TRYING NOT TO RENDER UNTO CAESAR - CHARITABLE GIFTS OF RETIREMENT BENEFITS

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TRYING NOT TO RENDER UNTO CAESAR - CHARITABLE GIFTS OF RETIREMENT BENEFITS

I. INTRODUCTION.

Congress enacted the Employee Retirement Income Security Act of 1974 ("ERISA") with the express purpose of providing retirement income for the employee and the employee's spouse through the ability to create accounts from pre-tax income and then to allow such assets to accumulate tax free until the employee retired or reached an age at which minimum required distributions ("MRD") must be made from the account.[1] This purpose was aided by the creation of individual retirement accounts under §408[2] of the Internal Revenue Code of 1986. (For convenience IRAs and qualified plans may hereafter sometimes be referred to as "retirement plans.") Even though the participant is allowed to designate a beneficiary in the event of the participant's death prior to complete withdrawal of all the funds in the account, it was Congress's intent that these retirement accounts were not meant to be a vehicle for accumulation of funds for transmission to later generations.[3] Therefore, transfers of interests in qualified plans at death to individuals (unless the transfer is to the surviving spouse in a manner which qualifies for the marital deduction), result in extremely heavy tax burdens, attracting both estate taxes and income taxes (at some point in time), and potentially generation skipping transfer taxes if the plan is distributed or paid to a skip person. However, transfers of interests in retirement plans to a qualified charity can result in significant estate tax and income tax savings.[4]

II. SCOPE.

The purpose of this paper is to analyze the effects of various kinds of transfers to charities from retirement plans. While many provisions of ERISA and the Internal Revenue Code are implicated in such transfers, the paper will analyze those complex provisions only to the extent necessary to discuss their impact on charitable transfers. Detailed discussions of income in respect of a decedent, the designated beneficiary rules or the MRD rules, for example, are beyond the scope of this paper except to the extent necessary for a basic understanding of the problems such requirements raise and how to solve them.

III. LIFETIME GIFTS TO CHARITIES.

If for no other reason than to provide a sharper focus, a brief discussion of lifetime gifts is in order. Use of retirement plan benefits to fund charitable giving is not an efficient income tax technique. The withdrawal from the retirement plan attracts an immediate ordinary income tax, but the charitable deduction is limited to a percentage of adjusted gross income depending upon the donee, and must be in excess of the floor on itemized deductions, and, of course, the distribution increases such floor. The charitable community has been trying for several years to pass the Charity Aid, Recovery and Empowerment Act (popularly known as CARE) which would, among other things, allow direct inter-vivos transfers to charities from retirement plans.[5]

IV. GIFTS TO CHARITIES AT DEATH – GENERAL CONSIDERATIONS.

A. Charitable Giving in General.

No tax advantaged technique should be used solely because of the tax savings. Used properly, such techniques will fit into the client's family, financial, philosophical and emotional situation. Therefore, as a general rule, this technique, no matter how advantageous, should only be used if the client has charitable intent. Once that is determined, then any gift will be entitled to the charitable deduction so long as it meets the requirements of §2055(a). This would include the client's private foundation or donor advised fund. Thus, the avoidance of income and estate taxes can also advance the family agenda. It goes without saying that proper identification of the charity is important, and any restrictions on the use of the funds should be noted on the beneficiary designation.

B. Method.

Direct gifts of interests in retirement plans are made by beneficiary designation and not by will. Therefore, as obvious as it seems, the donor must make sure that the beneficiary designation correctly identifies the charitable recipient and defines the interest to be received by the charity.

C. Practical Issue as to Amount.

Because of the MRD rules, the decedent is required to begin withdrawing annual amounts from the retirement plan upon reaching his RBD. Therefore, the decedent's charitable intent may be frustrated to some extent if he or she lives long enough to withdraw a substantial amount from the retirement plan before death. This, of course, can be cured with careful drafting which coordinates the charitable gift under the

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[1] The Required Beginning Date ("RBD") for MRDs must begin no later than the later of April 1 of the year following the year in which the participant reaches age 70½ or the time at which the employee actually retires. The age 70½ RBD is mandatory if the participant is still employed but is more than a 5% owner of the business.

[2] References to section numbers will refer to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[3] Although Roth IRAs and Roth 401(k)s dilute this purpose somewhat, at least those contributions are taxed at the time of the contribution, and thus are made with after tax dollars.

[4] The reader will notice that almost all the law in this area is contained in private letter rulings. This is unfortunately true of much of the law throughout the employee benefits area.

[5] The author must, in all candor, admit that he has serious reservations about inter-vivos contributions and the creation of an unlimited charitable deduction for one kind of asset. Additionally the author has concerns about the potential for predatory practices by charities which would persuade the elderly to take advantage of this tax avoidance when they really cannot afford to do so.

retirement plan with a gift under the will or will substitute. For example, the decedent could insert a provision (more precise than this) in the decedent's will or revocable trust as follows: "I intend to make a gift of at least $1,000,000 to the University of Texas School of Law to establish a chair in my honor. I have named the law school the beneficiary of my IRA, but if such gift from my IRA is less than $1,000,000, then I give an amount equal to the difference between $1,000,000 and the gift from my IRA to the law school."

D. Spousal Considerations -- Retirement Equity Act of 1984.

If the decedent is married at the time of his death or at the RBD, the participant must waive and the spouse must consent to the waiver of the spouse's right to a QJSA or QPSA for such designation to be effective[6]. It is beyond the scope of this paper to discuss the political and social implications of the Retirement Equity Act of 1984 ("REA") or the technical requirements for meeting its provisions. Suffice it to say that its announced purpose was to protect the interest of the non-employee spouse (in the view of Congress that meant the wife in most cases) from disposition of a principal asset of the marital community (not used in a community property context) in a way which would deprive the non-participant spouse of the benefits of that asset. It achieves this purpose by mandating the forms of benefits and the beneficiary, and permitting a change of either form or beneficiary only with the consent of the non-participant spouse. As it has evolved, a multitude of technical problems creates traps for the unwary. REA applies to the defined benefit plans and defined contribution plans to which the minimum funding standards of §412 apply.

1. Mandatory Forms of Benefits.

Subject to the exception is Paragraph 3, below, REA directs that any plan, to be a qualified plan, must provide a mandatory form of benefit which will be paid to a married participant or his or her beneficiary absent a waiver of such benefits by the participant and a consent to such waiver by the participant's spouse.

2. Qualified Joint and Survivor Annuity.

The accrued benefit payable to a participant who does not die before the annuity starting date must be paid in the form of a qualified joint and survivor annuity.[7] A qualified joint and survivor annuity (QJSA) is one in which the survivor's annuity is not less than 50% and not more than 100% of the annuity payable during the joint lives of the participant and his spouse.[8] Despite the statutory alternatives, most plans, for administrative convenience, require that 100% of the benefits of the annuity during their joint lives be payable.

3. Qualified Pre-Retirement Survivor Annuity (QPSA).

A QPSA is mandated if the participant dies before the annuity starting date.[9] In a defined benefit plan, the QPSA must be no less than the amount that would be payable as a survivor annuity under the plan's provisions for a QJSA.[10] In the case of a defined contribution plan,[11] a QPSA is an annuity for the life of the surviving spouse, which is not less than 50% of the portion of the account balance of the participant (as of the date of death) to which the participant had a nonforfeitable right.[12] This means that unless the plan provides a QPSA of a greater amount, only one-half of the participant's vested accrued benefit is subject to the waiver and spousal consent rules. The other one-half may be disposed of by the participant as he or she sees fit.[13] In determining one-half of the vested accrued benefit, the face value of life insurance is taken into account if the plan is a defined contribution plan. This is true regardless of the amount of the cash surrender value of the policy.[14]

4. Exception for Certain Defined Contribution Plans.

As noted above, REA applies to defined benefit plans and defined contribution plans. However, certain defined contribution plans are not subject to these rules.[15] If a defined contribution plan provides that the participant's non-forfeitable accrued benefit is payable in full on the death of the participant to the participant's surviving spouse, if such participant does not elect the payment of benefits in the form of a life annuity, and if the plan has not been the recipient of a transfer from a plan which does not qualify for these exceptions (unless such transferred funds are separately accounted for) then the QPSA and QJSA rules do not apply. This leaves the participant free to choose any form of lifetime benefit the participant selects. This would include the right of the participant to select a lump sum distribution with a rollover to an IRA (see below.)

5. Individual Retirement Accounts.

It is very important to note that REA does **NOT** apply to IRAs. Thus, once the funds have been rolled out of a qualified plan into an IRA, no further waiver by the spouse is required with respect to beneficiary designation. This is true despite that fact that some IRA sponsors require spousal consent. Under Texas law,

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[6]Technically, the participant spouse must waive the payment of benefits in the form of a QPSA or QJSA and the non-participant spouse must consent to another form of payment and/or another payee. An entire set of technical rules surround the waiver and consent.

[7]§401(a)(11)(A)(I).

[8]§417(b).

[9]§401(a)(11)(A)(ii).

[10]§417(e)(1)

[11]Although it is somewhat of an oversimplification, a "defined contribution plan" is a profit sharing plan in which the employee has his or her own account. A "defined benefit plan" is a pension plan.

[12]§417(c)(2).

[13]*See, e.g.* Q&A 4 of Regs. §1.401(a)-20.

[14]Regs. §1.401(a)-20, Q&A 12(b).

[15]§401(a)(11)(B)(iii).

during the participant's life or at his or death, the participant has the right to dispose of the non-participant spouse's community interest in the IRA (if any) subject only to the fraud on the community rules. If the non-participant spouse predeceases the participant, the non-participant spouse has the right to dispose of his or her community one-half interest in the IRA by will.[16]

E. Estate Tax Considerations.

The value of the retirement plan is included in the gross estate under §2039(a). §2055(a) permits a deduction from the gross estate for amounts paid to charities. Thus, to the extent that proceeds of a retirement plan are payable to a qualifying charity, such amounts are deductible for federal estate tax purposes and should not, absent a drafting error, attract an estate tax. Whether such gift is outright or a split gift will affect the amount of the charitable deduction. Under Texas Probate Code Ann. §322A, estate tax is not allocated to items which do not generate any estate tax, absent a specific direction to the contrary in the Will, or other dispositive instrument.

F. Income Tax Considerations.

Distributions from retirement plans are income in respect of a decedent ("IRD") and thus taxable under §691 to the recipient. Items of IRD are never properly reported on the final personal income tax return of the decedent, but as a general rule are taxed to the recipient of such IRD. Thus, to the extent proceeds are payable to a charity, there is no income tax effect because the charity is an income tax exempt entity.[17] Because distributions to charity do not attract an estate tax, the deduction for estate taxes paid under §691(c) may be partially or wholly lost. A more detailed discussion of the IRD issues and the §691(c) deduction are set forth in situations in which they present specific issues.

G. Defer, Defer, Defer.

The general rule, to the extent such a thing exists, in planning with retirement benefits is to keep the assets in a tax deferred solution for as long as possible to take advantage of compounding unreduced by taxes. Thus, it is possible that, even with the advantage of avoiding any tax on an asset that has never been taxed, the naming of individual beneficiaries rather than charities, some would argue, might produce a better overall advantage for the family. Unless the designated beneficiary is very young, the advantage would still seemingly lie with the charity for the following reasons: (i) Other assets may be invested in tax free investments or in investments which produce capital gains or qualifying dividends, thereby minimizing the income tax. (ii) If access to the principal is needed, withdrawal will not generate ordinary income, thereby increasing the amount needed to be withdrawn. (iii) Because there can be no certainty as to the tax structure in future years, avoiding any tax now would seem to be the wiser result. Yet, as with all generalities, each situation must be carefully analyzed in light of its peculiar facts.

H. Roth IRA.

Needless to say, the primary benefit of using retirement plan benefits to fund charitable gifts is the avoidance of the income tax upon distributions from the plan. In a Roth IRA [and the soon to be available Roth 401(k)], there is no income tax benefit. Therefore, the ability to avoid income tax entirely reduces the efficacy of using this type of retirement plan for charitable giving.

V. OUTRIGHT GIFTS TO CHARITIES AT DEATH.

By far the simplest and most straightforward technique is an outright charitable gift, but, as will be seen, even something this direct has other considerations.

A. Direct Gifts of Entire Account.

If the beneficiary designation simply leaves the entire retirement plan to charity at the death of the participant, then the issues seem to be relatively clear cut and mostly resolved, so that seeking a private letter ruling, except in exceptional circumstances would seem unnecessary. In one private letter ruling, the real question, among other issues, was whether the undistributed portion of the participant's MRD would be treated as a gift to charity.[18] In that PLR, the decedent named a charity as beneficiary of his IRA, which included a portion of his MRD which remained undistributed at the time of his death. There is no doubt that this PLR reaches the correct result as to the estate tax and income tax effects of the decedent's beneficiary designation.

1. Estate Tax Result.

If the beneficiary designation names a charity as the sole beneficiary of the retirement plan at the death of the donor, then the estate of the decedent is allowed an estate tax charitable deduction for the funds passing to charity under §2055(a).

2. IRD.[19]

This PLR gives a clear and cogent exposition of the IRD rules and their effect when someone other than the decedent's estate is a specific beneficiary of IRD. It concludes that the recipient and not the decedent's estate or the beneficiaries of the estate are taxable on the income. The discussion of IRD is set forth in detail below because some of the concepts affect other types of dispositions.

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[16] This power is not without its difficulties if the disposition is to someone other than the participant, because it may be treated as a distribution which attracts an immediate income tax and which arguably, at least, is payable by the participant. It should not attract a §72(t) penalty for early withdrawal because transmission at death is an exception to the early withdrawal penalty.

[17] In the case of a gift to charity of non-qualified stock options, the charity recognizes IRD on exercise of the options, and neither the estate nor its beneficiaries is required to recognize IRD. So ruled the Service in PLR 200012076 (12/23/99), analogizing the nonqualified options to nonvested restricted stock, citing Treas. Regs. §1.83-1(d).

[18] PLR 199939039 (June 30, 1999).

[19] *See* Rev. Rul. 92-47, 1992-1 C.B. 198, holding that lump sum distributions from an IRA, including unrealized appreciation, are IRD to the recipient of the distributions.

a. §691(a) (1) provides that the amount of all items of gross income which are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

b. §691(a) (3) provides that the right, described in § 691(a) (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under § 691(a) (1) or (2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

c. §1.691(a)-l(b) of the Income in Respect of Decedents Treasury Regulations provides that the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of the decedent's death or for a previous taxable year under the method of accounting employed by the decedent.

3. <u>Undistributed MRD</u>.

The PLR also correctly included the undistributed MRD for the year of death in the amount passing to charity and thus escaping tax.[20] The beneficiary owns the account after the participant's death, and thus is the person entitled to the undistributed MRD.[22]

4. <u>Gifts to a Private Foundation</u>.

A gift to a private foundation as defined in §509(a) is a gift to a charity and thus the rules stated above are applicable to the gift. Private foundations are subject to federal excise tax on investment income under §4940(a), and the question arises as to whether the IRD distributed from the retirement plan is net investment income.

a. In FSA199930039 (released 7/30/99), the Service did not answer those troublesome questions, but "considered separately" whether the foundation would recognize taxable income and whether it would be subject to the §4940(a) excise tax on investment income.

b. In an earlier ruling, however, PLR 9341008 (7/14/93)[23], the Service had answered those questions in the negative, so that gifts of retirement plan benefits do not generate a tax. The foundation only recognizes income when the property is sold or when income on the property is actually received. It seems clear that the distribution is IRD to the charity, but it receives no taxable income because of its tax exempt status. The classification as income (IRD) is artificial when it in reality is a distribution of the asset and therefore would not seem to fall under 4940(a). In other words, the 1993 PLR seems to have gotten it right.

B. Gifts of Partial Interests in Retirement Plan.

If the decedent wishes to leave his or her retirement benefits partially to charity and partially to his family or other beneficiaries, the decedent must first deal with the designated beneficiary rules. Designated beneficiaries may take the benefits out of the retirement plan over the lifetime of the beneficiary. If the individuals do not qualify as designated beneficiaries, then distributions must be made under the five year rule if the participant has not attained the participant's RBD,[24] or over the participant's remaining life expectancy if the participant dies after reaching the RBD.[25] Obviously, qualification as a designated beneficiary is irrelevant to the charity itself, since it will immediately take all the proceeds out of the plan and will pay no income tax because of its tax exempt status.

1. <u>Definition of Designated Beneficiary</u>.

Only individual beneficiaries or qualifying trusts can be designated beneficiaries.[26] Thus, an estate or a charity cannot be a designated beneficiary. No election by the employee is necessary if the beneficiary named by the employee or designated under the plan meets the definition of a designated beneficiary.[27]

2. <u>Multiple Designated Beneficiaries</u>.

Under the separate share rules, if there are multiple beneficiaries, at least one of whom is not an individual or qualifying trust, then there is no designated beneficiary.[28]

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[20]Evidently the decedent had passed his RBD, although the PLR is silent as to that.

[22]*See, e.g.,* PLR 199930052 (5/11/99).

[23]PLR 9341008 (7/14/93).

[24]§401(a)(9)(B)(ii).

[25]§401(a)(9)(B)(I).

[26]§401(a)(9)(E). Regs. §1.401(a)(9)-4, A-1 sets forth the definition of a designated beneficiary. The issues involving trusts as beneficiaries are discussed below.

[27]Regs. §1.401(a)(9)-4, A-2.

[28]Res. §1.401(a)(9)-4, A-3.

3. Removal" of a Beneficiary.

The identity of a designated beneficiary is "determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death"[29] [the "Designation Date"]. Thus, if all the benefits due the charity have been distributed to it prior to the Designation Date, then the charity is no longer a beneficiary, and the remaining individual beneficiaries qualify as designated beneficiaries.[30]

VI. GIFTS TO ESTATES OF RETIREMENT BENEFITS.

Although it is more efficient to name the charity as beneficiary of the retirement plan itself, the "plan"[31] may involve making the estate the beneficiary of the plan benefits with the charity named as a beneficiary under the will.

A. Estate Tax Charitable Deduction.

If the will directs that gifts be made to charity, and if the charitable bequest is in a form meeting the requirements of §2055, then the estate will be entitled to a charitable deduction irrespective of the source of the payment. Thus, if the estate is a beneficiary of retirement plans, and if there is a charitable bequest which is satisfied with the proceeds from the plan, the estate will get a charitable estate tax deduction.

B. Income in Respect of a Decedent ("IRD").

§691(a) dictates that income which is not "not properly includible in respect of the taxable period in which falls the date of his death or a prior period shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise or inheritance, if the amount is received after a distribution by the decedent's estate of such right."

1. Retirement Plan Benefits are IRD.

IRD has the same character in the hands of the recipient as it would have in the hands of the decedent.[32] Retirement plan benefits are, of course, ordinary income in the hands of the decedent and are clearly IRD.

2. Authority of Executor.

In PLR 200234019 (5/13/02), a percentage of the residuary estate was left to charity and a percentage to individuals. The will gave the executor authority to make distributions in cash or in kind, including non pro-rata distributions of undivided interests in property. The executor proposed assigning the retirement plans to charities in satisfaction of their share of the estate. The Service ruled that the outright assignment in kind of the retirement plans avoided inclusion of the plans in the income of the estate or its individual beneficiaries, causing the tax exempt entity to be treated as the recipient of the income. The key here was apparently the discretion of the executor to make in kind distributions. Otherwise, the separate share rule under §663(c) would cause the plans to be allocated pro-rata among the beneficiaries.[33] CAVEAT: Relying on this kind of flexibility in the executor to achieve the result in this PLR is risky at best. Clever lawyering resulted in a substantial saving to the estate's individual beneficiaries, but this should be regarded as a rescue technique and not as a planning technique.

3. Benefits Paid to Estate.

If the benefits are paid to the estate, does the estate recognize the amounts received as IRD in accordance with §691(a)(1)(A)? If so, is there a way to deduct that income? In PLR 200336020 (6/03/03), the estate was the beneficiary of retirement benefits which were actually paid to the estate.[34] There were some specific bequests and the residue was payable to named charities. The executor represented that all specific bequests, estate taxes and expenses had been paid.

a. The Service ruled that the distributions from the qualified plans were IRD that was included in the income from the estate.
b. However, because the executor represented that all of the proceeds from the retirement plans were to be distributed to the charities, the income was deductible under §642(c)(2) as an amount permanently set aside for charities.
c. The result of this is that even though the distributions were paid to the estate and constituted IRD to the estate, the estate was entitled to a charitable income tax deduction which offsets entirely the income to the estate.[35]
d. This, again, should be considered a rescue and not a planning technique.

4. Amounts Set Aside for Charities.

§642(c)(2) allows a deduction for amounts permanently set aside for charities *by an estate.* Note that this deduction is *not* available to trusts except for

[29] Regs. §1.401(a)(9)-4, A-4.

[30] Regs §1.401(a)(9)-4, A-3(a).

[31] It is difficult to fathom very many, if any, circumstances in which you would intentionally name the estate as the beneficiary, thereby creating all kind of difficulties in payout periods as well as allowing creditors to reach assets which would otherwise be exempt from claims of creditors.

[32] §691(a)(3).

[33] The PLR is silent as to whether the decedent had reached his RBD. Because an estate cannot be a designated beneficiary, the individual beneficiaries would have been forced to take distributions from the plans either over the decedent's life expectancy or under the five year rule had the executor not been allowed to distribute the benefits to charity.

[34] *See also* PLR200221011 (2/12/02).

[35] As noted earlier, the estate tax charitable deduction is available because of the charitable bequest.

certain grandfathered trusts.[36]

VII. GIFTS TO TRUSTS.

Although there is a set of very technical and complex rules surrounding the use of trusts as designated beneficiaries, they are largely irrelevant to the issues surrounding charitable contributions.

A. Treated Same as Gift to Estate.

The concern here is whether a gift of the retirement plan benefits to a trust would have the same result as gifts to an estate did in the above described PLRs. Although there seems to be no direct authority, assuming a substantially similar fact situation, there is no logical reason that the holdings should allow the estate to take estate tax benefits that a trust could not enjoy. Most importantly, however, the trust does not have available to it the permanent set aside rule, and thus, even if the trustee can show that all the retirement plan benefits are payable to the charity, the set aside rules re not available, and the trust would not be entitled to a charitable income tax deduction and would have to recognize the IRD.

B. Community Property Issues.

Suppose husband and wife have created a joint revocable management trust and husband has named the trust the beneficiary of his IRA, and his entire interest in the trust passes to a charity. Can the assets be "rearranged" to permit the IRA to be paid to the charity. At least one ruling, which involved trying to achieve the opposite result, getting the IRA entirely to the spouse, would support the use of the IRA to fund the husband's charitable intent.[37] In that PLR, the trust provided that the trustee could make non-prorata distributions, and thus could allocate all of the IRA to the wife, who had a power to revoke her trust and thus could achieve a rollover. The issue was whether there were adverse income tax effects under the IRD rules of §691(a)(2) or the gain or loss recognition rules on a sale or exchange under §1001(c). The Service determined this division was "in substance the same as the division of the property" at divorce. In an earlier Revenue Ruling[38], the Service had determined that an "approximately equal" division of property at divorce did not result in a sale or exchange. In this PLR, they extended that reasoning to also determine that such non-prorata distribution would not be a transfer subject to income tax under §691(a)(2).

VIII. SPLIT INTEREST GIFTS.

Gifts of retirement plan interests may also be made to fund split interest trusts or similar techniques, but the results are not nearly so tax efficient.

A. Charitable Remainder Trusts.

A gift to a charitable remainder trust will, of course, not produce a charitable deduction for the full amount of the transfer since it is not a wholly charitable gift. It will secure the benefits of avoiding any income tax, but at the expense of some of the benefits of the §691(c) IRD deduction. Once again, careful consideration must be given to the economics of the transaction in comparison to being able to "stretch out" the benefits in a tax deferred environment.

1. Estate Tax Result.

As would be expected, the estate tax deduction under §2055 is limited to the amount of the charitable interest payable to the trust. CAVEAT: Care must be taken to assure that the estate taxes with respect to the non-charitable interest are paid from some source other than the retirement plan benefits in order to maximize the charitable deduction and prevent the possibility of completely disqualifying the charitable trust.

2. Taxation of Lifetime Beneficiary of CRT.

Distributions to an individual beneficiary from a CRT are treated under a tier system of taxation.[39] The first tier which comes out to the beneficiary is ordinary income equal to the lesser of the trust distribution for that year or the ordinary income of the trust, whether earned in such year or accumulated from prior years. In other words, income in the hands of the CRT retains its character until actually distributed.

3. IRD to CRT.

Because all of the proceeds of the retirement plan benefits are payable to the CRT, and because such benefits are clearly, IRD, the CRT treats such distribution as ordinary income. Of course, because the CRT is exempt from income tax, it pays no income tax unless it has unrelated business taxable income in that year under §512.

4. Deduction in Respect of a Decedent.

§691(c) allows a deduction to the recipient of IRD in an amount equal to the share of estate tax generated by such IRD. It is computed based upon the difference between the estate tax with the IRD items included in the estate and the estate tax without the IRD items included in the estate. Thus, the question arises as to whether such deduction is available to the income beneficiaries when income from the trust is distributed to the beneficiaries. The answer is apparently "not exactly."[40] The IRD deduction is available to the person to whom the IRD is taxed, in this case the CRT. It is treated as an "other deduction" on line 11 of Form 5227, thereby reducing the amount of IRD attributable to the CRT.[41] The §691(c)(1)(A) deduction is not directly made available to the income beneficiaries under §664(b). The result of this is that the "benefit" of the deduction is

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[36] §642(c)(2)(A) and (B).

[37] PLR 199925033 (3/25/99). Because the wife can rollover the IRA and then name the children as DBs of her rollover IRA, the analysis as to the benefits of avoiding income tax versus keeping the assets in a tax deferred solution for a long period of time must be carefully analyzed.

[38] Rev. Rul. 76-83, 1976-1 C.B. 213.

[39] §664(b).

[40] PLR 199901023 (10/8/98). *See also* PLR 9634019 (5/24/96).

[41] In computing the hypothetical estate tax (that is excluding the IRD items) described in §691(c)(2)(C), the estate must also exclude the charitable deduction resulting from the contribution of the retirement plan to the trust.

delayed until all of the income net of the deduction is recognized by the individual distributee.

B. Charitable Gift Annuities.

While a charitable gift annuity ("CGA") is in many ways similar to a CRT, it also differs sharply in many respects.

1. What is a CGA?

A CGA is an annuity issued by a charity to pay a fixed annuity for life to a beneficiary (or 2 beneficiaries). Assets are exchanged for the charity's *unsecured* promise to pay the annuity from the general assets of the charity. In other words, a CGA is an insurance policy with no reserves set aside to assure the ability of the charity to meet its obligations since the assets transferred in exchange go into the general funds of the issuing charity. In order to avoid being treated as an insurance company and thus having the sale of the annuity be treated as UBTI, the annuity must have all of the following characteristics[42]:

a. The annuity has a value which is less than 90% of the value of the property received in exchange by the charity. In other words, the actuarially calculated charitable remainder must be in excess of 10%. This is *never* an issue in a charitable gift annuity issued in accordance with the guidelines of the American Council on Gift Annuities ("ACGA"), as discussed below.
b. The annuity is payable over the life of the annuitant(s).
c. The annuity does not guarantee a minimum amount of payments or specify a maximum amount of payments.
d. It does not provide for an adjustment which references the amount of income generated by the transferred asset.

2. Setting Rates for a CGA.

Unlike CRTs, in which the donor sets the rate of return to be paid to the annuitant, CGA returns are "suggested" quarterly by the ACGA, a trade association of charities.[43] While not mandatory, virtually all charities issuing CGAs, and certainly all major charities issuing CGAs, adhere to the rates. The rates are set to produce at least a 50% return to the charity on an actuarial basis after the annuity payments.

3. Estate Tax of CGA.

A person may enter into a contract with a qualified charity to purchase a CGA at death by making the charity the beneficiary of a retirement plan and adopting the ACGA rate in effect at death to determine the amount of the annuity payments to be made if the annuitant survives the donor. Of course, the amount must be ascertainable in order to get the desired tax treatment.[44] If the annuitant did not survive the donor, the gift to the charity was to be outright. As with a CRT, the entire value of the retirement plan is included in the estate under §2039 and the gift of the charitable remainder interest generates an estate tax charitable deduction under §2055. This gift is valued under the estate tax tables.[45] CAVEAT: As with the CRT, care must be taken to assure that the estate taxes with respect to the non-charitable interest are paid from some source other than the retirement plan benefits in order to maximize the charitable deduction.

4. General Rules for Income Tax on CGA.

A CGA is taxed as any other annuity under §72. If the transfer to the charity in exchange for the CGA is of appreciated assets, the basis of the asset is the annuitant's "investment in the contract."[46] Thus, there will be three elements to each annuity payment, ordinary income, capital gains, and tax-free recovery of basis.

5. Income Taxation of Estate for CGA Purchased with Retirement Benefits.

As to the decedent's estate, the rules would be the same as the CRT. The retirement plan distribution to the charity would generate IRD to the charity and not the estate or the annuitant, but because the charity is a tax exempt entity, it would actually pay no tax.

6. Income Taxation of Annuitants of CGA Purchased with Retirement Benefits.

The income taxation of annuitants is much less clear than the income taxation of a lifetime beneficiary of a CRT. Because a CGA is taxed under the annuity rules, the determination of the "investment in the contract" is critical in determining the amount of taxable income generated by each distribution.[47] There would be, of course, no capital gains portion since the asset exchanged (the retirement plan benefit) is all ordinary income. Thus, everything in excess of the investment in the contract is taxable as ordinary income.

a. Because the non-charitable portion of the retirement plan benefits are subject to the estate tax, do they

[42] §514(c)(5), defining "acquisition indebtedness".

[43] While this may appear to be a violation of the federal and state anti-trust laws and of Texas state insurance laws, the Congress and the Texas Legislature have granted charities an exemption from those laws with respect to charitable gift annuities.

[44] This was exactly the fact situation in PLR200230018 (4/22/02), and the statements of the rules as to CGAs rely on that PLR. Parenthetically, the author believes that the PLR reaches the correct conclusions unless otherwise stated.

[45] *See* Rev. Rul. 84-162, 1980-2 C.B. 200.

[46] Assuming all the requirements for donation of appreciated assets are met, the donor gets a deduction for the fair market value of the asset and there is no immediate income tax on the gain. However, in reality, that tax is shifted to the annuitant as the annuitant receives the annuity payments.

[47] §72(c)(1) which defines the investment in the contract as of the annuity starting date as the aggregate amount of consideration paid for the contract minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

constitute an investment in the contract? In PLR 200230018, *supra*, the Service refused to answer that issue on the grounds that it was speculative in that it required the Service to assume that the annuitant survived the donor. N.B.: It was also speculative to assume that the annuitant survived the donor in order to issue the rulings the IRS did decide. Thus, the assertion that the investment in the contract issue required the Service to make a speculative assumption is really a cop-out. The suspicion is that the IRS would have had to give an unfavorable ruling because it did not want to publish even a non-binding, non-precedential opinion as to this question.

b. The IRD deduction, as in the CRT, is available to the charity, which has no way to utilize it. And, since the annuitant's distributions are unrelated to the income of the charity, it would appear that the deduction is simply lost.

7. Usefulness of CGA as Beneficiary.

A very careful analysis of the economics of the CGA as beneficiary should be made to determine whether the lost benefit of the stretch out outweighs the immediate charitable estate tax deduction. This is especially true in light of the uncertainty of the investment in the contract issue and the real possibility that 100% of the annuity payments may be taxable to the annuitant. In the cited PLR, the annuitant was the donor's daughter. Assuming that she was in her middle 50s, the annuity might well consume the bulk of the value of the retirement plan, thus creating a very small charitable deduction.

IX. DISCLAIMERS.

Valid disclaimers can often be an effective tool to add flexibility to the estate plan or perhaps to cure problems which would otherwise exist in the estate plan by disclaiming bequests and/or powers which would interfere with obtaining the marital or charitable deduction or some other tax benefit.

A. Requisites for a Valid Disclaimer.

§2046 imports the gift tax rules for qualified disclaimers into the estate tax regime. Under §2518(b), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property, but only if: (1) the refusal is in writing; (2) the writing is received by the transferor of the interest, his or her legal representative, or the holder of the legal title to the property to which the interest relates, not later than the date that is nine months after the later of-(A) the date on which the transfer creating the interest in the person is made, or (B) the day on which the person attains the age of 21; (3) *the person has not accepted the interest or any of its benefits*; and (4) as a result of the refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either-(A) to the spouse of the decedent, or (B) to a person other than the person making the disclaimer. (Emphasis added).

B. Validity of Partial Disclaimers.

§25.2518-2(d)(1) of the Gift Tax Regulations provides that a qualified disclaimer cannot be made with respect to an interest in property if the disclaimant has accepted the interest or any of its benefits, expressly or impliedly, prior to making the disclaimer. Acceptance is manifested by an affirmative act that is consistent with ownership of the interest in the property. Acts indicative of acceptance include: using the property or the interest in the property; accepting dividends, interest, or rents from the property; and directing others to act with respect to the property or interest in the property. However, a disclaimant is not considered to have accepted the property merely because, under applicable local law, title to the property vests immediately on the decedent's death in the disclaimant.

C. Disclaimers and MRDs.

A valid disclaimer can be made within nine months of date of death, but, if the decedent has passed his RBD at date of death, then the MRD must be taken by the beneficiary of the retirement plan no later than December 31 of the year of death to the extent that the decedent has not already withdrawn all of the MRD. So, if death occurs in 2005 and no disclaimer is made prior to December 31, the named beneficiary must withdraw the MRD by that date. Does such withdrawal constitute an acceptance of benefits, thereby prohibiting a disclaimer. The IRS has spoken in Rev. Rul. 2005-36, issued June 27, 2005, has and said that it does not.[48] In that Ruling, the Service postulates three hypothetical situations.

1. Situation 1.

Under the terms of the IRA beneficiary designation pursuant to the IRA governing instrument, Decedent's spouse, Spouse, is designated as the sole beneficiary of the IRA after Decedent's death. A, the child of Decedent and Spouse, is designated as the beneficiary in the event Spouse predeceases Decedent. Three months after Decedent's death, in accordance with §1.401(a)(9)-5, A-4, of the Income Tax Regulations, the IRA custodian pays Spouse $100x, the required minimum distribution for 2004. No other amounts have been paid from the IRA since Decedent's date of death. Seven months after Decedent's death, Spouse executes a written instrument pursuant to which Spouse disclaims the pecuniary amount of $600x of the IRA account balance plus the income attributable to the $600x amount earned after the date of death. The income earned by the IRA between the date of Decedent's death and the date of Spouse's disclaimer is $40x. The disclaimer is valid and effective under applicable state law. Under applicable state law, as a result of the disclaimer, Spouse is treated as predeceasing Decedent with respect to the disclaimed property. As soon as the disclaimer is made, in accordance with the IRA beneficiary designation, A, as successor beneficiary is paid the $600x amount disclaimed, plus that portion of IRA income earned between the date of death and the date of the disclaimer attributable to the $600x amount ($12x).

a. With respect to the MRD, the Service ruled that the spouse had accepted the amount of income earned by the MRD between the date of death and the date of the disclaimer as required by Treas. Reg.

[48] 2005-26 I.R.B. 1368 (6/27/05)

§25.2518-3(c).[49]

b. With respect to the disclaimer, the Service ruled that spouse had made a valid disclaimer as to everything but the MRD and the income imputed thereto.

2. Situation 2.

The facts are the same as in Situation 1, except that, instead of disclaiming a pecuniary amount, Spouse validly disclaims, in the written instrument, 30 percent of Spouse's entire interest in the principal and income of the balance of the IRA account remaining after the $100x required minimum distribution for 2004 and after reduction for the pre-disclaimer income attributable to the $100x required minimum distribution ($2x). As soon as the disclaimer is made, in accordance with the beneficiary designation, A is paid 30 percent of the excess of the remaining account balance over $2x.

a. The ruling with respect to the MRD is the same as in Situation 1.

b. Spouse has accepted MRD plus its attributable income, and the disclaimer of the percentage amount is a valid disclaimer if spouse has accepted no benefits from the disclaimed amount.

3. Situation 3.

The facts are the same as in Situation 1, except that A is designated as the sole beneficiary of the IRA after Decedent's death, Spouse is designated as the beneficiary in the event A predeceases Decedent, and the $100x required minimum distribution for 2004 is paid to A three months after Decedent's death. Seven months after Decedent's death, A disclaims the entire remaining balance of the IRA account except for $2x, the income attributable to the $100x required minimum distribution paid to A. As soon as the disclaimer is made, in accordance with the IRA beneficiary designation, the balance of the IRA account, less $2x, is distributed to Spouse as successor beneficiary. A receives a total of $102x.

a. The MRD ruling to A is the same as it was to spouse. A is deemed to have withdrawn the MRD plus the attributable income.

b. Since A is no longer a beneficiary by September 30 of the year following the year of death, A is no longer a designated beneficiary.

4. Importance of Ruling.

This is really the first time the IRS has indicated how a MRD works in conjunction with an interpleader. Although it does not directly answer the question as to who is responsible for the penalty for failure to make a MRD, it implies that would be the responsibility of the primary beneficiary if the disclaimer occurs after December 31. Likewise, the Ruling makes it clear that the MRD need not be made prorata even if there are multiple beneficiaries.

D. Spouse as Primary Beneficiary.[50]

The designation of the spouse as the primary beneficiary of the estate plan with a bypass trust as a contingent beneficiary is often used as a technique to provide flexibility in the planning. Particularly in these times in which the repeal of the estate tax may happen, or exemptions may be raised so that the tax is effectively repealed for all but a small minority of decedents, the ability of the surviving spouse to determine whether to take the retirement plan or allow it to pass into the credit shelter trust can often be a very valuable tool.[51] The same is true with respect to using a charity as the contingent beneficiary.

1. Ability of the Spouse to Rollover the Benefits.

Since the spouse can rollover the benefits to his or her own IRA and designate beneficiaries at the spouse's death, the issue of there being no DB with a contingent charitable beneficiary goes away if or to the extent the spouse does not disclaim and if the rollover is done prior to September 30 of the year following the year of death.

2. Ability of the Spouse to Make Partial Disclaimers.

The spouse, of course, is not required to disclaim the full amount of the IRA, but may disclaim only a portion of such amount, thus tailoring the charitable distribution to her desires and, secondarily, to the tax laws existing at such time.

3. Community Property Issues.

Assuming the retirement plan is community property, can the spouse disclaim 100% of the benefits?

a. If the retirement plan is an IRA, under Texas law the participant has the right to dispose of 100% of the benefits to a third party assuming that would not be a fraud on the surviving spouse's community rights.[52] Therefore, can the spouse disclaim 100% of the benefits of the IRA of which the spouse is a beneficiary. Although there is no authority answering this question, the answer should be that the spouse can disclaim only the participant's community one-half since the other one-half belongs to the spouse by virtue of the community property laws.

b. The issue is a little more muddled if the benefits are in an ERISA plan at the date of the decedent's

[49] The Regulations would appear to be lacking in logic. How can money already withdrawn be earning income? Perhaps it is a rule of administrative convenience to avoid calculating the income attributable to the income not withdrawn (although that would not seem so hard to do). As the King of Siam says, "Is a puzzlement."

[50] The surviving spouse may disclaim the assets and yet retain the befits of the disclaimed assets so long as the spouse does not retain the power to direct the beneficial enjoyment of the transferred property. Treas. Regs. §25.2518-2(e)(2). No other person can disclaim and retain any benefits from the disclaimed assets.

[51] *See* PLR 200522012 (2/14/05), released June 22, discussing just such a partial disclaimer (in conjunction with a trust modification). The ruling also discusses the proper measuring life as well as the requirements for an effective disclaimer.

[52] In some community property states, such as California, the participant could only dispose of those benefits to a third party with the written consent of the other spouse.

death. ERISA preempts state community property law, so that if the surviving spouse has consented to the waiver of his or her REA rights, the surviving spouse has no right to dispose of a community one-half interest if that spouse were to predecease the participant.[53] It is unclear whether the assets in the retirement plan lose their community property identity, or whether ERISA simply deprives the non-participant spouse of his or her right to dispose of his or her community one-half if the non-participant predeceases. The better public policy would seem to be that *Boggs* dealt only with the right of a disposition, and that the proceeds, once distributed, are community property. If this is so, then, as in an IRA, only one-half could be disclaimed. If the assets in the plan are not community property, then the possibility of a disclaimer of 100% exists.

E. Disclaimers with Third Party Beneficiaries.

Disclaimers can also be used with other beneficiaries. In one relatively recent private letter ruling,[54] a decedent owned three IRAs and six annuities, all of which were payable to his sister. Decedent also created an inter-vivos *unfunded* revocable trust, the residue of which passed to a trust for sister which was intended to be a charitable remainder unitrust. However, sister had the right to invade the corpus of the sister's trust. At the sister's death, the trust was to pass to charities selected by the trustees. IRA #1 passed to the decedent's revocable trust if sister predeceased, and the remaining two IRAs and the six annuities passed to the estate of the decedent. Under his Will, the residuary estate passed to the revocable trust. Sister disclaimed her right to receive the unitrust distributions and all power to invade the trust. There was also a judicial modification in which sister resigned as trustee and a charitable beneficiary unrelated to sister was named as the beneficiary. The Service ruled that the disclaimers were qualified disclaimers and therefore IRA #1 passed to the trust and the other two IRAs and the six annuities passed to the estate of the decedent, and from the estate to the trust by virtue of the decedent's will. Then all of those assets passed from the trust outright to the charity, entitling the estate to a charitable deduction.

X. CONCLUSION.

Retirement plan benefits can be an effective and efficient way to make certain gifts to charities at death. As with any other technique, its efficacy will vary in light of the facts of any given situation. Therefore, careful analysis is in order, and the income tax and estate tax savings must be weighed against the loss of the ability to defer income tax. If generalizations can be made, it is relatively clear that outright gifts are likely to produce a better result than split gifts. Disclaimers may be used to effectuate charitable transfers, and are probably most effective if planned for rather than being used to rescue an otherwise faulty plan. Last, but not least, recognize that dealing with retirement plan benefits places the practitioner into a technical morass which can hold many and unexpected traps for the unwary and the less knowledgeable.

[53] *Boggs v. Boggs*, 520 U.S. 833 (1997).

[54] PLR200052006 (9/25/2000).