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Life and Death Planning for Retirement Benefits, 7th edition, 2011

Post-Publication Updates

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This document contains post-publication updates to the 7th edition of *Life and Death Planning for Retirement Benefits* by Natalie B. Choate, Esq. If you own an earlier edition (such as the 5th edition (2003) or 6th edition (2006)) you need to buy the new 7th edition (2011). Visit www.ataxplan.com or call 800-247-6553. A "★" indicates a section with new material.

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TRUIRJCA SUPPLEMENT

TS-1 ***Introduction; overview***

The "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (Pub. L. 111-312, enacted December 17, 2010) ("TRUIRJCA") affects three aspects of planning for our clients' retirement benefits: lifetime charitable giving, Roth conversions, and estate planning. This Supplement summarizes TRUIRJCA's impact on benefits planning.

For the complete statute and explanation, see the CCH Publication *2010 Tax Legislation: Law, Explanation, and Analysis* ($71.50 at www.cchgroup.com).

- **Lifetime charitable giving from IRAs.** "QCDs" have been extended through 2011. See ¶ 7.6.07–¶ 7.6.09 below.

- **Roth conversions.** TRUIRJCA does not directly affect Roth conversions. None of the rules regarding Roth conversions or Roth recharacterizations was changed at all. TRUIRJCA has an *indirect* effect on Roth planning, by extending the "Bush-era tax rates" for two more years; see "*TS-2* ***Extension of Bush-era income tax rates***" below.

- **Estate planning: Higher exemption, lower rates, and "portability."** By increasing the estate tax exemption to $5 million (indexed for inflation), TRUIRJCA has made estate planning a whole lot easier for clients with modest net worth. For the wealthiest clients, TRUIRJCA's lower rates (maximum 35%) make estate taxes less onerous. For married "middle class" or "mass affluent" clients who have a substantial portion of their assets in retirement plans, the new "portability" of the estate tax exemption eliminates the need to make a tough choice between saving estate taxes and saving income taxes. See "*TS-3* ***Portability: Major impact on estate planning for retirement benefits***" below.

- For all of the above, the fact that all these reforms "sunset" at the end of 2012 (or 2011, in the case of QCDs) puts everybody back in the same fix we've been in since EGTRRA 2001: The lack of a permanent tax code makes planning impossible. See "*TS-4* ***When all of this 'sunsets'*** " below.

TRUIRJCA has other provisions impacting estate planning and administration that do not uniquely affect retirement benefits and so are not covered in this Supplement. For example, the federal estate tax and "stepped up basis," both of which had "expired" at the end of 2009, are retroactively reinstated for estates of individuals who died in 2010, but with the executor having the option to elect *out* of the new rule and opt instead to stick with zero federal estate tax and carryover basis. Many of these issues have been covered extensively by various estate planning experts in the highly recommended *Leimberg's Estate Planning Newsletter* (email only; $28 per month includes all four Leimberg newsletters and 24-hr access to extensive database; visit one-time free or subscribe at www.leimbergservices.com).

TS-2 ***Extension of Bush-era income tax rates***

For clients who did Roth conversions in 2010, TRUIRJCA will require them to do some careful calculations, and possibly revise their planning, before October 17, 2011. October 17, 2011, is the deadline for someone who files his 2010 income tax return on time to "recharacterize" 2010 Roth conversions (see ¶ 5.6 for explanation of the deadline for recharacterizations) and (for someone who has obtained an extension of time to file his 2010 tax return) to decide whether to report 2010 conversion income in 2010 or push it forward into 2011–2012 (see ¶ 5.4.05).

TRUIRJCA has extended, for two more years (through the end of 2012), the "Bush-era tax rates" (and various tax-lowering income tax rules) that applied in 2010 and that had been scheduled to "sunset" on 12/31/10. Thus, instead of the increase of the top tax bracket (to 39.6%) that was expected to occur effective 1/1/2011, the maximum tax rate will continue to be 35 percent (on taxable incomes in excess of approximately $375,000, adjusted annually for inflation) *through 12/31/2012.* TRUIRJCA continues the "EGTRRA sunset" concept for these rates and rules, but changes the "sunset" date from 12/31/10 to 12/31/12. See § 901 of EGTRRA, as amended by TRUIRJCA.

Individuals who did 2010 Roth conversions because they believed income tax rates would go up in 2011 no longer have that particular worry. Some of those people may decide to undo ("recharacterize") their 2010 Roth conversions since the feared tax increase has been postponed for two years; see ¶ 5.6 regarding recharacterization.

But remember, income tax increases are still scheduled to occur; they have just been delayed a little. The Bush-era tax rates were only extended through 2012. In 2013, the old higher rates (maximum 39.6%) are scheduled to reappear, along with the new *additional* 3.8% surtax on investment income (and higher "Medicare" tax on earned income) to pay for "health care reform." *Thus, a 2010 Roth conversion may still be an income tax bargain compared with higher future tax rates that may apply.*

Some clients may decide to keep their 2010 Roth conversions, but elect to have the income spread forward, half into 2011 and half into 2012. See ¶ 5.4.05. Through most of 2010 it appeared that no one would want to spread 2010 Roth conversion income forward into 2011 and 2012 because tax rates were scheduled to be higher in those years. Now that TRUIRJCA has extended the lower 2010 tax rates for two more years, spreading the income from a 2010 Roth conversion forward into 2011 and 2012 may become more attractive. After all, tax rates aren't going up, so you might as well keep the tax money in your pocket a little longer.

There's no one right answer for everyone on these questions. The new tax law is just one more factor to consider in the difficult decision of whether to recharacterize all or part of a 2010 Roth conversion and whether to include the 2010 conversion income in 2010 or push it forward into 2011–2012. Clients and their advisors can agonize about that all the way up to October 17, 2011.

TS-3 ***Portability: Major impact on estate planning for retirement benefits***

The most significant effects of TRUIRJCA have to do with estate planning. The federal estate tax exemption, which had been $3.5 million for deaths in 2009 and was scheduled to drop to $1 million in 2011, is set at $5 million per individual for deaths in 2011–2012, to be adjusted annually (beginning in 2012) for inflation occurring after 2010. § 2010(c)(2)(A), (B). The new estate

tax exemption level is higher than it has ever been (except for 2010, when optionally there was no estate tax at all), and will eliminate estate tax concerns for many clients in the modest-wealth and so-called "mass affluent" categories. Estates are taxed only if they exceed the exemption amount. As has "always" (except for certain deaths in 2010) been true, heirs receive a new basis in inherited property for income tax purposes equal to the date of death value of the inherited property, regardless of whether an estate tax was paid. And, as always, this so-called "stepped-up basis" does not apply to retirement benefits and other "IRD" assets; see ¶ 4.6.

For the wealthiest clients, the new maximum 35 percent estate tax rate for estates above the exemption will substantially ease estate tax pressures. This rate is significantly lower than the maximum marginal rates applicable in prior years (45% or even more).

And the gift tax exemption is once again "unified" with the estate tax exemption: The $5 million estate tax exclusion can be used during life by making gifts. § 2505(a)(1). This contrasts with the pre-2010 rules, under which the gift tax lifetime exclusion was capped at $1 million regardless of the size of the estate tax exemption.

The above changes significantly affect estate planning across the board. But perhaps TRUIRJCA's biggest game-changer for married couples with significant retirement assets is called "portability" of the estate tax exemption:

A. **What portability is.** The TRUIRJCA estate tax provision that most particularly impacts *retirement benefits* is a brand new concept in the Code, **portability of the estate tax exemption**. The Code doesn't use that phrase, but that's what everyone calls it. A surviving spouse can add to his or her own "basic exclusion amount" ($5 million adjusted for inflation) the unused estate tax exemption amount (the deceased spousal unused exclusion amount, or "DSUEA") of her or his "last deceased spouse," *provided* that the executor of such last deceased spouse timely filed an estate tax return for the estate of such last deceased spouse, computing (and irrevocably electing to allow the surviving spouse to use) the DSUEA. § 2010(c)(2)(B), (4), (5)(A). (Note that, unlike with the basic exclusion amount, the DSUEA amount is frozen at the first death—it does not increase with inflation. Compare § 2010(c)(3) with § 2010(c)(4). Also, the GST tax exemption is equal only to the individual's basic estate tax exclusion amount ($5 million adjusted for inflation); there is no ability to add on any unused GST exemption of a predeceased spouse. See § 2631(c).)

This is revolutionary. It means that the first spouse to die can leave his $5 million exemption to the surviving spouse, so the surviving spouse will have a $10 million exemption.

Under the bad old system, which might be called "use it or lose it," the estate tax exemption of the first spouse to die was "wasted" unless he or she (1) owned assets equal to the exemption amount and (2) left such assets to a beneficiary other than the surviving spouse or charity—such as the couple's children, or a "credit shelter" (bypass) trust for the life benefit of the surviving spouse.

Thanks to TRUIRJCA, couples no longer have to create "credit shelter trust" estate plans to make full use of both spouses' exemptions. No longer do they have to carefully rearrange their assets to make sure that, regardless of which spouse dies first, the deceased spouse will have assets at least equal to the exemption amount, to avoid "wasting" his or her exemption.

This will make estate planning easier for many couples, *especially* when one or both spouses have most of their assets in the form of retirement plans and IRAs (see "E" below).

B. Details, round one: How does unused exemption pass to the surviving spouse? Here is how the basic concept of portability works. A married person dies, survived by his spouse. The decedent's taxable estate is determined and an estate tax return is filed. The estate tax return may show that the decedent "used" some or all of his federal estate tax exemption. For example, if the decedent died in 2011 leaving $5 million of assets to his children, or to a credit shelter trust, or to any other beneficiary who is not the surviving spouse, a marital deduction trust, or a charity, the decedent has "used up" all of his estate tax exemption and that's the end of it. If the decedent left his entire estate to his spouse or charity, or had no assets at all, he didn't use *any* of his exemption. If the decedent left some assets, but less than $5 million, to nonspouse noncharitable beneficiaries, then he used *part* of his exemption.

Whatever portion of his $5 million exemption the decedent did NOT use can pass to the surviving spouse. But it doesn't pass to the surviving spouse automatically. Rather, the executor of the first spouse's estate must file an estate tax return ON TIME and elect to leave any unused exemption to the surviving spouse. § 2010(c)(5)(A). The Code does not require that the decedent's estate plan "leave" unused exemption to the spouse, so you don't have to have a will provision bequeathing this item to the surviving spouse, for example. It only requires that the executor elect to do so.

The fly in the ointment here is the requirement that the election be made on a *timely filed* estate tax return. "On time" means within nine months after the date of death, or by any extended deadline the estate has sought and obtained from the IRS. With no estate tax return being required for estates under $5 million, there will be large numbers of estates that lose the portability advantage because nobody bothers to file an estate tax return at the first death. Except in the case of very close-in-time deaths, it will be too late, when the surviving spouse dies, to go back and file an estate tax return for the first spouse.

C. Details, round two: How does surviving spouse use the exemption? When the surviving spouse later dies, her estate tax return will report her own exemption and the DSUEA from her last deceased spouse, all to be applied to her gross estate to determine her taxable estate. Note that the IRS can audit the estate tax return of the first spouse for purposes of verifying (and revising if appropriate) the DSUEA amount, even after the statute of limitations has passed for assessing tax against the first estate. § 2010(c)(5)(B).

What can make the DSUEA subject very complicated is remarriage of the surviving spouse. There is a limit on how many "DSUEAs" (Deceased Spouse Unused Exemption Amount) a surviving spouse can collect. Basically on the surviving spouse's subsequent death she only gets to use the DSUEA of her "last" deceased spouse. Planners will spend considerable time working with this limitation to see whether DSUEAs can nevertheless be "stacked" by means of lifetime gifts. For extensive commentary on this subject see *Leimberg Estate Planning Newsletters*. Since this aspect affects "all" estates' portability issues, not just retirement benefits, it is not further discussed here.

D. Details, round three: Which predeceased spouses? The statute allowing use of the DSUEA applies "with respect to a surviving spouse of a deceased spouse dying after December 31, 2010." § 2010(c)(4). The question is whether "dying after December 31,

2010" modifies "a surviving spouse" or "a deceased spouse." Although when I first read this clause I thought it could be read to modify "a surviving spouse" or at the very least that it was ambiguous, I have since changed my mind and joined the rest of the world in concluding that there can be no "DSUEA" with respect to a deceased spouse who died before 2011.

The whole section only applies to people dying after 12/31/2010 (see § 302(a)(1) of TRUIRJCA), so there would be no need to insert "dying after 12/31/2010" to define which surviving spouses you are referring to—that would be redundant. Therefore the clause must identify *which predeceased spouses we are talking about*. Also, there would be no need to include the words "of a deceased spouse" unless you were doing so to limit the provision to *certain* deceased spouses; ALL surviving spouses are surviving spouses of deceased spouses. Therefore the purpose of including "of a deceased spouse" was to allow the DSUEA provision to be limited to surviving spouses *of deceased spouses who died after 2010*.

Bottom line: A widow or widower whose deceased spouse died prior to 2011 can NOT reach back and claim the decedent's unused exemption amount.

E. Advantage of portability for benefits-heavy estates. Joe and Lucia are married to each other, with three children. Their only asset is Joe's $10 million IRA. With $10 million of assets they obviously want to make sure they take full advantage of their estate tax exemptions, so the full $10 million can eventually pass to their three children with no federal estate tax.

Without portability, the only way they could have taken advantage of their exemptions was for Joe to cash out half his IRA, pay the income tax on it, and give the net to Lucia (so she would have assets in her name even if she died first—assets she would leave either directly to the children or to a "bypass trust" for Joe's life benefit), then (if Lucia survives him) leave what was left of his IRA either directly to the children or to a "credit shelter" or "bypass" trust for the life benefit of Lucia. Leaving the IRA direct to the children could be a good tax move, but most clients don't like it because it takes money away from the surviving spouse.

Leaving an IRA to a bypass or credit shelter trust for the surviving spouse SEEMS to protect the surviving spouse financially, and it definitely saves estate taxes for the children by keeping the IRA out of the surviving spouse's estate, but it causes a huge loss of income tax benefits. There is no spousal rollover for retirement benefits left to a trust, and no stretch payout over the children's life expectancy even after the spouse's later death. Instead, the entire IRA gets dumped out into the credit shelter trust over the single life expectancy of the surviving spouse, a relatively short period of time.

So (prior to TRUIRJCA) clients in Joe's and Lucia's situation had to make a hard choice: Do we go for the income tax benefits of the spousal rollover by leaving the entire IRA outright to the surviving spouse, even though that costs extra estate taxes by wasting the first spouse's estate tax exemption? Or do we save estate taxes by leaving the benefits to a credit shelter trust but give up on the long term deferral that would otherwise be available via the spousal rollover?

Thanks to TRUIRJCA clients will no longer have to make that particular hard choice. Instead, Joe can leave his $10 million IRA outright to Lucia and Joe's executor can *also* elect to leave her Joe's $5 million estate tax exemption. Joe and Lucia can now get the income tax savings

of long-term deferral of distributions via the spousal rollover, *without* having to waste one spouse's estate tax exemption to get it. When Lucia later dies, she will have a $10 million IRA and a $10 million estate tax exemption.

Of course, as with all estate tax planning, there are many factors to consider besides federal taxes. There are other reasons couples might leave assets in trust for each other rather than outright to each other, such as: desire to preserve assets for the couple's children in case the surviving spouse remarries; concern about the surviving spouse's vulnerability to creditors, disability, or poor investing/spending choices; state estate tax issues; concern about future changes in the estate tax law; etc. And for couples whose assets are *not* primarily in the form of retirement benefits, leaving assets in trust for the surviving spouse is usually a neutral choice income tax-wise compared with leaving assets outright to the spouse, so that if these other factors apply they can ignore portability and leave assets in trust with no income tax loss.

But for couples where a substantial portion of the assets are in retirement benefits, leaving such retirement benefits to a trust for the spouse versus outright to the spouse is *not* an income tax-neutral choice. Leaving benefits to a trust for the spouse is extremely unfavorable compared to leaving such benefits outright to the spouse who rolls them over to her own IRA. See ¶ 3.3.02. "Portability" has a major favorable impact on these couples, enabling them to get *both* the income tax benefits of the spousal rollover (by allowing all retirement benefits to belong outright to the surviving spouse) *and* the estate tax benefits of using both spouses' estate tax exemptions. .

F. The executor's dilemma. At first it appears that portability is "easy": You don't need to change clients' wills to "leave" the exemption to the surviving spouse; the executor or administrator can make this election even if there is no will at all (client died intestate). And there is no disadvantage to the first estate to leaving unused exemption to the surviving spouse, except possibly the increased cost caused by filing an estate tax return if one would not have been required otherwise. So what's the problem?

There will be difficult decisions for executors of estates under $5 million (no return required). Should the executor incur the cost of filing an estate tax return when no return is required? After all there is no benefit to the estate itself to "leave" the unused exemption to the surviving spouse, but the estate has to pay the cost of filing the return. And there is no benefit to *anyone* of making the election if the surviving spouse dies after 2012 (after the law has sunsetted) and/or dies owning assets that are under the basic exemption amount.

Consider the executor of a $1 million estate of a 2011-deceased husband whose wife has no assets other than the $1 million husband leaves her; should that executor file a return to make the election on the assumption that the wife may win the lottery and then die before 2013? What if the wife has already remarried, or if the executor knows the wife plans to leave her entire estate to charity? To help out the executor, it may make sense, when updating clients' estate plans, to include a provision authorizing the executor to file a federal estate tax return for the purpose of leaving the DSUEA to the surviving spouse. The will should specify who pays the cost of preparing the return if it would not otherwise be required.

TS-4 ***When all of this "sunsets"***

As noted, TRUIRJCA's estate tax structure has significant effects and planning consequences for all individuals, whether wealthy, not so wealthy, or "mass affluent." The problem is, like Cinderella's coach, this structure is scheduled to "turn into a pumpkin" at midnight December 31, 2012. (QCDs sunset even earlier: December 31, 2011.) Once again we have a "temporary" estate tax law, which discourages clients from making any plans. All planners and their clients will have to decide how best to cope with a death tax law that changes shape every year or two and doesn't even purport to be permanent.

If all of TRUIRJCA will truly sunset, then there are certain courses of action that appear recommended for estate planning clients. The wealthiest clients will want to take advantage of the $5 million gift tax exemption as soon as possible. Married couples will have the following choices:

- Arrange their assets and estate plans so the estate plan will "work" to minimize taxes under either portability or use-it-or-lose-it, with either a 35% or a 45% estate tax rate, and with either a $5 million or a $1 million exemption. This is the "best" approach but also the most expensive and complicated.

- Ignore the whole problem until we get a permanent law. This approach is not recommended.

- Arrange their assets and estate plans so the estate plan will work based on the assumption that Congress will make the TRUIRJCA changes permanent, and then watch developments closely, and be ready to make further changes if sunset occurs or gets close to occurring (and make sure the durable power of attorney enables the power holder to make these changes in the estate plan). This may be a popular compromise.

Chapter 1: THE MINIMUM DISTRIBUTION RULES

No updates at this time.

★Chapter 2: INCOME TAX ISSUES

★ *2.1.02* ***Post-2010 tax increases; surtax on investment income****, pp. 122–124:*

The tax increases described in paragraphs (A) and (D) that were scheduled to occur in 2011 have been postponed until 2013. See ¶ TS-2 above.

Chapter 3: MARITAL MATTERS

No updates at this time.

★Chapter 4: INHERITED BENEFITS: ADVISING EXECUTORS AND BENEFICIARIES

★ *4.1.01* ***The Executor's Road Map***

For a new responsibility applicable to executors of 2010 decedents, see ¶ 4.3.08 below. For a new responsibility of executors of post-2010 married decedents, see ¶ TS-3(F) above.

★ *4.3.08* ***Deaths in 2010: One-year "repeal" of the federal estate tax***

As a result of TRUIRJCA, we have a new but still temporary estate tax law. See ¶ TS-3 above for description of the estate tax regime applicable for deaths in 2011–2012. This regime is *also* applicable to estates of decedents who died in 2010, but with two twists: First, executors of 2010 decedents can elect OUT of this estate tax regime, and choose instead to have no estate tax and to have the mostly-carryover basis described in ¶ 4.3.08. See § 301(c) of TRUIRJCA. The due date for filing estate tax returns for decedents who died in 2010 is extended to nine months after the date of enactment of TRUIRJCA (12/17/2010); see § 301(d) of TRUIRJCA. Second, "portability" (see ¶ TS-3 above) is not available for 2010 decedents' estates, even if the executor does not elect out of the estate tax. § 2010(c)(4).

★ *4.6.08* ***IRD deduction on the income tax return***

Delete the last paragraph of this section and substitute the following:

"On the negative side, the § 691(c) deduction is subject to § 68, under which an individual's itemized deductions are reduced by an amount equal to as much as three percent of the individual's AGI in excess of an annually-adjusted threshold amount, or (if less) 80 percent of total itemized deductions. § 68(a), (b). EGTRRA repealed § 68 effective in 2010; see § 68(g). Under TRUIRJCA, this repeal "sunsets" after 2012, reinstating the reduction at 2001 levels starting in 2013. See § 901 of EGTRRA, as amended by TRUIRJCA. The § 68 reduction of itemized deductions does not apply to trusts or estates; see ¶ 6.5.04."

Chapter 5: ROTH RETIREMENT PLANS

No updates at this time.

★Chapter 6: LEAVING RETIREMENT BENEFITS IN TRUST

★ *6.4.06* ***Planning choices: trust for spouse***

A. Conduit trust as credit shelter or QTIP substitute, p. 460:

See ¶ TS-3 above regarding the effect of "portability" of the federal estate tax exemption on planning choices for married couples.

★Chapter 7: CHARITABLE GIVING

★ *7.6.01* ***Lifetime gifts from distributions***, p. 511

To reflect enactment of TRUIRJCA, in paragraph (B) of this section change "(before and after 2010)" to (before 2010 and after 2012)."

★ *7.6.07* ***Qualified Charitable Distributions***, p. 514

When *Life and Death Planning for Retirement Benefits* went to press, "Qualified Charitable Distributions" had expired at the end of 2009, so the book includes no material on that subject. Subsequently, Congress enacted TRUIRJCA and "revived" QCDs for 2010–2011. Accordingly, ¶ 7.6.07 on page 514 is hereby replaced by the following new ¶ 7.6.07–¶ 7.6.09:

7.6.07 ***Qualified Charitable Distributions***

In a year when "qualified charitable distributions" (QCDs) are permitted, an IRA owner or beneficiary who is older than age 70½ can transfer funds directly from his IRA (or inherited IRA, as the case may be) to charity without having the distribution be reportable as a distribution to himself. Here are the limitations and restrictions on QCDs; see ¶ 7.6.09 regarding 2011 QCDs that can count as 2010 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). In December 2010, as part of TRUIRJCA, § 408(d)(8)(F) was extended for two more years (2010–2011). Accordingly, barring further extensions, QCDs are or have been permitted for the six years 2006–2011, and will no longer be allowed after December 31, 2011. See TRUIRJCA § 725.

B. **How much.** The QCD income exclusion (see "F") 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. So, a husband and wife who are both over age 70½ and both have IRAs can each transfer up to $100,000 to charity from their IRAs in the same year.

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. A QCD can come from a Roth IRA (to the extent the distribution would be included in the owner's gross income; see "D"). § 408(d)(8)(B).

D. **Who.** The QCD donor can be either an IRA participant donating from his own IRA, or a beneficiary donating from an inherited IRA. IRS Notice 2007-7, A-37. The only requirement is that the donor (whether owner or beneficiary) must be age 70½ or older.

§ 408(d)(8)(B)(ii). This is the first tax provision to make 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 (see ¶ 1.4.02). 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.

E. **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 can NOT be made to a charitable remainder trust (¶ 7.5.04), pooled income fund (¶ 7.5.10), or charitable gift annuity (¶ 7.5.08), or in exchange for any consideration. Note however 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).

F. **Income tax treatment: exclusion.** 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.

G. **Income tax treatment: effect on basis.** The QCD must be a distribution that would otherwise be includible in the donor's gross income. § 408(d)(8)(B). Thus, a qualified distribution from a Roth IRA (see ¶ 5.2.01) could not be a QCD because a qualified Roth IRA distribution is nontaxable.

To accommodate this requirement, there is a special basis recovery rule for QCDs. Normally, any traditional IRA distribution carries out proportionate amounts of the "pretax" and "after-tax" money in the individual's IRA (with all of his traditional IRAs being treated as single account for purposes of determining the proportions). See ¶ 2.2.08. QCDs are one of the few exceptions to this "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 Red Cross. 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 can then convert this small "stub" IRA to a Roth IRA (¶ 5.4) tax-free, or cash it out tax-free.

H. **Income tax: reporting.** The IRA custodian is supposed to report the QCD on Form 1099-R, just as if it had paid the distribution to the individual donor rather than to a charity, and the

1099-R will *not* reveal that the distribution is nontaxable. As the IRS put it in the instructions for Form 1099-R (2009), "There's no special reporting" that IRA providers have to do for qualified charitable distributions. (Form 1099-R for 2010 has not been released at the time of this writing.)

Rather, it's up to the donor to report the nontaxable status, as follows (from the IRS instructions for Form 1040, 2010): First, he enters the total distribution (as shown on Form 1099-R) on Line 15a of his personal income tax return, Form 1040. Then he enters the taxable portion of the distribution (zero) on Line 15b. See instructions for IRS Form 1040, 2010, pp. 22–23 (Lines 15a and 15b, Exception 3). Then the donor is supposed to "Enter 'QCD' next to line 15b," apparently by hand in the margin of the tax form.

7.6.08 ***Planning uses and pitfalls of QCDs***

A. **Use QCD to fulfill 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 is an ideal way for a charitably-inclined individual over age 70½ to fulfill the MRD requirement during any year QCDs are permitted.

B. **Mixing up QCDs and MRDs.** Someone who has already taken his MRD for a particular year cannot use a QCD later in the year to fulfill his MRD requirement for that year; he cannot roll the already-taken MRD back into the IRA (to enable him to use a QCD instead) because MRDs are not eligible rollover distributions. ¶ 2.6.03. He can still make a QCD from his IRA; it just will not be his MRD. People will get confused about the MRD/QCD relationship. The two things have nothing to do with each other (other than the fact that a QCD counts towards the MRD, to the extent the MRD has not already been taken). A person can make QCDs of up to but not more than $100,000 (in any year QCDS are permitted), *regardless* of: whether his MRD for the year is more or less than $100,000; *regardless* of whether he has already taken the MRD; and *regardless* of what other distributions he has taken or later takes from the IRA.

C. **Advantages of the QCD.** The QCD eliminates *some* of the problems that arise when making lifetime charitable gifts from an IRA (see ¶ 7.6.01). A QCD does not increase AGI and therefore does not: decrease the deductibility of medical expenses or miscellaneous itemized deductions; increase the taxability of Social Security benefits; increase the reduction of other itemized deductions under § 68(a); increase Medicare premiums; or increase state income taxes (in a state that uses federal AGI as the basis for computing state income tax but does not allow a charitable deduction). Since there is no itemized charitable deduction involved, the gift does not "count" for purposes of the percentage-of-income limits on charitable deductions in § 170(b); does not get reduced by § 68(a) (in year when itemized deductions

are reduced for high-income taxpayers; § 68(a) applies only for years before 2009 and after 2012, see § 68(g)); and is in effect "deductible" even for someone who does not itemize deductions.

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

E. **Drawbacks, problems, and what will go wrong.** QCDs are allowed only for direct transfers from the IRA to one of the permitted types of charitable recipients. If the money is first distributed to the participant, then donated to charity, it is not a QCD, and all the usual limits and drawbacks described at ¶ 7.6.01 above will apply. While it might appear desirable for an over-age 70½ individual to use QCDs to fund all of his charitable contributions, there will be practical limits on this: Presumably, IRA providers will start charging "distribution fees" or setting minimum distribution amounts if they are asked to issue dozens of tiny QCDs. Finally, other requirements for charitable contributions still apply! Thus the donor must still obtain a receipt from the charity and a confirmation that there was no consideration received in exchange for the donation. See § 170(f)(8).

7.6.09 ***January 2011 QCDs treated as 2010 QCDs***

When enacting the extension of QCDs in mid-December 2010, Congress had to admit that its action came too late to help most people with their tax planning for 2010. So TRUIRJCA includes a unique provision valid for one month only: § 752(b)(2) of the Act contains the following very "Special Rule" regarding QCDs: "At the election of the taxpayer," any QCD made in *January 2011* "shall be deemed to have been made on December 31, 2010" for purposes of § 408(a)(6), (b)(3), and (d)(8) of the Code. § 408(a)(6) and (b)(3) are the provisions that make the "minimum distribution rules" applicable to IRAs (see ¶ 1.1.02) and individual retirement annuities. § 408(d)(8) governs the income tax treatment of QCDs (see ¶ 7.6.07). So:

- **Minimum distributions, good news:** If an over-age-70½ individual failed to take his 2010 IRA minimum required distribution (MRD) by December 31, 2010, he normally would owe a 50 percent penalty on the amount that he was supposed to withdraw in 2010 but didn't. See § 4974 and ¶ 1.9. But under TRUIRJCA, this individual can transfer funds (up to $100,000) directly from his IRA to a qualifying public charity *in January 2011* and elect to have that transfer "count" towards his 2010 MRD, thus eliminating any otherwise applicable penalty to that extent. Though the existence of this election is acknowledged in the instructions for IRS Form 1040 (2010), the IRS has not yet issued forms or rules with respect to this election.

- **Minimum distributions, bad news:** An individual who actually took his MRD in 2010 (as he was supposed to do) by withdrawing money or assets from the IRA cannot now somehow return the MRD to the IRA and then (in January 2011) "redo" his 2010 MRD as a QCD by sending the money to charity instead. An MRD, once it has been distributed out of the IRA,

cannot be rolled over; it cannot be rolled back into the IRA it came out of or into any other plan or IRA. See ¶ 7.6.08(B) and ¶ 2.6.03.

- **Minimum distributions, unclear:** See ¶ 1.2.05 regarding how to calculate each year's MRD based on the prior year-end account balance. If the taxpayer elects to have his January 2011 QCD treated as having been made on December 31, 2010, it is not clear whether the amount of the "deemed" 2010 QCD is deducted from the "prior year-end account balance" for purposes of determining the *2011* MRD.

- **QCD $100,000 annual limit:** Regardless of whether the individual needs to have his January 2011 QCD "count" to fulfill his 2010 MRD, by making the election under § 725(b)(2) of the Act, the individual can actually give up to $200,000 to charity from his IRA in 2011, if he transfers $100,000 to charity from his IRA in January 2011. Up to $100,000 so transferred in January 2011 could be treated as if it had been transferred December 31, 2010, for purposes of applying the $100,000-per-year limit.

★Chapter 8: INVESTMENT ISSUES; PLAN TYPES

★ *8.1.02* ***Investment losses and IRAs***, p. 517

To reflect enactment of TRUIRJCA, in the last line of paragraph (C) of this section change "through 2009 and after 2010" to "through 2009 and after 2012."

★ *8.1.04* ***Paying, deducting, IRA investment expenses***, p. 522

To reflect enactment of TRUIRJCA, in paragraph (B) of this section change "(through 2009 and after 2010)" to (before 2010 and after 2012)."

Chapter 9: DISTRIBUTIONS BEFORE AGE 59½

No updates at this time.

[end of Update to *Life and Death Planning for Retirement Benefits*, 7th ed. 2011]