Giving Through Retirement Plans for Advisors

Any funds withdrawn during life from an IRA or other tax-favored retirement plan (other than Roth IRAs) will normally be subject to income tax. If the funds are then donated for charitable use, there is an offsetting charitable income tax deduction and, when properly structured, the transaction can be a wash for tax purposes. Careful consideration should be given to limitations of deductions based on adjusted gross income and any other provisions of the Internal Revenue Code (IRC) that may act to reduce the amount of deductions in certain circumstances. The impact of state law should also be considered.

In years when individuals are facing requirements to withdraw minimum funds from an IRA or other tax-favored retirement account in excess of what they currently need to fund living expenses, they may consider making special gifts to fulfill charitable commitments utilizing the withdrawal amounts.

If they have highly appreciated securities, they may wish to use those assets to fund their gifts, while using cash from the withdrawal to make new investments at a higher cost basis for tax purposes.

As part of the Pension Protection Act of 2006 (PPA), Congress enacted a number of charitable giving incentives and reforms. Insofar as gifts from retirement accounts are concerned, the PPA made an exception to the law outlined above and provided in section 408(d)(8) that individuals aged 70½ or older could direct that a total of up to $100,000 per year be distributed from their traditional or Roth IRA directly to an organization described in section 170(b) (1) (A) (other than an organization described in section 509(a)(3)) or a donor-advised fund (as defined in section 4966(d)(2)).

The exception applied only to distributions completed in 2006 and 2007. In October 2008, in conjunction with the Emergency Economic Stabilization Act of 2008, Congress passed the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which extended the PPA charitable IRA provisions to cover gifts completed in 2008 and 2009. In December 2010, Congress further extended these benefits for gifts made before the end of 2011 as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

The Taxpayer Relief Act of 2012 again extended the PPA charitable IRA provision through December 31, 2013 and retroactively reinstated it for 2012. The Tax Increase Prevention Act extended the provision for 2014 and it was made permanent by the Protecting Americans from Tax Hikes Act of 2015.

To qualify under the provisions of the PPA, the distribution must be made by the IRA trustee to the charitable recipient and must be otherwise fully deductible. Distributions to fund charitable gift annuities, charitable remainder trusts and other split interest gifts do not qualify, nor do gifts that feature other tangible benefits that would otherwise cause a reduction in the tax-deductible amount.

Amounts transferred in this manner are not included in a taxpayer's adjusted gross income (AGI), but are counted as part of a mandatory withdrawal. This can hold special advantages for donors who otherwise exceed 50 percent of AGI limits on their gifts or experience other adverse tax consequences that would keep the gift from being a complete wash for tax purposes.

For a complete explanation of the PPA, see the Joint Committee on Taxation explanation of H.R.4 at http://www.house.gov/jct/. See JCX-38-06 (August 3, 2006) publication.

Making testamentary gifts from retirement accounts

From a tax planning perspective, one of the most efficient ways to leave a gift to a charitable interest at death may be through a traditional Individual Retirement Account (IRA) or other qualified retirement plan.

> Simplified example: Joan, a widow, 75, plans to leave her $100,000 IRA to her granddaughter, Ellen.
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> An IRA balance as well as other qualified retirement plans may be subject to estate taxes (at an assumed rate of 40 percent) and income taxes (at an assumed rate of 39.6 percent). State income and estate taxes may also be due on these amounts.

Under these assumptions, therefore, Ellen may eventually receive less than half of the IRA balance.

Why are these funds subject to both estate and income taxes? Because qualified retirement fund balances are considered income in respect of a decedent (IRD) under Internal Revenue Code section 691 (c). (Note that section 691(c) provides for an income tax deduction for estate tax attributable to IRD.)

Joan, on the other hand, could leave the $100,000 in the IRA directly to one or more charitable interests free of all income and estate taxes. There would be no federal estate tax because of the estate tax charitable deduction and no income tax because of the charitable organization's exemption from income taxes.

If Joan wished to leave bequests to both Ellen and her charitable interest(s), it would thus be better for Ellen to receive assets other than the IRA balance, with the gift to charity through the IRA. This way, Ellen's inheritance would possibly be subject to estate tax, but not income tax. If no estate tax were due, Ellen would receive the entire $100,000.

Special considerations

Providing for charity: The term "designated beneficiary" is a technical term that primarily includes individuals. An irrevocable trust that meets certain requirements can also be a designated beneficiary. Although a charity can be a beneficiary, it cannot be a designated beneficiary. Neither can a charitable remainder trust (CRT). Nor can any of multiple beneficiaries if any one of them is a charity or a CRT.

If, however, the plan owner names both a charity (or a CRT) and an individual as beneficiaries and the distribution to the charity (or CRT) is made before the date for determining whether there is a designated beneficiary, the individual beneficiary will be considered a designated beneficiary.

Spousal rollover: If the surviving spouse of an IRA owner receives a lump-sum distribution from the IRA, the surviving spouse generally may roll the distribution over into his or her own IRA tax free within 60 days of receipt.

Rollover IRAs: If a donor leaves IRA money in a lump sum to his or her spouse, who then rolls the money over into the spouse's own IRA, it may make sense to provide for all or part of the money remaining in the rollover IRA at the spouse's death to go to charity.

QTIP trust: It is possible, subject to certain requirements, to make the QTIP election with respect to both an IRA and a trust named as beneficiary of the IRA. See Rev. Rul. 2000-2 and Rev. Rul. 2006-26. In this case, it may be desirable to provide that part or all of any principal remaining in the trust at the surviving spouse's death go to charity.

Rollover to charitable trusts: As of January 2013, federal tax law does not afford any means of rolling money out of an IRA or other tax-qualified retirement plan account during lifetime directly to a trust or other split-interest charitable gift without the account owner having to report the money as income for federal income tax purposes.

A charitably motivated individual, however, might want to withdraw money from his or her IRA today, place part of the money in a charitable remainder trust (or other charitable life income arrangement) to provide a retirement income, and use the remainder of the money to pay tax on the withdrawal. In this case, the charitable deduction with respect to the trust will help reduce but not eliminate the tax owed.

Designating a charitable remainder trust as beneficiary: While tax-free transfers from IRAs to trusts and other split-interest gifts are not possible during lifetime, it is possible to name a charitable remainder trust (CRT) to receive the balance of an IRA at death. In this case, the money is not subject to income tax on the transfer from the IRA to the CRT because of the CRT's tax exemption under Code section 664(c). The individual beneficiary of the CRT simply pays income tax on the distributions he or she receives from the trust.

Upon the transfer from the IRA to the CRT, an estate tax charitable deduction is allowed for the value of the remainder interest in the trust as determined under IRS regulations. When IRA assets are left at death to a CRT, a question arises: What becomes of the income tax deduction under Code section 691(c) for estate tax attributable to income in respect of a decedent (IRD)?

In Letter Ruling 199901023, the IRS said the deduction was allocated to the CRT and was used to reduce the amount of first-tier income (ordinary income) for trust income tax accounting purposes.

With increased estate tax exemptions confirmed in theAmerican Taxpayer Relief Act of 2012, planning for estate tax consequences of establishing a CRT at death have been less of a consideration for many. Several legislative proposals have been made to simplify the process of making outright and deferred gifts using retirement plan assets.

Donors and advisors should always check the latest statutes and regulations prior to completing gifts in this manner.

Other relevant rulings: In Letter Ruling 9237020, the IRS considered a proposal to leave residual IRA money at the IRA owner's death to a charitable remainder unitrust, which would make payments to the IRA owner's son for a term of 20 years and then distribute all of its assets to charity. The IRS ruled that the IRA money would not be subject to income tax as it rolled out of the IRA into the unitrust because of the trust's exemption from income taxes under IRC section 664(c). The IRS also ruled that the IRA money rolling into the unitrust would qualify under the usual rules for the federal estate tax charitable deduction. In Letter Ruling 9253055, the IRS took the same basic position with respect to a proposal to leave, at death, residual money in a corporate retirement plan account to a unitrust for the benefit of the donor/employee's spouse. This ruling stated that the spouse's interest in the unitrust would qualify for the federal estate tax marital deduction. This type of plan can make sense for the charitably motivated person who (1) wants to shield residual IRA or other retirement plan money from what may seem to be punitive estate and income taxes; (2) wants to provide an income to a family member; and (3) likes the idea of outlining the use of any remaining funds at the termination of the trust.