Payment of Charitable Bequests from IRD Assets

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The desire to mimimize or avoid taxes is a significant driver for much of traditional estate planning. It is certainly not the only factor, nor is it even the primary factor that motivates people to plan. But it is undeniably a major driving force for certain planning techniques even in an era of unprecedented high exemption levels in the history of the federal estate tax. As the estate tax exemption has increased, the tax-oriented aspects of estate planning have turned more and more to income tax issues.

The primary tax issue faced by most without question is income tax on certain tax-qualified retirement plans and other assets that carry ordinary income tax liability with them through the death of the current owner. These have been and remain some of the most difficult assets to address in estate planning, and the options for avoiding income tax on them are limited. In fact, using them for charitable giving is really the only way to avoid tax on them entirely, but even that must be done carefully.

Terminology

Before discussing the issues with using these types of assets for charitable bequests, we should clarify some of the terms that will be used. The term "*qualified retirement plan*" or "*retirement account*" generally means a plan qualified under Section 401 of the Internal Revenue Code. These include, but are not limited to, profit sharing plans, money sharing plans, thrift plans, 401(k) plans, employee stock ownership plans (ESOPs), simplified employee pension plans (SEPs), SIMPLE plans and other defined contribution plans, individual retirement arrangements under Section 408 (IRAs) or Section 408A (Roth IRAs), and tax–sheltered annuities under Section 403 (TSAs). The term "*qualified retirement benefits*" means the amounts held in or distributed pursuant to a plan qualified under Section 401, an IRA, a TSA or any other benefit subject to the distribution rules of Section 401(a)(9). The term "*Participant*" means the employee who participates in a qualified plan, or the account owner in the case of an IRA or TSA.

Tax Issues Facing Retirement Accounts

Many people have heard of the “stepped-up basis” rules for certain assets left to others by a person who dies. Internal Revenue Code Section 1014(a) provides that capital assets left by a decedent will be transferred to the recipients with a fair market value basis. Thus, the recipient will be deemed to have paid for the asset what it was worth at the date of death. While this is referred to as a step up in basis, one can see that there could actually be a step down in basis. Generally, however, the result is an increase in the basis, saving the recepient capital gains taxes if he or she sells the asset.

Unlike capital assets that are part of a decedent's estate, qualified retirement benefits inherited by a beneficiary carry with them potential ***income tax*** consequences to the beneficiary who receives them. Qualified retirement benefits (less nondeductible contributions made by the decedent) are income with respect of a decedent (IRD) property subject to income tax to the beneficiary who receives them at the owner's death. The Treasury Regulations define IRD as an income interest that a deceased person earned or brought to the point during his lifetime that he or she would have recognized the interest as income if only he or she had lived long enough to receive or report it under his or her tax accounting method.[1] Since the decedent did not include this income on his or her income tax return, the Internal Revenue Code (Code) taxes it to the party who succeeds to the right to receive it. IRD retains the same character when taxed to the beneficiary as it would have had in the hands of the decedent.[2]

Using IRD for Charitable Bequests

A charity is a tax–exempt entity, so it will not pay tax on IRD that it receives by "bequest, devise, or inheritance."[3] So, one might argue that just as a lifetime gift of a capital asset to charity produces a double tax benefit (i.e., avoidance of capital gains and an income tax deduction for the value of the contribution), so should a testamentary contribution of retirement plan benefits directly to a charity. So, it should seem a simple conclusion to reach that using IRD assets to satisfy any charitable gifts at death is the most tax efficient planning. One should strive to leave the taxable assets (i.e., the IRD items) to the nontaxable beneficiaries, and the nontaxable assets (i.e., all capital and non-IRD assets) to the taxable beneficiaries.

Although that conclusion is easy to reach, putting the idea into action is not quite as simple. It can be quite difficult to coordinate IRD assets with entire estate plan by utilizing a beneficiary designation, and it can also be a mine field or trap for the unwary. For example, how would a person give 10% of his or her total estate to charity with a beneficiary designation. One option would be drafting a specific beneficiary designation and attaching it to the beneficiary designation form with some kind of formula to direct a portion of the retirement account or accounts to charity that happen to equal 10% of the total estate. The hope, then, is that the company will accept the special designation submitted. That does not give much certainty to the plan, or comfort the the person doing the planning

In recent years, many attorneys began directing these IRD assets to the client's estate or to a revocable living trust (RLT) and then including language to designate the gift to charity in the client's last will and testament (Will) or RLT. A problem arose, however, in that the IRS takes position that in the absence of specific language in the Will or RLT

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[1] Treas. Reg. § 1.691(a)–1(b).
[2] I.R.C. § 1014(c).
[3] I.R.C. § 691(a)(1)(C). *See* PLR 200002011 (Income from decedent's specific bequest of stock options to charity is not IRD to the decedent's estate.

specifically allocating the IRD income to charity, federal tax law deems gifts to charity to come from trust *principal* at death, and ***not*** from *income or from IRD assets.*

To address this issue, attorneys then began including ordering provisions in the RLT. Typically, the attorney would attempt to accomplish that goal by adding language to a Will or RLT requiring the satisfaction of any charitable gifts using IRD property. By adding this language, the idea is to qualify the gift for not only the estate tax charitable deduction, but also an income tax deduction for the contribution under Section 642(c) as an amount paid or permanently set aside for charity by the estate or trust. Without this language the administrative trust can claim an estate tax charitable deduction for the charitable contribution but not an income tax charitable deduction since, in the absence of specific language allocating IRD income to charity, federal tax law deems gifts to charity to come from trust *principal* at death, and ***not*** from *income or from IRD assets.*[4] This language would seem to solve the problem.

However, in T.D. 9582, 77 Fed. Reg. 22483 (April 14, 2012), the Treasury Department issued final regulations stating that for charitable lead trusts and other trusts and estates making payments or permanently setting aside amounts for a charitable purpose, an ordering provision will be given effect for income tax purposes only if they have economic effect separate from their income tax consequences. The IRS will ignore other ordering provisions, and income distributed for charitable purposes will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes. This muddies the water significantly.

Some experts are concerned that the new regulations may put an end to this planning technique. The concern is that the IRS could argue this allocation of IRD falls within the purview of the new regulation, and that the allocation is ineffective because it has no economic effect separate from its income tax consequences. Other planners argue that the IRS lacks authority to promulgate regulations that require independent economic effect when 642(c) itself (1) allows income ordering and (2) does not require any type of independent element beyond the income tax consequences of the order rules. We think the arguments in the last sentence are strong, but recent years have proven that it is difficult to predict tax law with any certainty.

A Safe Alternative

So, what is a prudent planner to do? While it is quite possible we could all continue including ordering provisions and end up just fine if the IRS does not tax an adverse position or loses if and when it does so, that is not likely to put clients (or planners, for that matter) much at ease. A cautious approach that is certain to work in the meantime is determining what percentage of the IRD assets alone is equal to the value of the total charitable gift of gifts intended, and then making direct beneficiary designations to the charity or charities from the IRD accounts.

[4] *See Crestar Bank et al., Executors of the Estate of James Linen v. IRS* 47 Fed Supp 2d 670 (E.D.Va 1999);*Van Buren v. Commissioner*, 89 T.C. 1101(1987).

For example, if a person with a $1 million estate that includes $200,000 in an IRA intends to leave 10% of his or her estate to charity at death, then he or she could designate the intended charity as a beneficiary of 50% of the IRA. Then, the nontaxable charity would receive the intended charitable gift of $100,000 directly from the IRA while avoiding the risk of losing the income tax deduction that routing the account through the estate or trust would carry.

The downside of this option is obvious—it requires continued monitoring of asset values as a proportion of the overall estate, along with some adjustments in the beneficiary designation as needed to keep the charitable portion in line with the intended size of the gift. In our example, for instance, if the overall estate value remained the same but the IRA grew to be $300,000 of that $1 million estate, then the beneficiary designation would need to be revised to direct one-third of the account to charity. But every option has its benefits and drawbacks. Planners and their clients need to weight the risks and determine which risk is more manageable or tolerable.