Charitable Gifts of Retirement Plan Assets

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INTRODUCTION

Gifts from retirement plan accounts (tax-qualified plans and IRAs) are an increasingly popular way for donors to benefit charity. Their growing popularity is a result both of increased plan accumulations and the tax benefits of such gifts. This outline discusses several topics useful to the gift planner: In addition to statistical information on retirement accumulations and analysis of the tax benefits associated with related gifts, this discussion effectively provides the gift planner with a checklist of issues to address with a prospective donor to determine whether a gift of retirement assets is possible and practical and, if so, how best to structure the gift to benefit the donor and charity. Although the principal focus of this outline is on gifts made at the time of the retirement plan participant’s death, a discussion of lifetime gifts of retirement assets is also included, with special emphasis on the “IRA charitable rollover” opportunities created by the Pension Protection Act of 2006.

I. THE INCREASING IMPORTANCE OF RETIREMENT PLAN ASSETS FOR DONORS AND CHARITY

Americans rely on a variety of tax-advantaged investment vehicles to enhance their retirement savings, including Individual Retirement Accounts (IRAs), employer-sponsored 401(k), 403(b) and 457 plans, federal, state or local government pension plans and others. In 2005, assets held in Americans’ retirement plan accounts reached a record high of $14.5 trillion dollars, and now account for over one-third of household financial assets. While retirement plan account owners have long benefited from income tax deferral accorded these plans under federal law, recent tax law changes permitting (1) larger plan contributions and (2) longer tax deferral periods appear to have contributed to enhanced growth of assets in these accounts in recent years. As the value of assets in retirement plans has increased, the use of these accounts to fund charitable gifts has also become quite popular, especially for plan participants who have accumulated more in their IRAs or other plan accounts than they can use during their lifetimes.

1) Growing Significance of Retirement Plan Accumulations.

a) 2005 Retirement Accumulations: Americans’ savings in Individual Retirement Accounts (IRAs), employer-sponsored defined contribution (DC) and defined benefit (DB) pension plans and annuities has grown substantially over the past two decades. According to research conducted by the Investment Company Institute, in 2005 these assets reached a record $14.5 trillion – a seven percent increase since 2004 and a nearly 40 percent increase since 2002. For a complete discussion, see: www.ici.org/pdf/fm-v15n5.pdf

i) Assets by Plan Type: IRA and Keough accounts represented over 25% of U.S. retirement assets as of December 2004.

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined Benefit</td>
<td>14.2%</td>
</tr>
<tr>
<td>Defined Contribution</td>
<td>19.5%</td>
</tr>
<tr>
<td>Private Insured</td>
<td>13.5%</td>
</tr>
<tr>
<td>Federal Government</td>
<td>7.8%</td>
</tr>
<tr>
<td>State and Local Government</td>
<td>19.6%</td>
</tr>
<tr>
<td>IRA &amp; Keough</td>
<td>25.4%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute

ii) Increase in Plan Accumulations from 1985 to Present: Historical data show significant growth in retirement accumulations since 1985, and an extraordinary increase from 2002 to present: Totaling $2.3 trillion in 1985, retirement plan assets hit a high of $11.8 trillion in 1999 and then declined along with the bear market down to $10.4 trillion in 2002, before rebounding to reach new highs (in excess of $14.5 trillion by 2005). The cumulative growth over the three-year period from 2002 to 2005 has
been 39.4%. A table with historical data, including accumulations by plan type since 1985 can be found at [www.ici.org/stats/res/1fm-v15n5_appendix.pdf](http://www.ici.org/stats/res/1fm-v15n5_appendix.pdf).

iii) Investment Company Institute research indicates that retirement plan savings account for approximately 38% of Americans’ household financial assets.

2) **Legal Changes Encourage Growth of Retirement Accumulations**

   a) The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) created increases in plan funding limits, allowing taxpayers to contribute more money to retirement accounts. Under EGTRRA, these funding increases were to sunset in 2011, but the Pension Protection Act of 2006 (“PPA”) makes the increases permanent.

   i) EGTRRA increased employee contributions for traditional IRAs, creating great opportunity for additional tax-deferred savings.

   ![IRAs - INCREASED FUNDING LIMITS UNDER EGTRRA](chart)

   (1) EGTRRA also introduced so-called “catch-up” provisions for IRA accounts, allowing taxpayers age 50 and older to fund traditional IRAs to an even greater extent. For tax years 2002-2005, these taxpayers could contribute an additional $500 per year over and above the increased limits. For 2006 through 2010, the catch-up amount is an additional $1,000 per year. These increases were made permanent by the PPA.

   ii) EGTRRA raised salary-reduction contribution limits for 401(k), 403(b), 457 plans, as well, and did away with the old “coordination” rules between 401(k) and 457 plan contributions (under which contributions to one type of plan limited the ability to contribute to the other).
(1) Additional catch-up contributions for these plan types were also permitted under EGTRRA, for those age 50 and above, pursuant to the following schedule:

- 2002 - $1,000
- 2003 - $2,000
- 2004 - $3,000
- 2005 - $4,000
- 2006 & thereafter - $5,000

These plan funding limit increases, scheduled under EGTRRA to sunset in 2011, have been made permanent by the PPA.

b) Question: Have these changes in plan funding limits resulted in greater contributions to retirement plan accounts? Although there seems to be no industry research on this precise topic, the impact has likely been fairly limited since few participants contribute the maximum allowed. For example, a rough estimate of the impact of this legislation on 401(k) assets (based on survey data from the 2005 Retirement Market Update by Cerulli Associates) would indicate that approximately $16 billion in additional contributions were made to these plans in 2004 as a result of EGTRRA funding limit increases. This increase represents approximately 7% of total annual contributions and less than 1% of total 401(k) assets.

c) On April 16, 2002, the IRS issued new final regulations under Code Section 401(a)(9) regarding required minimum distributions from retirement accounts. Generally, an account owner must begin taking distributions from an IRA or other retirement account by his or her Required Beginning Date (“RBD”), April 1 of the year following the year the participant turns age 70 ½. The minimum annual distribution required is determined by dividing the participant’s account balance at the end of the prior year by his or her remaining life expectancy.

i) The regulations mandate the use of a Uniform Lifetime Table to calculate minimum lifetime distributions for nearly all retirement plan participants. This Uniform Table results in smaller Minimum Required Distributions for nearly all account owners than under prior law, and applies no matter who the account owner has named as his or her Designated Beneficiary. Obviously, smaller required distributions mean greater potential for ongoing tax-deferred growth of plan assets.
<table>
<thead>
<tr>
<th>Age of Account Owner</th>
<th>Distribution Period</th>
<th>Age of Account Owner</th>
<th>Distribution Period</th>
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</thead>
<tbody>
<tr>
<td>70</td>
<td>27.4</td>
<td>93</td>
<td>9.6</td>
</tr>
<tr>
<td>71</td>
<td>26.5</td>
<td>94</td>
<td>9.1</td>
</tr>
<tr>
<td>72</td>
<td>25.6</td>
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<tr>
<td>73</td>
<td>24.7</td>
<td>96</td>
<td>8.1</td>
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<td>74</td>
<td>23.8</td>
<td>97</td>
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</tr>
<tr>
<td>76</td>
<td>22.0</td>
<td>99</td>
<td>6.7</td>
</tr>
<tr>
<td>77</td>
<td>21.2</td>
<td>100</td>
<td>6.3</td>
</tr>
<tr>
<td>78</td>
<td>20.3</td>
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<td>80</td>
<td>18.7</td>
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<td>87</td>
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<td>110</td>
<td>3.1</td>
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<td>88</td>
<td>12.7</td>
<td>111</td>
<td>2.9</td>
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<tr>
<td>89</td>
<td>12.0</td>
<td>112</td>
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<tr>
<td>90</td>
<td>11.4</td>
<td>113</td>
<td>2.4</td>
</tr>
<tr>
<td>91</td>
<td>10.8</td>
<td>114</td>
<td>2.1</td>
</tr>
<tr>
<td>92</td>
<td>10.2</td>
<td>115 and older</td>
<td>1.9</td>
</tr>
</tbody>
</table>

The Uniform Lifetime Table can be used by all account owners, unless their sole beneficiary for the entire year is their spouse who is more than 10 years younger (in which case the Minimum Required Distribution will be even less than calculated using the Table). To calculate the Minimum Required Distribution, determine the account owner’s age on his or her birthday in the distribution year and divide the prior calendar year’s ending account balance by the distribution period divisor.

ii) The new regulations made another significant change beneficial to charitable donors. A participant’s “Designated Beneficiary” (for purposes of calculating required distributions after the participant’s death) is now determined as of September 30 of the year following the participant’s year of death. As discussed below, this change makes it much easier to name charity as a partial beneficiary of a retirement plan and still preserve an individual beneficiary’s right to defer distributions over his or her life expectancy.

d) Question: Have these changes in Required Minimum Distributions resulted in greater retention of assets in retirement plan accounts? Yes, based on TIAA-CREF’s experience: In 2001, 27% of TIAA-CREF participants were choosing the Minimum Distribution Option, having grown steadily since TIAA-CREF first introduced that payout option in 1991. With a significant percentage choosing the minimum required distribution, these IRS changes translate to smaller payouts for a large number of participants and, thus, to larger remaining account accumulations than if the distributions had not been stretched out.
II. GENERAL DONOR CONSIDERATIONS

A potential donor of retirement assets has several issues to consider in determining whether such a gift is practical, or even possible. The donor’s and the family’s need for the assets is a principal concern, of course, and will turn on the availability of other assets and income, family composition and other circumstances unique to each donor. Other, more universal concerns (discussed in detail below) are: the taxation of retirement assets and strategies to reduce the tax burden; the type(s) of plan available to fund the gift; any restrictions inherent in the plan’s governing document that may impede the gift; and any actions that the potential donor may have already taken with respect to the plan that affect his or her ability to make a charitable gift of plan assets.

1) Taxation of Retirement Plan Assets.

a) The manner in which retirement assets are taxed at the account owner’s death may be the most compelling factor leading to use of these assets in charitable giving. When left to individual beneficiaries, retirement assets are subject both to income tax in the hands of the recipient and, if applicable, estate tax in the participant’s estate. When left to charity, however, these assets can pass free of income or estate tax, thus leaving the decedent’s other property available to fund bequests to individual beneficiaries and achieving a much better overall tax result.

b) Retirement assets are Income in Respect of a Decedent (“IRD”). IRD is taxable income to which the decedent was entitled at death but which was not included on any previous income tax return. Other examples of IRD include final wages and accounts receivable, interest accrued but not yet paid, dividends dated prior to decedent’s death, etc.

i) Under Code §691, the decedent’s beneficiary acquiring the right to receive this postmortem income is taxed on it as it is received. This true whether the beneficiary is the decedent’s estate, a person acquiring the right to receive the IRD as a result of the decedent’s death, or a person acquiring the right to receive IRD through a bequest from the decedent’s estate.

c) Retirement assets are also included in the taxable estate of the account holder. The calculation of an individual’s gross estate upon death includes all property the decedent owns or has an interest in, and therefore would include any income owed to the decedent at the time of death but not yet received. Retirement assets, like other IRD, are subject to taxation in the deceased participant’s estate.

d) The combination of income and estate taxes on IRD creates “double taxation” of these assets. To help lessen the impact of this double tax, however, the IRD beneficiary is entitled to an income tax deduction under §691(c) of the Code for estate taxes paid on the IRD in the decedent’s estate. Even with this income tax deduction, however, the combination of estate and income tax on retirement accumulations and other items of IRD can reduce assets available to individual beneficiaries by nearly two-thirds:

Example: Professor Jones has a taxable estate of $4 million, including a $1 million IRA of which his son is the beneficiary. Estate tax on the entire estate is $920,000. Estate tax on the estate less the IRA account would be $460,000. The amount of estate tax attributable to the IRA is thus $460,000 ($920,000 – 460,000 = $460,000). Under Code §691(c), the son will owe income tax on the value of the IRA account less estate tax attributable to it (i.e., $1 million – 460,000 = $540,000). Assuming an income tax rate of 35%, son’s income tax liability is $189,000.

\[
\begin{align*}
\text{IRA value at Professor’s death} & \quad $1,000,000 \\
\text{- Estate tax} & \quad -460,000 \\
\text{- Income tax (after 691(c) deduction)} & \quad -189,000 \\
\text{Net amount for son after both estate and income tax} & \quad $351,000
\end{align*}
\]
2) Strategies to Reduce Tax Impact

a) The most common strategy employed to reduce the tax impact on retirement plan assets following the participant’s death is “stretch-out” planning; i.e., taking advantage of the rules regarding minimum distributions (under Code §401(a)(9)) to stretch out the payment period for plan benefits to the recipient, allowing assets to remain invested tax-deferred for a longer period of time. (Note: Not all plan documents allow for all distribution methods. Some 403(b) plans, for example, permit only an annuitized distribution.)

i) Generally, if the surviving spouse is named as beneficiary, he or she may make a tax-free rollover of the plan balance to another plan of his or her own (or treat an IRA inherited from a deceased spouse as his or her own IRA) and delay taking required minimum distributions until his or her own Required Beginning Date, in accordance with the Uniform Lifetime Table. Note that a plan payable to a surviving U.S. citizen spouse also qualifies for the unlimited marital deduction against the federal estate tax, thus allowing the account to escape estate taxation at participant’s death. (The remaining account balance will be included in the spouse’s taxable estate, however.)

ii) The PPA of 2006 has created a similar rollover right for a non-spouse beneficiary of an employer plan, allowing him or her to roll inherited employer plan assets to an inherited traditional IRA. This provision is effective for employer plan distributions after December 31, 2006.

iii) Generally, non-spouse “designated beneficiaries” can defer plan distributions over their own individual life expectancies. If the participant has died before his or her Required Beginning Date, then an individual beneficiary may take required distributions from the plan in annual installments over a period not longer than the individual beneficiary’s life expectancy (so long as the plan document permits this distribution method). If the participant has died on or after the RBD, then the individual designated beneficiary must take distributions over a period not longer than the longer of the beneficiary’s life expectancy or the participant’s remaining life expectancy at the time he or she died (provided the plan permits this distribution method).

iv) When a trust is named as beneficiary of a retirement account, distributions may be stretched over the life expectancy of the oldest individual trust beneficiary (provided the trust has been drafted to qualify for so-called “look-through” treatment).

b) A more powerful tax saving strategy, however, is to name a tax-exempt charitable organization as beneficiary of the retirement plan.

i) A gift of retirement assets to a qualified charity qualifies for the unlimited charitable deduction against the federal estate tax. Although the participant’s estate will include the value of the retirement account, the offsetting deduction for the amount passing to charity results in no federal estate tax liability for those gifted assets.

ii) Further, because the charitable beneficiary is income tax-exempt, the entire amount of plan benefits left to charity will remain available to help the organization achieve its tax-exempt purposes, rather than being eroded by payment of federal (and possibly state) income tax by the beneficiary.

3) Funding charitable bequests with IRD assets.

a) A broader and more fundamental planning point is that charitable bequests at death should generally be funded with IRD assets if income tax savings is a goal.

i) Because charities are income tax-exempt, they are ideally suited to receive IRD assets. Unlike individual beneficiaries, charities do not pay income tax on IRD and therefore retain the full value of these assets.
ii) Using IRD assets first to fund charitable bequests means that other, non-IRD assets are left for individual beneficiaries (who will also benefit from the automatic step-up in basis afforded to capital assets passing at death).

iii) The use of “boilerplate” language in a donor’s Will or trust along the following lines may help to achieve this result:

“I direct that my Executor [or Trustee, as applicable] make all charitable gifts or devises under this instrument, to the extent possible, from property that constitutes “income in respect of a decedent” as that term is defined in U.S. income tax laws.”

*Example:* An example may help to illustrate this planning point. Professor Smith’s estate is worth $200,000, consisting of $100,000 of IRA assets and $100,000 of securities. She wishes to leave one-half of her estate to Local University and the other one-half to her daughter.

Without any designation as to which beneficiary should receive which assets, the following results (assuming a 35% income tax rate for the Professor’s daughter):

<table>
<thead>
<tr>
<th></th>
<th>University Receives:</th>
<th>Daughter Receives:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>IRA</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Income tax liability</td>
<td>($0)</td>
<td>($17,500)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$100,000</td>
<td>$82,500</td>
</tr>
</tbody>
</table>

Since the University is income tax-exempt, it will not pay any income tax on its gift from Professor Smith. Her daughter, on the other hand, will pay income tax on the value of the retirement plan assets when they are received.

Note the change in this result if the University’s interest is funded first with the assets in Professor Smith’s retirement plan:

<table>
<thead>
<tr>
<th></th>
<th>University Receives:</th>
<th>Daughter Receives:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td>IRA</td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td>Income tax liability</td>
<td>($0)</td>
<td>($0)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Income Tax Savings</td>
<td>$0</td>
<td>$17,500</td>
</tr>
</tbody>
</table>

As the illustration above indicates, there can be a significant advantage to individual (or non-charitable) beneficiaries if the charity’s interest is funded first from retirement plan assets.

4) Which Plan Should Fund the Gift?

a) A prospective donor should consider several factors in deciding whether to make a gift from a retirement account (or in choosing among accounts - or among different account types - from which to fund a gift). Although the family’s potential need for these assets is usually the most immediate concern, a donor must also consider whether each account is governed by ERISA (the Employee Retirement Income Security Act of 1974), whether a plan’s governing document contains any restrictions that may impact its availability or usefulness as a source for charitable giving and whether the donor has taken any irrevocable action with respect to the plan that precludes a bequest or transfer to charity.

b) ERISA vs. Non-ERISA plans

i) ERISA is the federal law governing operation of private sector retirement plans such as 401(k), Employee Stock Ownership Plans (ESOPs) and pension plans, including private sector 403(b) plans.
ii) ERISA does not govern IRA accounts, Section 457 plans, or retirement plans sponsored by federal, state or local government, including public sector 403(b) plans. Such non-ERISA plans are instead governed by applicable state law.

iii) Waiver of spousal rights required with ERISA plan:

1. ERISA provides that: If the participant is married at the time of his or her death, the surviving spouse is entitled to receive, as primary beneficiary, 50% of participant’s qualified pre-retirement survivor annuity death benefits under a retirement or tax-deferred annuity plan covered by ERISA (or the required amount under the sponsoring institution’s spousal policy).

2. If the participant names someone other than his or her spouse as primary beneficiary for more than 50% (or more than the required amount) of the benefits AND the spouse has not consented to this primary beneficiary designation by completing a Spousal Waiver, then 50% (or more if the required amount is more than 50%) of those qualified pre-retirement survivor annuity death benefits will be payable to the surviving spouse regardless of the participant’s beneficiary designation in effect at the time of death. The remainder, if any, will be payable to participant’s other named beneficiaries. (Certain institutions, including some non-ERISA institutions, require that more than 50% of any qualified pre-retirement survivor annuity death benefit be paid to the surviving spouse upon a participant’s death.)

3. In order to name a charity (or other non-spouse) as primary beneficiary of more than 50% of ERISA plan benefits (or more than the plan sponsor’s required amount), a valid consent must be obtained from the participant’s spouse waiving his or her rights under the plan. The requirements of a valid consent are:

   a. The waiver must be made after the participant has reached age 35 and prior to the participant’s death. (The IRS permits a waiver prior to age 35, so long as the waiver is made again after the participant reaches age 35.)

   b. The spouse must understand the effects of the waiver. This requirement for a knowing waiver means that spouse should be provided with a description of the plan and the options available under it.

   c. The consent cannot be made as part of a prenuptial agreement since the participant’s fiancé / fiancée is not a “spouse” at that point.

   d. The consent or waiver must be signed by the spouse and witnessed by either a plan representative or a notary public.

      i. The spouse’s consent may be limited to a particular beneficiary designation, or may be a general consent to participant’s making future changes to the beneficiary designation.

      ii. The IRS has published four sample consent forms in Notice 97-10, 1997-2 I.R.B. 41.

iv) Creditor protection varies by plan type and state law

1. Assets held in plans governed by ERISA enjoy nearly complete creditor protection due to the anti-alienation provisions of ERISA section 206(d) and Internal Revenue Code section 401(a)(13). There are two major exceptions, however:

   a. Under Code section 414(p) and ERISA section 206(d)(3), a Qualified Domestic Relations Order (QDRO) will cause a participant’s interest in an ERISA plan to be divided in order to satisfy a dissolution decree or an order of child support.
(b) Treasury regulations section 1.401(a)-13(b) permits federal tax levies and judgments to be satisfied with the taxpayer’s ERISA plan assets.

(2) Non-ERISA plans (such as IRAs) are afforded creditor protection under relevant State law, only. These laws vary by State, but typically provide protection of plan assets to the extent necessary for the account owner’s support.

v) In choosing among different plans to leave to charity or to individual beneficiaries, a donor may wish to preserve ERISA plan assets for individual beneficiaries who could have creditor protection issues. (Note, however, that ERISA plan assets are subject to attachment by creditors after they have been distributed out to beneficiaries. *Houl v. Hoult*, 373 F3d 47 (1st Cir. 2004), cert. denied, U.S. S. Ct. (2004).)

<table>
<thead>
<tr>
<th>Plan Types</th>
<th>ERISA</th>
<th>Non-ERISA (Governed by State Law)</th>
</tr>
</thead>
<tbody>
<tr>
<td>401(k)</td>
<td></td>
<td>IRA</td>
</tr>
<tr>
<td>Private 403(b)</td>
<td></td>
<td>Public 403(b)</td>
</tr>
<tr>
<td>ESOP</td>
<td></td>
<td>Section 457</td>
</tr>
<tr>
<td>Spousal Waiver Required?</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>Creditor Protection</td>
<td>QDRO or IRS</td>
<td>Varies by State Law</td>
</tr>
</tbody>
</table>

c) Plan Document Restrictions

i) A retirement plan account is not required to offer all the payout options that the law allows. For example, while most IRAs permit a life expectancy payout, the situation is just the opposite with qualified plans. A majority of qualified plans offer death benefits only in the form of lump sum distributions or, in some cases, annuities, and do not offer the “life expectancy payout method.” A donor participating in a plan with limited distribution options may be unable to use plan assets to benefit charity or may have only a limited opportunity to do so.

(1) If a participant survives to his or her required beginning date and takes a lump sum distribution at that time, there will be nothing left in his or her plan at death to benefit charity.

(2) If the participant’s plan requires an annuitized distribution, charity may benefit from the plan only if the participant elects a “guarantee period” (as discussed below) and does not survive the period. If the participant survives the guarantee period, there will be nothing remaining for charity (or any beneficiary) at the participant’s death.

d) Participant Action May Impede a Charitable Gift

i) The donor may have taken an action with respect to his or her plan that prevents or curtails the ability to use plan assets for a charitable gift. For example, if donor has already elected to take his or her retirement plan distributions in the form of an annuity (over his or her own life, or over the joint lives of the donor and an “annuity partner” such as a spouse), this irrevocable election effectively prevents the donor from naming a charity (or anyone else) as a beneficiary of the plan.

(1) An exception exists where the donor has annuitized his or her distribution, but has also elected a guarantee period for the annuity. The guarantee period (typically 10 or 20 years) means that the donor’s annuity will pay for at least the term of the guarantee period, even if the donor (and the annuity partner, if applicable) does not survive that long. When a guarantee period is elected, the
donor may name a beneficiary to receive the remaining payout should the primary annuitant(s) not survive the term.

(2) In this case, a charity named as beneficiary will receive the remaining payout should the annuitant(s) die prior to the expiration of the guarantee period. Typically, the charity will prefer to take immediate payment of the commuted value of the remaining annuity, since there is no income tax advantage to “stretching” the payments.

III. Planned Giving Techniques for Retirement Assets

When retirement assets are both available and appropriate for a charitable gift, the donor must also consider the timing of the transfer (typically at death, though lifetime giving is possible under current law) and the gift structure (whether outright, or to fund a split-interest arrangement such as a charitable remainder trust or charitable gift annuity). The tax ramifications vary widely and a careful donor will explore the options before finding the gift arrangement that best accomplishes his or her goals.

1) Outright Gift at Death

   a) An outright or direct gift at the participant’s death is the easiest and most straightforward way for charity to benefit from a retirement plan account. The participant has retained access to plan assets throughout his or her life and the charitable beneficiary receives the full, immediate use of remaining assets at death.

      i) Assets passing pursuant to beneficiary designation do not pass through the probate process, saving the estate both time and expense.

      ii) Because of its tax-exempt status, a charitable beneficiary’s share of a retirement account is not diminished by payment of income tax.

      iii) The mechanism for an outright gift at death is the Beneficiary Designation form (available from the plan’s administrator or from the employer’s HR Department).

         (1) A charity may be named as either a primary or contingent beneficiary. A primary beneficiary receives its share of the account at the participant’s death. A contingent beneficiary receives a share at the participant’s death, but only if the primary beneficiary has not survived the participant (or has disclaimed his or her interest in the account).

         (2) A charity may be named as the sole beneficiary of a retirement account, or as a partial beneficiary of the account, to receive a percentage of the account balance or a specific dollar amount.

         (3) The donor should NOT name his or her estate as beneficiary of a retirement plan account if the intent is to use those funds for charity. Even if the donor’s Will contains a charitable bequest provision, naming the estate as beneficiary is almost certain to cause the estate to be liable for income tax on the value of plan assets.

         (4) The plan administrator will require the same basic information to fulfill a charitable designation as it would for designation of an individual beneficiary:

            (a) The amount of the benefit must be stated clearly; and

            (b) Sufficient information must be provided to identify and locate the charity.

         (5) The beneficiary designation might name a specific fund (a scholarship fund, for example) operated by a charitable organization or may state that the funds are to be used for a specific purpose. Note, however, that the plan administrator will not be in a position to “police” the use of the gift for its stated purpose after the distribution to the named charity is made.
iv) Designating a charity does not affect the participant’s lifetime Minimum Required Distribution. As discussed above, the final regulations under IRC Section 401(a)(9) create a Uniform Lifetime Table for calculation of minimum distributions during a participant’s lifetime. Required distributions are calculated under the Table regardless of whom the beneficiary has named on his or her Beneficiary Designation form.

(1) This is a significant improvement over prior law, under which minimum distributions were calculated by reference to the participant’s designated beneficiary on his or her Required Beginning Date (April 1 of the year after the participant reached age 70 ½).

(2) Designation of a charity as beneficiary under prior law would have prevented the participant from stretching required distributions over a period longer than his or her own actuarial life expectancy.

v) So long as charity is paid its share by September 30th of the year following the year of the participant’s death, individual beneficiaries of the account may “stretch out” distribution of their own separate shares. The 401(a)(9) regulations clarify that a participant’s “Designated Beneficiary” (for purposes of setting the schedule of minimum required distributions after the participant’s death) is determined as of September 30 of the year following his or her death. If charity has received its share of the account by that date and the remaining beneficiaries of the account are all “individuals,” their minimum required distributions are calculated according to their life expectancies.

(1) This is a significant improvement over prior law, under which the Designated Beneficiary was determined as of the participant’s Required Beginning Date (“RBD”).

(2) Designation of a charity as beneficiary as of the RBD under prior law would have forced individual beneficiaries of the account to take their distributions within five years of the participant’s death, with no opportunity for a significant stretch-out.

vi) As mentioned above, retirement plan assets are included in the participant’s estate for federal Estate Tax purposes. However, the participant’s estate is entitled to an offsetting charitable deduction against the federal Estate Tax for an outright distribution to a qualifying charity.

b) To the extent plan assets pass outright to a charitable beneficiary, there is no retained benefit for family members or other individuals. If a donor intends to use a retirement account as a source of giving both to charitable and individual beneficiaries, he or she may name multiple primary beneficiaries for partial shares of the account (as described above). Alternatively, the donor may consider naming a Charitable Remainder Trust as primary beneficiary of the account, as discussed below.

2) Testamentary CRT

a) When the donor desires to provide plan benefits both to charity and individual beneficiaries (e.g., surviving family members), a charitable remainder trust (“CRT”) may be an appropriate beneficiary.

i) A charitable remainder trust is an income tax-exempt entity. The CRT’s governing instrument provides for an income stream to individual (or other non-charitable) beneficiary(ies) for life or for a term of years (not to exceed 20 years) in the form of a fixed annuity or a unitrust amount (a fixed percentage of the trust’s value as of the beginning of each year). At the end of this trust term, the remaining assets of the CRT pass outright to a designated charity or charities.

ii) Because the CRT is required to pay income to non-charitable beneficiaries during the trust term, the eventual gift to charity will likely be much smaller than if an outright gift of the plan assets had been made.

iii) The donor’s estate is entitled to a federal Estate Tax charitable deduction on funding of the CRT. However, the size of the deduction is equal only to the actuarial value of charity’s future right to
receive the remaining trust corpus at the expiration of the trust term. The deduction will therefore be smaller than if an outright charitable gift of the plan assets had been made.

b) The mechanism for funding a CRT with plan assets is the Beneficiary Designation form, coupled with an appropriate trust instrument.

i) Typically, the terms of a CRT to be funded at the participant’s death will be included in his or her Will or revocable trust instrument. The donor’s counsel should be careful to comply with IRS Regulations Section 1.664-1 when drafting the trust to make it compatible with testamentary funding. The CRT’s governing instrument should provide that, although the Trustee’s obligation to make the annuity or unitrust payment commences at the participant’s death, the actual payment may be deferred until the end of the year in which complete funding of the CRT occurs.²

ii) Alternatively, the donor may wish to name as beneficiary the Trustee of a pre-existing charitable remainder unitrust (“CRUT”). A CRUT may accept additional contributions after its initial funding, while a charitable remainder annuity trust (“CRAT”) may not.

1. Typically, the pre-existing CRUT will have been funded at its inception and operated according to its terms (i.e., invested prudently and paying out the required unitrust amount to non-charitable beneficiary(ies)) since then.

2. Occasionally, however, a donor will have drafted a so-called “dry” CRUT during his or her life, funded - if at all - with only a nominal amount (e.g., $10.00), in anticipation of its eventual true funding at the donor’s death.

   a) CAVEAT: The validity of such a dry trust is subject to question under both State trust law and federal law regarding CRTs.

      i) An essential element of a trust under the common law is a trust res, or corpus, to be held by the Trustee for the beneficiary. Without the transfer of some property to the Trustee, there is likely no trust created under relevant State law.

      ii) IRS regulations governing CRTs provide that, in order for a trust to qualify as a charitable remainder trust, it must function exclusively as a charitable remainder trust from its creation.³ When a so-called dry CRUT is established, it fails to qualify as a charitable remainder trust unless operated as a CRT from inception. A CRUT funded with only a nominal contribution is unlikely to have made unitrust payments to beneficiaries, to have been invested prudently, to have filed required tax returns, or otherwise to have been administered as a charitable remainder trust from its creation.

   (b) A donor designating such a pre-existing “dry” CRUT as retirement plan beneficiary runs some risk that the IRS will not consider the trust to qualify as a charitable remainder trust, thereby jeopardizing the trust’s tax-exempt status and its effectiveness as a planning vehicle.

   (ii) The participant’s beneficiary designation form should correctly reference and identify the Trustee of the CRT, making it clear to the plan administrator whether the CRT is created under the terms of his or her Will or revocable trust, or is a pre-existing CRUT to which an addition is being made.

iii) According to its governing instrument, a CRT pays either a unitrust or annuity amount to non-charitable (normally individual) beneficiary(ies) for life or a term of years (not to exceed 20 years).

   i) Because of the CRT’s tax-exempt status, the Trustee will not pay income tax on its plan distribution and will therefore have the entire amount of the distribution to invest, both to grow the trust corpus for the benefit of the charitable remainder beneficiary and to generate funds to pay the required income interest during the trust term.
(1) For CRUT beneficiaries, this means a larger unitrust payment than if the corpus had been eroded by income taxation.

(2) For CRAT beneficiaries, this larger corpus reduces the likelihood of the CRT’s depletion or exhaustion during the trust term.

ii) Payments to individual beneficiaries during the trust term are subject to taxation when received, pursuant to a four-tier system under Code §664(b). Because beneficiaries are liable for income tax on payments only as they are received, a CRT accomplishes a result similar to the “stretch-out” plan described above for individual beneficiaries of a retirement plan.

(1) Note, however, one significant potential drawback of naming a CRT as retirement plan beneficiary: Under PLR 199901023, the Service ruled that individual beneficiaries of a CRT are not entitled to an income tax deduction under Code §691(c) for estate tax paid on retirement assets passing to the CRT.

(2) In a large estate, the donor’s tax advisor should compare the tax results of a CRT plan (where individual beneficiaries have no 691(c) deduction) against the results of an outright gift plan where charitable and individual beneficiaries are each designated to receive a portion of the retirement plan directly.

d) At the end of the trust term (the death of the surviving individual beneficiary or the end of a designated term of years), the remaining assets of the CRT pass outright to qualifying charity(ies).

EXAMPLE OF RETIREMENT ASSETS FUNDING CRT

Professor Jones names his CRUT as primary beneficiary of $500,000 of retirement assets at his death. The CRUT provides for payments to his daughter for 10 years of 7% of the CRUT’s market value, with the remainder to his favorite charity.

![Diagram of CRT example]

CRUT $500,000

Prof. Jones’ IRA

Estate Tax Charitable Deduction $248,773

Annual Payments (7% of Trust) ($35,000)

These amounts are calculated using 6.2% as the assumed applicable federal rate for purposes of calculating the value of the remainder interest

3) Other Uses of CRT Funded with Retirement Assets

a) A CRT can be used to “stretch” IRA distributions for individual beneficiaries where a traditional credit shelter trust or QTIP marital trust may not be appropriate or available.
i) A CRT provides not only for individual beneficiaries (as a traditional credit shelter trust likely would), but also for charity. The CRT creates an estate tax charitable deduction not available with a credit shelter trust.

ii) The CRT can be funded (through the use of a formula provision) and the payout structured (under the terms of the governing instrument) so that the value of the individual beneficiaries’ interest is equivalent to the participant’s remaining estate tax exemption amount. In this way, the CRT serves much the same function as a credit shelter trust for estate tax-planning purposes.

iii) A CRT can extend the payout of trust income (annuity or unitrust) over the actual lifetimes of two or more beneficiaries, while a QTIP marital trust (restricting payments to the surviving spouse during his or her lifetime) may deplete a retirement plan account before other, non-spouse beneficiaries are entitled to any trust distribution.

iv) CAVEAT: A CRT has significant limitations that should be kept in mind before selecting this tool as a credit shelter or marital trust substitute.

1. With a CRT, no discretionary invasion of trust principal is permitted for individual beneficiaries; only the unitrust or annuity payment is available. As such, a CRT should probably not be the family’s sole source of support following the participant’s death.

2. As discussed above, with a CRT, individual beneficiaries are not entitled to claim an income tax deduction under Code §691(c). A participant’s tax advisor should explore the tax results carefully in helping the client to determine whether a CRT is the appropriate vehicle to receive retirement plan benefits.

EXAMPLE: USING THE CRT TO “STRETCH” AN IRA

Professor Jones established a 6% CRUT for lives of his surviving spouse (75) and two children (45 & 50) from a previous marriage.

These amounts are calculated using 6.2% as the assumed applicable federal rate for purposes of calculating the value of the remainder interest

4) Lifetime Gifts of Retirement Plan Assets?

Large lifetime gifts from retirement plan accounts have historically been impractical from an income tax perspective. In order to make such a lifetime gift, a donor must first withdraw assets from his or her account, thereby recognizing taxable income. The contribution to charity gives rise to an offsetting deduction which, in most cases, would produce a “wash” for
income tax purposes. The difficulty arises, however, when a donor wishes to make a gift in excess of 50% of his or her Adjusted Gross Income (AGI) for the year. In that instance, the donor has recognized income over and above the available deduction amount, creating a current income tax liability.

New federal legislation (Pension Protection Act of 2006) addresses this dilemma with a restricted version of the “IRA charitable rollover” provisions contained previously in the CARE Act and other similar legislation. The PPA makes outright, lifetime gifts from IRA accounts to charity much more attractive to some donors than under previous law, but its applicability and timeframe are limited. It is important to understand how the new law works and which donors benefit from it.

a) The Pension Protection Act of 2006 (“PPA”) was signed into law by the President on August 17, 2006. The legislation makes broad changes to many aspects of the pension system (including making permanent the EGTRRA changes to plan contribution limits discussed above). In addition to these pension law changes, the PPA contains a limited version of “IRA charitable rollover.” Specifically:

i) The PPA provides an exclusion from gross income for otherwise taxable IRA distributions during 2006 and 2007 of up to $100,000 per year from traditional IRAs and Roth IRAs for qualified charitable distributions, by account owners age 70 ½ or older on the date of contribution.

(1) The exclusion applies only to IRAs and Roth IRAs, (not to 401(k), 403(b), Keoughs or other retirement plans.

(2) The maximum amount excludable from a participant’s income is $100,000 per taxpayer per year.

(3) Qualified charitable distributions are applied in satisfaction of a participant’s Required Minimum Distribution under the §401(a)(9) regulations.

ii) A “qualified charitable distribution” must be made directly from the plan administrator to an organization described in Code §170(b)(1)(A); i.e., public charities and private operating foundations. The distribution must be one that would otherwise have been taxable to the participant.

(1) The distribution must be directly from the plan administrator to charity. A check made payable to the participant who then makes a gift to charity himself or herself will not qualify.

(2) Distributions to Donor Advised Funds or Supporting Organizations are specifically excluded from qualification.

(3) Other funds operated by qualifying charities (such as scholarship funds) are acceptable recipients of rollover distributions under the PPA.

iii) Qualified charitable distributions do NOT include distributions to fund “split-interest” gifts such as charitable gift annuities or charitable remainder trusts.

(1) The exclusion from income applies only if the contribution deduction “for the entire distribution” would otherwise be allowable. The deduction associated with split-interest gifts is always less than the entire funding amount because of the donor’s retained interest.

(2) Further, the donor may receive NO benefit of value in exchange for the distribution. Otherwise, the ENTIRE rollover will be subject to inclusion in the donor’s income.

iv) The donor must obtain “written substantiation” of the gift from the charitable donee in order for the distribution to qualify under the PPA. Charities should therefore provide donors with written acknowledgment as required under Treasury regulations.

b) Which donors benefit the most from IRA charitable rollover?
(1) Non-itemizers who would otherwise recognize taxable income without taking an offsetting charitable deduction.

(2) Donors subject to AGI limits due to other significant charitable gifts made during the year (i.e., up to the 50% of AGI limit).

(3) Donors who live in states with no state income tax charitable deduction but which would, absent the PPA, have included retirement plan distributions in a resident’s taxable income.

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ii Id.
iv Treasury Reg. §1.691(a)-1(b)
v Treasury Reg. §1.664-1, et seq.
vi Treasury Reg. §1.664-1(a)(4)