

Charitable Giving with Retirement Benefits

Why, How, and When to Donate Retirement Benefits to Charity
(And To Which Type of Charity)

by
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Summary Contents
(Detailed Table of Contents on Next Page)

About the Author	4
Abbreviations and Acronyms Used in this Document	4
7.1 Three “Whys”: Reasons to Leave Benefits to Charity	4
7.2 Seven “Hows”: Ways to Leave Benefits to Charity	8
7.3 MRDs and Charitable Gifts Under Trusts	17
7.4 Income Tax Treatment of Charitable Gifts From a Trust or Estate	22
7.5 Seven “Whiches”: Types of Charitable Entities	41
7.6 Lifetime Gifts of Retirement Benefits	53
7.7 Putting it All Together	62
Bibliography	63
Appendix A: The Minimum Distribution Rules	64

About this Document

This document is the seminar handout for Natalie Choate’s seminar “Charitable Giving with Retirement Benefits.” It is an expanded version of Chapter 7 of the book *Life and Death Planning for Retirement Benefits* by Natalie B. Choate (6th ed., 2006), published by Ataxplan Publications, a complete reference work of over 500 pages on estate and distribution planning for retirement benefits. The book may be purchased for \$89.95 plus shipping at www.ataxplan.com or by calling 800-247-6553. “¶” references refer to sections of that book unless otherwise indicated. Cross references to Chapters and sections of *Life and Death Planning for Retirement Benefits*, other than cross references to other parts of Chapter 7, refer to parts of the book that are not reproduced in this document.

DETAILED TABLE OF CONTENTS

About the Author	4
Abbreviations and Acronyms Used in this Document	4
7.1 Three “Whys”: Reasons to Leave Benefits to Charity	4
7.1.01 What practitioners must know	5
7.1.02 Reasons to leave retirement benefits to charity	5
7.1.03 Charitable pledges (and other debts)	8
7.2 Seven “Hows”: Ways to Leave Benefits to Charity	8
7.2.01 Name charity as sole plan beneficiary	8
7.2.02 Leave benefits to charity, others, in fractional shares	9
A. The problem: The IRS’s multi-beneficiary rule.	9
B. First exception: separate accounts.	9
C. Second exception: distribution or disclaimer by Sept. 30.	9
D. When to rely (or not rely) on the exceptions.	10
E. If the spouse is the only noncharitable beneficiary.	12
7.2.03 Leave pecuniary gift to charity, residue to individuals	12
A. Pecuniary gift may not qualify as a “separate account.”	12
B. Consider separate IRAs for large pecuniary bequests.	13
C. Put small pecuniary bequest in will?	13
D. Make charity’s gift conditional on payment by 9/30?	13
7.2.04 Formula bequest in beneficiary designation	14
7.2.05 Leave benefits to charity through a trust	15
7.2.06 Leave benefits to charity through an estate	15
7.2.07 Disclaimer-activated gift	16
7.3 MRDs and Charitable Gifts Under Trusts	17
7.3.01 Trust with charitable and human beneficiaries	17
7.3.02 If charitable gift occurs at the participant’s death	18
7.3.03 If charitable gift occurs later	19
7.4 Income Tax Treatment of Charitable Gifts From a Trust or Estate	22
7.4.01 Introduction to trust income tax rules and “DNI”	22
7.4.02 DNI deduction, retirement benefits, and charity	23
7.4.03 Charitable deduction under § 642(c)	24
A. Introduction to § 642(c): the fiduciary charitable deduction	24
B. “Pursuant to the governing instrument”	25
C. Out of gross income, Part I: Tracing	25
D. Out of gross income, Part II: Authorization	26
E. Out of gross income, Part III: Governing instrument provision	27
F. Out of WHICH income?	27
G. Meaning of “independent economic effect”	29
H. Example: directing payment to charity out of retirement benefits	29
7.4.04 Trust with multiple beneficiaries: Separate share rule	31
7.4.05 Timing of charitable deduction for trust or estate	35
7.4.06 Transfer benefits, intact, from trust or estate to charity	36
7.4.07 How to name a charity as beneficiary through a trust	38

7.5 Seven “Whiches”: Types of Charitable Entities	41
7.5.01 Suitable: Public charity	41
7.5.02 Suitable: Private foundation	41
7.5.03 Suitable: Donor-advised fund	42
7.5.04 Suitable: Charitable remainder trust	42
7.5.05 Income tax rules for CRTs; IRD deduction	43
7.5.06 Solving planning problems with a CRT	45
A. CRT to benefit an older individual.	45
B. CRT to provide life income for multiple adults.	46
C. CRT as a QTIP alternative.	46
D. CRT for lump sum distribution-only plan.	47
E. Special needs beneficiaries.	49
7.5.07 Reasons NOT to leave benefits to a CRT	49
7.5.08 Suitable: Charitable gift annuity	51
7.5.09 Usually unsuitable: Charitable lead trust	51
7.5.10 Unsuitable: Pooled income fund	52
7.6 Lifetime Gifts of Retirement Benefits	52
7.6.01 Lifetime gifts from distributions	52
7.6.02 Give your MRD to charity	54
7.6.03 Gifts from a pre-age 59½ “SOSEPP”	54
7.6.04 Gift of NUA stock	55
7.6.05 Gift of other low-tax lump sum distribution	55
7.6.06 Give ESOP qualified replacement property to CRT	55
7.6.07 Lifetime gifts made directly from an IRA	56
7.6.08 Qualified Charitable Distributions	56
A. When.	57
B. How much.	57
C. Which plans.	57
D. Which IRA assets.	57
E. Who.	57
F. Which charities.	57
G. Income tax treatment.	58
H. QCDs deemed to come from pretax money in IRA	58
7.6.09 Planning uses and pitfalls of QCDs	58
A. QCD can be an MRD.	58
B. Can beneficiaries use QCDs?	58
C. Advantages of the QCD.	59
D. Fulfilment of pledge.	59
E. Drawbacks, problems, and what will go wrong.	59
F. Mixing up QCDs and MRDs.	59
7.6.10 The CHIRA™	60
7.7 Putting it All Together	62
Bibliography	63
Appendix A: The Minimum Distribution Rules	64

According to PLR 2005-18012, a disclaimer in favor of a donor-advised fund (DAF; ¶ 7.5.03) does not violate requirement #2, even if the disclaimant is an “advisor” to the DAF, because the advisor merely advises; he cannot “direct” distribution of the DAF’s funds.

7.3 MRDs and Charitable Gifts Under Trusts

This Section 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 a summary of the minimum distribution rules, see Appendix A. For full details regarding the minimum distribution rules as they apply to trusts, also called the “MRD trust rules,” see Chapter 6 of *Life and Death Planning for Retirement Benefits*. All cross-references in this section beginning with “¶ 6.2” or “¶ 6.3” refer to sections of that chapter, which may also be found in its entirety in the Special Report “Making Retirement Benefits Payable to Trusts.” Both the book and the Special Report are available through www.ataxplan.com.

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 in installments over the life expectancy of his oldest child. To achieve the desired result, the “MRD trust rules” must be complied with, so that 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-2. 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 benefits to fund the charitable bequest; see discussion at ¶ 6.3.01(D) of *Life and Death Planning for Retirement Benefits*. 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. See discussion at ¶ 6.3 of *Life and Death Planning for Retirement Benefits* and PLR 9820021. 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 MRD trust rules; see ¶ 6.3 of *Life and Death Planning for Retirement*

Benefits). This is not a problem with a true “charitable remainder trust” (see ¶ 7.5.04), because such trusts are income tax-exempt. The problem is with a trust that is primarily a family trust but which definitely or even possibly has charitable gifts that will be made after the family members’ 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 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 (see ¶ 6.3.01(B) of *Life and Death Planning for Retirement Benefits* for discussion of this technique), if qualifying for the life expectancy payout is an important goal (see ¶ 6.2.01 of *Life and Death Planning for Retirement Benefits* for discussion of when this may not be 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 the life expectancy payout method for the benefits.

7.3.02 If charitable gift occurs at the participant’s death

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.

The trustee can “eliminate” the charitable beneficiary by paying to the charity its \$10,000 bequest before the Beneficiary Finalization Date; see ¶ 7.2.02(C). If the charity is paid in full prior to the Beneficiary Finalization Date, then it is no longer a “beneficiary” of the trust as of the Beneficiary Finalization Date, and (assuming the \$10,000 bequest to charity was the only defect of the trust under the minimum distribution trust rules) the trust has only individual beneficiaries and qualifies 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 Beneficiary Finalization Date. See ¶ 7.4 regarding income tax treatment of the trust’s distribution to the charity.

7.3.03 If charitable gift occurs later

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 over the life expectancy of the oldest individual trust beneficiary becomes much more complex.

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 of appointment, 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) would mean that, under the multiple beneficiary rule, this trust would flunk the IRS’s minimum distribution trust rules. The trust would not be able to use the life expectancy of the oldest child to measure MRDs from the IRA to the trust after Heather’s death. It would be stuck with the applicable “no-DB rule” (see Appendix A for definition).

Adding a blanket prohibition against paying retirement benefits to charity is *not* the best way to solve the problem in Heather’s trust. For one thing, it is not clear that such prohibitions “work” under the MRD trust rules; see discussion at ¶ 6.3.01(D) of *Life and Death Planning for Retirement Benefits*.

For another, 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 the IRA) 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, here are 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 the life expectancy payout for the retirement benefits, then give up whichever one is less important. If the charitable gifts are high priority, consider giving up the life expectancy payout. 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 the life expectancy payout was not of significant value, and therefore not bother taking steps to try to preserve it.

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 totally a gift if the donor retains an income interest) is considered a gift for this purpose. PLR 9732023 answered this question favorably to the taxpayer involved in that ruling, 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)....”

Unfortunately, even aside from the fact that a private letter ruling cannot be relied on as precedent, the language of the ruling is ambiguous and limited. It says: “In the present case, the transfer of the [qualified replacement property] to the charitable remainder unitrust constitutes a disposition of such property with the meaning of section 1042(e) of the Code. However under the facts of the present case, no gain is realized by the Taxpayers on the transfer...,” with no indication of *why* no gain is realized. Presumably the rationale is that the transfer is a gift, and therefore excepted from the recognition of gain.

7.6.07 Lifetime gifts made directly from an IRA

Charities have long dreamed of a law that would permit the direct transfers of funds from an IRA to a charity. § 408(d)(8) (see ¶ 7.6.08–¶ 7.6.09) was the first such “charitable IRA rollover” to actually be enacted, after years of proposals, near-enactments, and vetoes. It fell far short of the ideal charitable IRA rollover law the charities would like to see someday, which would be unlimited in amount (not limited to \$100,000), available for all ages (not just over age 70½), and most of all would be PERMANENT (not expire at the end of 2009).

The “ultimate” charitable IRA rollover law envisioned by charities would permit a charitably-inclined participant to transfer his IRA to a charitable remainder trust (CRT; ¶ 7.5.04). The CRT would receive the funds income tax-free, then pay a unitrust or annuity income to the participant for his life, then to the participant’s surviving spouse for her life. When both spouses died, the funds would pass to the participant’s chosen charity.

The participant and spouse would get a life-long stream of income that would be somewhat steadier than an MRD payout from an IRA (and also would be longer-lasting, if they live into their mid 90s), and satisfy their charitable intent. *No income or estate taxes would ever be paid on the IRA balance* (though the annual distributions from the CRT would be taxable). The spouses could provide a replacement asset for their descendants by buying life insurance (via gifts to an irrevocable trust) with some of the income stream they received from the CRT. The life insurance also would never be subject to income tax or estate tax. However, this is still just a pipe dream; for now, lifetime gifts to charity using retirement benefits are limited to the options discussed at ¶ 7.6.01–¶ 7.6.06.

7.6.08 Qualified Charitable Distributions

§ 1201 of PPA ’06 created a temporary way to avoid *some* of the drawbacks of lifetime giving with retirement benefits discussed at ¶ 7.6.01. Under § 408(d)(8), added by PPA ’06, an IRA could make a “qualified charitable distribution” (QCD), which is a transfer directly from the IRA

to a charity; the QCD would be excluded from the IRA owner's income. Here are the limitations and restrictions on QCDs:

- A. **When.** Originally enacted as a temporary measure (good for IRA distributions in 2006 and 2007 only), this was extended in late 2008 for two more taxable years (2008 and 2009). § 408(d)(8)(F). After 2009, QCDs will cease to be available (unless Congress extends them again).
- B. **How much.** 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." IRS Notice 2007-7, 2007-5 I.R.B. 395, A-34.
- C. **Which plans.** QCDs may be made from IRAs only. You cannot have a QCD from a QRP, 403(b) plan, 457 plan, or ongoing SEP or SIMPLE. An "ongoing" SEP or SIMPLE in any particular year is one that receives an employer contribution in such year. IRS Notice 2007-7, A-36. PPA permits QCDs from Roth IRAs (to the extent the distribution would be included in the owner's gross income; see "D"), but Roth IRAs are not a favorable choice as a source of charitable gifts. § 408(d)(8)(B).
- D. **Which IRA assets.** The QCD must be a distribution that would otherwise be includible in the taxpayer's gross income. § 408(d)(8)(B). Thus, a qualified distribution from a Roth IRA (see ¶ 5.2.01 of *Life and Death Planning for Retirement Benefits*) could not be a QCD because a qualified Roth IRA distribution is nontaxable. What if the participant causes a transfer to be made to a charity from an IRA that contains both pre-tax and after-tax money (basis)? In the case of a distribution from a traditional IRA, the *usual* rule for allocating basis to any particular IRA distribution is that the distribution is deemed to come proportionately from the pre- and after-tax money in all of the participant's aggregated IRAs; see ¶ 2.1.10 of *Life and Death Planning for Retirement Benefits* for details. However, PPA 2006 creates a special exception to this rule for QCDs. A QCD is deemed to come *first* from the owner's pre-tax money in all of his aggregated IRAs, until that has been used up. § 408(d)(8)(D).
- E. **Who.** The IRA owner must be age 70½ or older. § 408(d)(8)(B)(ii). This is the first tax provision that has made the age 70½ "birthday" itself a significant event; minimum required distributions are based on the YEAR the participant reaches age 70½, not the DAY he reaches that age. 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 Congress provided.
- F. **Which charities.** A QCD can be made to any charity EXCEPT a donor-advised fund (see ¶ 7.5.03), a supporting organization (§ 509(a)(3)), or certain private foundations. § 408(d)(8)(B)(i). Also, there is a requirement that the QCD must be a contribution that would be 100 percent deductible if paid from the owner's nonIRA assets, so a split-interest gift will NOT qualify. Thus, QCDs cannot be made to a charitable remainder trust, pooled

income fund, or charitable gift annuity, or in exchange for any consideration. Note that in determining whether the gift would be 100 percent deductible if made with nonIRA assets the percentage-of-income limits in § 170(b) are ignored. § 408(d)(8)(C).

- G. Income tax treatment.** The QCD is excluded from the individual's gross income for all purposes. 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 deduction for the QCD.
- H. QCDs deemed to come first from pretax money in IRA.** There is a special basis recovery rule for QCDs. Normally, any IRA distribution carries out proportionate amounts of the "pretax" and "after-tax" money in the individual's IRA (with all of his IRAs being treated as single account for purposes of determining the proportions). See § 408(d)(1), (2), § 72(e)(2)(B), (5)(A), (5)(D)(iii), and (8)(B). Ed Slott, CPA, one of America's leading IRA experts and author of several books on retirement distribution planning and publisher of *Ed Slott's IRA Advisor* newsletter, calls this the "cream-in-the-coffee rule." Once after-tax money (cream) has been combined with the pretax money (coffee) in your IRA, every "sip" (distribution) taken from your IRA will contain some cream and some coffee. However, QCDs are one of the few exceptions to the cream-in-the-coffee rule: QCDs are deemed to come out of the IRA's pretax money first. § 408(d)(8)(D).

Burton Example. Burton is a charitably-inclined individual age 71 who does not like to pay taxes. He happens to own a \$70,000 IRA with a \$20,000 basis resulting from nondeductible contributions in prior years. In 2009, he directs the IRA provider to transfer \$50,000 from the IRA to the Santa Fe Opera Company, his favorite charity. This is a QCD, so the \$50,000 is deemed to come from the IRA's pretax money "first." Now he is left with a \$20,000 IRA which is 100 percent after-tax money. He converts this small "stub" IRA to a Roth IRA tax-free (if he is eligible). If he is not eligible to convert it to a Roth, he cashes it out tax-free instead.

7.6.09 *Planning uses and pitfalls of QCDs*

- A. QCD can be an MRD.** A QCD will count as a distribution for purposes of determining whether an individual has fulfilled the MRD requirement. IRS Notice 2007-7, A-42. This is consistent with Regs. § 1.401(a)(9)-5, A-9(a), and § 1.408-8, A-11(a), which state that, except as otherwise provided in A-9(b) or A-11(b) of such regulations, or as may later be otherwise provided by other IRS pronouncements, "all amounts distributed" from a plan or IRA "are taken into account in determining whether section 401(a)(9) is satisfied..." The charitable IRA rollover was an ideal way for a charitably-inclined individual over age 70½ to fulfill the MRD requirement during the years 2006–2008. There are no MRDs for the year 2009 (see Appendix A), so over-age-70½ individuals can still make QCDs in 2009, but they just won't count as MRDs (because there are no MRDs).
- B. Can beneficiaries use QCDs?** A beneficiary who is over age 70½ and who holds an inherited IRA can make a QCD from the inherited IRA. IRS Notice 2007-7, A-37.