Jody's trust *required* the trustee to allocate the IRA to Angelina's share, then all the income arising from the IRA distribution is allocated to Angelina's "separate share" and the $1 million cash distribution from the trust carries out $1 million of DNI to Angelina. Reg. § 1.663(c)-5, Example 9.

<u>Scenario 2</u>: Alternatively, if Jody's trust (or applicable state law) requires that each beneficiary receive an pro rata share of each asset, the separate share rule will require that the DNI resulting from the retirement plan distribution be allocated equally to Brad's and Angelina's shares. Under Scenario 2, even though the trust distributed $1 million to Angelina, the trust's income tax deduction is only $500,000, and Angelina includes only that much in her gross income for Year 1. The trust will have taxable income of $500,000 for Year 1. This is the fair result the separate share rule was designed to bring about: Under a trust where the beneficiaries "own" fractional shares, no one beneficiary bears a disproportionate share of income tax just because he happened to receive more distributions in a particular year.

6.5.06 ***IRD, separate shares, and discretionary funding***

<u>Scenario 3</u>: Continuing the Jody Example from ¶ 6.5.05, suppose Jody's trust provides that "The Trustee shall not be obligated to allocate each asset equally to the two shares, but rather may allocate different assets to each child's share, provided that the total amount allocated to each child's share is equal." The trust thus authorizes discretionary pick-and-choose (non-pro rata) funding. The trustee has exercised its authority to choose which assets to use to fund each beneficiary's share: The

trustee, in proper exercise of its discretion, allocated the entire $1 million IRA distribution to Angelina's share. Does this enable the trustee to deduct the entire distribution as DNI?

Probably not. Though other interpretations are possible, the usual interpretation of the regulation is that, since the trustee *could* have elected to fund either beneficiary's share of the trust with the IRD, the trustee *must* (in computing its taxable income and DNI) allocate the IRD equally to the two shares. Under this interpretation, discretionary pick-and-choose funding generally produces the same result as mandatory pro rata funding (see exceptions below).

If the trustee of a trust that (1) is subject to the separate share rule and (2) permits discretionary pick-and-choose funding wants the gross income arising from a retirement plan to be allocated disproportionately, there are two ways to avoid the separate share rule and its apparently-mandatory pro rata allocation of IRD-corpus, assuming use of such techniques is consistent with state law and the fiduciary's obligations to all trust beneficiaries:

- **Transfer the IRA itself, rather than a distribution.** In the Jody Example, the trustee could transfer the IRA itself to Angelina, rather than withdrawing money from the IRA and distributing the money to Angelina. [See Appendix B.] Such a transfer generates no gross income at the trust level and accordingly the separate share rule for allocation of DNI never comes into play. The problem of Reg. § 1.663(c)-2(b)(3) is avoided.

- **Fund other shares first.** If the trustee wants to allocate a particular IRD-corpus item to one beneficiary's share, the trustee can distribute all the *other* assets first, fully funding all the other beneficiaries' shares before the year in which he withdraws funds from the plan. Then he is left with only one asset, the retirement plan, which he cashes out in the later year. This cash can only be used to fund one beneficiary's share (because all other beneficiaries have received their shares in full in previous years), so the distribution carries out all the DNI.

Appendix B
How to Transfer an IRA out of a Trust or Estate

The following is excerpted from ¶ 6.1.05 of *Life and Death Planning for Retirement Benefits* (8th ed. 2019).

When a trust terminates, the trustee generally can transfer, intact, to the residuary beneficiaries of the trust, any IRA or Roth IRA then held by the trust. The same applies to the participant's estate (if the IRA passes to the estate as either named or default beneficiary), and to the estate of a beneficiary who dies prior to withdrawing all the assets from an inherited IRA: The estate can transfer the IRA to the estate's beneficiaries.

The "transfer" of an IRA is normally effected in the following manner: We start with an inherited IRA titled "[name of decedent], payable to [name of trust or estate] as beneficiary," or "[name of trust or estate], as beneficiary of [name of decedent]." The beneficiary to whom the account is to be transferred opens an inherited IRA titled "[name of beneficiary], as beneficiary [or "as successor beneficiary"] of [name of decedent]." At the direction of the trustee (or executor), the assets in the trust- (or estate-) held IRA are transferred to the inherited IRA opened by the beneficiary.

This ¶ 6.1.05 explains the *legal basis* under which such transfers are permitted, and also discusses transfers of other types of retirement benefits. See ¶ 6.5.07–¶ 6.5.08 of *Life and Death Planning for Retirement Benefits* for the *federal income tax effects* of such a transfer; generally, such transfers are nontaxable events if the transfer is to a specific or residuary beneficiary. The IRS position is that the transfer is treated as a "sale" of the transferred account if made in fulfillment of a pecuniary gift.

A. Transferability of IRA. An IRA is transferable. The owner of an IRA (whether such owner is the participant or the beneficiary of the account) can transfer the ownership of the account to another person or entity. Nothing in § 408 (the statute that authorizes IRAs) prohibits transferring an IRA; on the contrary, the Code recognizes that IRAs can be assigned, since it discusses transfer of an IRA in connection with divorce (§ 408(d)(6)) and pledging the account as security for a loan (§ 408(e)(4)). The question is not whether the account can be transferred; the question is whether such transfer will be a taxable event. See, *e.g.*, CCA 2006-44020, in which the IRS ruled that a trust's transfer of an IRA in fulfillment of a pecuniary bequest conferred an immediate economic benefit on the trust and was accordingly taxable; the Chief Counsel Advice did not say the transfer itself was unlawful in any way.

Numerous PLRs have recognized these principles. The PLRs take it for granted that the benefits can be transferred, intact, out of an estate or trust, and address only the income tax consequences of such transfers; see "C" below. For an opposing viewpoint, see "D."

A trust can make such a transfer to its beneficiaries regardless of whether the trust qualifies as a "see-through trust" for minimum distribution purposes. An estate can make such a transfer even though an estate can never qualify as a "Designated Beneficiary" for minimum distribution purposes.

The transfer of an inherited retirement plan or IRA from a trust or estate to the beneficiary(ies) of the trust or estate is solely for the purpose of allowing the trust or estate to terminate its own existence, or otherwise cease to have control of the benefits. Such a transfer generally has no effect on the Applicable Distribution Period [see ¶ 1.2.01[3] of *Life and Death Planning for Retirement Benefits* for explanation of this minimum-distribution term] for the benefits. The exception: Transferring the account out to individual beneficiary(ies) prior to the Beneficiary Finalization Date could change the ADP [see ¶ 7.3.02 of this Outline].

B. Examples of fiduciary transfers of inherited retirement plans. Here are some common examples of situations in which such transfers are called for: [omitted]

C. PLRs approving these transfers. Many letter rulings have approved the transfer of an inherited IRA from the trust named as beneficiary of the IRA to the individual trust beneficiaries, including the rulings listed here; see also ¶ 3.2.09 of *Life and Death Planning for Retirement Benefits* regarding payment of benefits to a *surviving spouse*, through a trust or estate named as beneficiary, to facilitate a spousal rollover.

PLR 2001-31033 (Rulings 5, 6, and 7) is typical. This ruling allowed the transfer of "IRA Y" from a terminating trust to the participant's children, C and D. From the ruling: "The provision of Trust X which provides for its termination does not change either the identity of the individuals who will receive the IRA Y proceeds or the identity of the designated beneficiary of IRA Y.... Furthermore, the Trust X termination language which results in distributions from IRA Y being made directly to Taxpayers C and D instead of initially to Trust X and then to Taxpayers C and D was language in Trust X approved by [the participant] during his lifetime which reflects [the participant's] intent to pay his children directly instead of through Trust X."

Note: In many of the rulings listed here the parties could have avoided the need for any transfer or obtaining a PLR by simply naming the intended beneficiaries directly on the beneficiary designation form rather than naming them through a trust.

Other rulings approving the transfer of an inherited IRA from a trust to the individual trust beneficiaries (without requiring termination of the IRA or otherwise triggering immediate income tax) are: PLRs 2000-13041, 2001-09051; 2003-29048 (IRA payable to a trust divided into four "sub-IRAs," each to be held by one of the individual trust beneficiaries); 2004-33019; 2004-44033–2004-44034; 2004-49040–2004-49042; 2007-40018; 2007-50019; 2008-03002; 2010-38019; 2012-10045; and 2012-10047 (discussed at ¶ 6.5.07(A)). Regarding transfer of an inherited IRA to *charitable* residuary beneficiaries, see 2005-26010, 2006-52028, and 2008-26028.

In PLR 2010-13033, an IRA was payable to an estate; the IRS permitted transfer of the IRA from the estate to the "pourover" trust that was beneficiary of the estate, and thence to the trust's beneficiaries. For more PLRs allowing transfer of an IRA from an estate to the estate's beneficiaries, see PLRs 2011-28036, ¶ 6.5.07(B).

For transfer of IRAs (as well as 403(b) plans) from an estate to *charitable* residuary beneficiaries, see PLR 2002-34019.

For rulings permitting Beneficiary IRAs to be opened directly in the name of the individual trust or estate beneficiaries (rather than first in the name of the trust or estate), where the IRA was payable to a trust or estate that was to terminate immediately upon the participant's death and be distributed outright to the individual beneficiaries, see PLRs 2005-38030, -38031, -38033, and -38034 (trust), and 2008-50058 and 2012-08039 (estate).

D. Legal authority for such transfers. As the preceding sections show, there are many private letter rulings discussing and approving the transfer of an inherited retirement account out of the decedent's estate or trust to the beneficiaries of the estate or trust. Unfortunately, a PLR cannot be relied on or cited (by someone other than the person who obtained it) as a binding legal precedent. § 6110(k)(3).

The PLRs cited in this ¶ 6.1.05 cite (as their legal "authority") Rev. Rul. 78-406, 1978-2 CB 157, which ruled that an IRA-to-IRA transfer is not a "distribution" and accordingly does not have to meet the requirements applicable to a "rollover." However, Rev. Rul. 78-406 did not deal with transferring an *inherited* IRA, let alone transferring it from a terminating trust (or estate) to the trust (or estate) beneficiaries. It dealt with a transfer from one IRA to another IRA in the same name (the participant's), which is not quite the same as a transfer from an IRA in the name of a trust as beneficiary to an IRA in the name of an individual or charity as successor beneficiary. Thus, to date, PLRs are still the only directly-on-point "authority" we have for IRS acquiescence in the transfer of an IRA out of a trust or estate.

However, even though a PLR does not rise to the level of binding precedent, it has some legal weight. For example, a PLR can serve as "substantial authority" for a position taken on a tax return for purposes of avoiding the penalty for substantial understatement of income (§ 6662(d)(2)(B)(i)), unless the PLR has been "revoked or...[is] inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin." Reg. § 1.6662-4(d)(3)(iii).

Furthermore, the Supreme Court has held that the IRS can be bound by a position it has taken consistently in numerous PLRs. *Hanover Bank*, 369 U.S. 672 (1962). See, e.g., *Trimmer*, 148 T.C. 14 (2017) in which the Tax Court held that the taxpayer was entitled to receive from the IRS a hardship waiver of the 60-day rollover deadline (¶ 2.7.05), based on the IRS's previously issued PLRs granting such waivers to other taxpayers similarly situated.

E. IRA providers and plan administrators. Some IRA providers readily permit these transfers, upon proper instructions from the fiduciary plus (in some cases) an opinion of counsel. However, some IRA providers do not allow these transfers.

A fiduciary faced with an IRA provider's refusal to allow transfer of an inherited IRA from a trust or estate to the trust or estate beneficiaries has four choices: #1. Cash out the IRA and give up further deferral. #2. Keep the trust or estate open until the end of the ADP, to preserve continued deferral of distributions, but at the cost of ongoing administration expenses. #3. Get an IRS ruling, if that will convince the IRA provider to allow the transfer. #4. Move the account (still in the name of the estate or trust), by means of an IRA-to-IRA transfer to a more cooperative financial institution, and *then* transfer it to the beneficiaries. Since options #1–#3 involve substantially increased taxes or costs, #4 is encouraged.

F. **Transferability of non-IRA plans.** Theoretically non-IRA plans, such as QRPs, can be transferred out of a trust or estate to the trust or estate beneficiaries just as IRAs can be, but such transfers appear rarely if at all in PLRs. Regarding transfer of *nonqualified annuities* to charitable residuary beneficiaries, see PLRs 2006-18023 (from an estate) and 2008-03002 (from a trust). For transfer of 403(b) plans from an estate to charitable residuary beneficiaries, see PLR 2002-34019.

A qualified retirement plan benefit generally "may not be assigned or alienated" (§ 401(a)(13)(A)); this is called ERISA's "anti-alienation rule." The rule is intended to prevent assignment (voluntary or involuntary) of retirement plan benefits to creditors of the participant or beneficiary, or any attempt to borrow against or sell the benefits. The anti-alienation rule has no bearing on the disposition of the benefits at the death of the participant (when the benefits are "assigned" to the beneficiary), or at the subsequent death of the beneficiary (which, again, causes the benefits to be "transferred" to someone else) or upon the termination of the existence of the beneficiary (in the case of an estate or trust which is closing). Transfers of benefits out of a trust or estate to the trust or estate beneficiary(ies) are transfers *to* the participant's beneficiary, not transfers *away* from the beneficiary.