CHARITABLE GIFTS
OF RETIREMENT PROCEEDS

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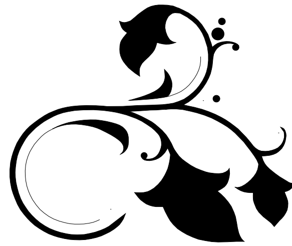

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- Instructor, Tax Benefits of Charitable Giving and International Charitable Gift Planning for the American Institute of Philanthropic Studies at California State Long Beach (1995-Present)

Philanthropic Endeavors

- Director, Liberty Hill Foundation
- Member and Past Director (2003-2006), National Committee on Planned Giving
- Member, Planned Giving Roundtable of Southern California
- Director and Founder, The Women's Leadership Council
- Member, Council on Foundations
- Member, City of Hope Blue Ribbon Advisory Panel
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Publications

- Author, "Emerging Legal Issues in International Philanthropy," Perspectives on Foundation Management: Innovation and responsibility at Home and Abroad, John Wiley & Sons (2002)
- Author, "Estate Planning Design and Drafting After the EGTRRA," Major tax Planning, University of Southern California, Matthew Bender (2002)
- Author, "Hot Topics in Charitable Giving," Major Tax Planning, University of Southern California, Matthew Bender (2000)
- Author, "Creative Uses of Charitable Lead Trusts,: Major Tax Planning, University of Southern California, Matthew Bender (1999)
- Author, "Cross-Border Gifts," Journal of Gift Planning (2nd Quarter 1999)
- Author, "Charitable Gifts of Retirement Plan Assets," Planned Giving Design Center Website (April 1999)
- Author, "The Handbook of International Philanthropy," Bonus Books (Chicago, 1998)
- Author, "Tax Planning for Cross-Border Philanthropy by U.S. Donors," Trusts & Estates Magazine (May 1998)
- Lecturer, "Here There Be Dragons: Navigating the Waters of Cross-Border Philanthropy," Thirty-First Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Matthew Bender (1997)
- Co-author, "Socially Responsible Investment and the Private Trust," Probate & Property Magazine (July/August 1992)
- Co-author, "A Primer on U.S. Estate and Gift Taxation of Aliens," Major Tax Planning, University of Southern California, Matthew Bender (1991)

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CHARITABLE GIFTS
OF RETIREMENT PROCEEDS

by Jane Peebles, Esq.

Karlin & Peebles, LLP

I. OVERVIEW OF 2002 REGULATIONS

A. Welcome Relief

On January 11, 2001, the world of planning for IRA and retirement plan distributions was revolutionized. The 1987 proposed Treasury Regulations governing these matters were notoriously difficult for professional advisors and plan administrators to understand and even more difficult to explain to clients. The 2001 proposed Regulations and the final Regulations issued April 17, 2002 highly simplified the rules and made clear that the IRS had heard years of complaints over how complex these rules were. They also make it much easier to effect charitable gifts of IRA and retirement plan proceeds at death.

B. Scope of 2002 Regulations

The 2002 Regulations revise the 1987 Regulations under IRC Section 401(a)(9), which provided guidance on the minimum distribution requirements under Section 401(a)(9) for retirement plans qualified under Section 401(a). The rules are incorporated by reference into the Section 408 rules governing traditional IRAs, the Section 408A rules for Roth IRAs, the Section 403(b) rules for annuity contracts and the Section 457(d) rules for eligible deferred compensation plans.

C. Effective Date

1. The rules under the 2002 Regulations became effective for distributions for calendar years beginning on or after January 1, 2002, and apply even to clients who were already taking required distributions as of January 1, 2002.

2. For distributions for 2001, sponsors of qualified plans were permitted to continue to rely on the old rules or to follow the 2002 rules. The proposed Regulations included language for a model amendment that plan sponsors could adopt to permit them to apply the proposed Regulations without violating the requirement that a plan be operated in accordance with its terms.

If the administrator had not adopted the amendment by December 31, 2001, the participant was required to take the larger distribution under the old tables, but only the lower amount under the new tables was taxed, and the balance of the participant's 2001 distributions could be rolled to an IRA.

3. IRA owners were permitted, but not required, to follow the 2002 rules for distributions for the 2001 calendar year, notwithstanding the terms of their IRA documents.

D. **Primary Changes Made by the 2002 Rules**

The 2002 Regulations simplified matters by:

(i) providing a uniform table to determine lifetime required minimum distributions, with no need to elect to recalculate or not recalculate one's life expectancy and no need to determine the beneficiary by the age 70½ required beginning date;

(ii) permitting the beneficiary or beneficiaries to be determined on September 30 of the year following the year of the participant's death; and

(iii) allowing life expectancy at the time of death to be taken into account in calculating post-death minimum distributions.

II. MINIMUM REQUIRED DISTRIBUTIONS DURING PARTICIPANT'S LIFE

A. General Rule for Distributions After Required Beginning Date

1. The "required beginning date" (RBD) remains the same: April 1 of the year after the calendar year in which the participant reaches age 70½ for IRAs, and the later of that date or the actual date of retirement for qualified plans, except that participants owning 5% or more of the company cannot use the later retirement date.

2. The 50% penalty for failure to take the minimum required distribution has not changed.

3. What has changed are the rules for calculating the minimum required distributions.

(a) Generally, there is one and only one table of numbers that tells the participant the portion of his or her IRA or plan that must be distributed each year starting with the RBD. It is the old minimum distribution incidental benefit ("MDIB") table.

(b) The only exception is if the participant is married to a person who is more than 10 years younger than he or she and the spouse is the only primary beneficiary on the account. In that case, the required distributions are lower because they are based on the actual joint life expectancies of the participant and the participant's spouse.

- It appears that, if the much younger spouse dies first or they are divorced after the participant's RBD, the participant has to revert to using the

uniform table. This was not the case under the old rules unless the much younger spouse died first and that spouse's life expectancy was being recalculated.

- It also appears that, if the participant marries a much younger spouse after his or her RBD, the participant can switch to the true joint life expectancy starting in the next year. This was not allowed under the old rules.

(c) When the exception does not apply (i.e., the spouse is not over 10 years younger or is not the sole beneficiary), the distributions are always based on numbers reflecting the joint life expectancy of the participant and a person 10 years younger. This decreases the required minimum distribution for many participants.

(d) The new, simple, uniform table makes it far easier to calculate the required minimum distributions.

(e) Participants no longer need to determine their designated beneficiary by the RBD. The participant can change the designated beneficiary after the RBD without increasing the required minimum distributions during his or her lifetime.

(f) Participants also no longer have to elect whether to recalculate life expectancy.

(g) Participants no longer need to satisfy a separate incidental death benefit rule.

B. Computation of Required Minimum Distributions

The computation of the annual required minimum distributions after the RBD requires only two simple steps:

1. Determine the value of the IRA or plan on the last day of the preceding year. For example, on New Year's Day, the participant can look at the closing stock prices for December 31.

2. Multiply the value of the IRA or plan by the percentage in the table that is next to the age the participant will be at the end of the current year. This is the minimum required distribution.

> Example: Mary has $200,000 in her IRA on December 31, 2007. She will be 82 at the end of 2008. She must receive at least $12,500 during 2003 to avoid a 50% penalty (6.25% x $200,000).

Here is the table for computing minimum distributions during the participant's life unless the sole beneficiary is the participant's spouse and is more than 10 years younger than he:

(Treas. Reg. Sec. 1.401(a)(9)-9 Q&A 2)

Age	Percentage	Age	Percentage
70	3.8168%	90	9.5238%
71	3.9526%	91	10.1010%
72	4.0984%	92	10.6383%
73	4.2553%	93	11.3636%
74	4.4053%	94	12.0482%
75	4.5872%	95	12.8205%
76	4.7847%	96	13.6986%
77	4.9751%	97	14.4928%
78	5.2083%	98	15.3846%
79	5.4348%	99	16.3934%
80	5.6818%	100	17.5439%
81	5.9524%	101	18.8679%
82	6.2500%	102	20.0000%
83	6.5359%	103	21.2766%
84	6.8966%	104	22.7273%
85	7.2464%	105	24.3902%
86	7.6336%		
87	8.0645%		
88	8.4746%		
89	9.0090%		

3. The recalculation - MDIB method in the 2002 rules will mean that IRAs are never exhausted. Even at ages over 115, the divisor will be 1.8. Thus, it is nearly certain that all IRAs will have a remaining balance that may be distributed to a designated beneficiary.

4. The lower level of required distributions will enable most IRAs to increase in value during the period of mandatory distributions to the participant. Unless the participant lives well into her 90's, the value when she passes away will exceed the value at the RBD.

- Since the distributions start at about 4%, and IRA owners can earn 6% to 9% within the IRA, most IRA owners will accumulate excess income within the IRA during their late 70's. In much later years when the payouts increase, all income and some principal of the IRA will be distributed.
- An IRA owner earning 7% will not start to invade principal until age 85. A person earning 8% will not start to invade principal until age 87. For a 9% earnings rate, the invasion starts at age 89.

- The vast majority of people will have from 40% to 80% more value in their IRA when they die than they do at age 70½. Many with $100,000 in the IRA at the RBD will die at age 90 with over $150,000 in the IRA.

5. If the participant has more than one IRA, the minimum distribution is computed annually with respect to each IRA, but the aggregate required distribution for the year may all be taken from any one or more of the IRAs.

6. If the IRA owner also has a qualified plan, or has multiple qualified plans and no IRA, the minimum distributions for each plan must be withdrawn from that respective plan, but the distributions from multiple IRAs can still all be taken from any one or more of those IRAs.

7. If the participant takes an excess distribution in one year, it is not credited against the required distribution for the next year. The IRS decided that record keeping for carry forwards would be too complex. However, the excess distribution will reduce the plan balance as of the end of the year and therefore reduce the required minimum distribution for the next year.

8. A new requirement under the 2002 Treasury Regulations mandates reporting of minimum IRA distributions by custodians. Under Regulation Section 1.408-8, Paragraph A-10, the custodian must report the required distribution to the IRA owner and to the IRS.

9. The lower required minimum distributions may allow more clients to reduce AGI to below $100,000 to qualify for conversion to a Roth IRA. Roth IRAs have no lifetime minimum distribution requirements, so this is solely an income tax planning option. A Roth IRA is funded with after-tax dollars, but later withdrawals are not subject to income tax. Thus, growth in the Roth IRA escapes income tax entirely.

10. A client already in pay status as of January 1, 2002 was able to reduce annual payouts unless he or she had a non-spouse beneficiary or beneficiaries more than 10 years younger than the participant, in which case he or she was already using the new table.

11. The new lower payouts are good news for wealthy clients who don't need the distributions, less wealthy clients trying to conserve their retirement resources, and money managers who will retain more under management for longer periods.

C. <u>Rationale for New Table</u>

The new table for calculating lifetime distributions reflects life expectancies of the account owner and a beneficiary 10 years younger than he or she, at each age beginning at age 70. This reflects the fact that the beneficiary is subject to change and ultimately may be an individual more than 10 years younger than the participant. The lifetime distributions are now consistent with that possibility. The new approach eliminates the use of two tables and the interaction of the multiple beneficiaries and change in beneficiary rules.

III. POST-DEATH DISTRIBUTIONS

A. Beneficiary Determined as September 30 of Year Following Year of Death

1. Under the new Regulations, the "designated beneficiary" is generally determined as of September 30 of the year following the year of the participant's death, rather than as of the earlier of the RBD or the participant's death, as required under the old rules.

2. Since the designated beneficiary is determined at the end of September of the year following the year of death, any beneficiary eliminated by distribution of the benefit or through disclaimer (or otherwise) during the period between the participant's death and the end of the year following the year of death is disregarded.

> Example: Nancy dies at age 80 having designated charity X, her alma mater, and her 55 year old son as the beneficiaries of her IRA. A charity has no life expectancy so cannot be a designated beneficiary. Under the old rules, the son would have been forced to take a lump sum distribution, accelerating the income tax on the IRA. Under the 2002 rules, if charity X receives full distribution of its share before September 30th of the year following the year of Nancy's death, the son can take distributions over his own life expectancy of 28.6 years. Treas. Reg. Sec. 1.401(a)(9)-4, Q&A 4(a). Otherwise, he would have to take distribution over Nancy's remaining life expectancy of 9.5 years. Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 7.

> Example: Max dies at age 82 having designated his spouse as the beneficiary of 50% of his IRA and each of his two sons as the beneficiary of 25%. If the spouse is not cashed out by September 30th of the year after the year of Max's death, and the separate share rules (discussed below) are not satisfied, all three beneficiaries must take distribution over her lifetime. If the spouse is cashed out within that period, she can roll her distribution to her own IRA, and the sons can take distribution over the life expectancy of the older son.

3. A deceased participant's personal representative cannot change the beneficiaries after the death of the participant. See IRS Announcement 2001-23. However, by December 31 of the year after the year of death, the personal representative can establish separate shares for outright beneficiaries of fractional or percentage interests, which would allow each participant to take distributions over his or her own life expectancy.

4. Participants past their RBD should revisit their beneficiary designations since they can now change beneficiaries without increasing their minimum distributions.

B. **Distribution Period - Death After RBD**

1. The general rule is that distributions from an IRA can be made over the life expectancy of a person who is the same age the participant would have been on the last day of the year in which he died. Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 5. However, this rule will apply *only* if there is *no designated beneficiary*.

> Example: Max dies at age 79 with no designated beneficiary. His IRA must be paid out over the next 10 years since a 79 year old person has a 10 year life expectancy. The minimum required distribution is 1/10th of the account in the first year, 1/9th in the second year, 1/8th in the third year, and so on.

2. If the participant had a designated IRA beneficiary, that beneficiary's life expectancy is used. If the designated beneficiary is younger than the participant was, the IRA proceeds can be distributed over the longer life expectancy of the designated beneficiary. A designated IRA beneficiary who is older than the participant can take over the participant's remaining life expectancy at death, based on the age the participant reached or would have reached in the calendar year of death. Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 5.

> Example: When Peter died at age 79, he had named his 22 year old granddaughter as the sole beneficiary of the IRA. Next year, his granddaughter was age 23. According to the table, a 23 year old has a 59 year life expectancy. Thus, instead of making distributions over 10 years (Peter's remaining actuarial life expectancy at age 79), they can be made over 59 years. The first required distribution is 1/59th, the next is 1/58th, etcetera.

3. Note that if a designated IRA beneficiary was older than the participant, younger designated beneficiaries will not be forced to take distribution over the shorter life expectancy of the participant if the older beneficiary is cashed out by September 30 of the year after the year of the participant's death, or if each is a beneficiary of a fraction or percentage of the proceeds and separate shares for them are established by December 31 of the year after the year of death.

4. The minimum distribution for the participant's year of death is still based on his normal lifetime distribution schedule. If the deceased participant did not take his full distribution for that year prior to his death, the beneficiaries must take that distribution by the end of the year in which death occurred.

5. If the participant's spouse is a beneficiary, the spouse can roll her portion of the proceeds to her own IRA and take distribution over her own life expectancy starting no later than the second to occur of (i) December 31 of the year the participant would have reached age 70½ or (ii) December 31 of the year after the year of the participant's death.

- A surviving spouse can still elect to treat the deceased spouse's IRA as her own, but only after distribution of the required minimum amount for the year of the participant's death. If the spouse does not roll the IRA into her own IRA, distributions to her will be made over her life expectancy, using her birthday for each distribution year for which a distribution is required following the participant's death. (Treas. Reg. Sec. 1.401(a)(9)-5). Following the spouse's death, individual contingent beneficiaries designated by the predeceased spouse will take over the spouse's life expectancy in the year of her death reduced by one year each subsequent year.

- Example: Jim dies at age 75 leaving his 401(k) plan 100% to his wife, Lisa, also age 75. Lisa decides not to roll the 401(k) over to her own IRA. As long as the 401(k) remains in Jim's name, Lisa's annual required distributions are computed based on her life expectancy as of her birthday each year. She dies at age 77. The minimum required distribution for her year of death is based on her single life expectancy at age 77, which is 11.2 years. This life expectancy is now frozen because of her death, and Jim's successor beneficiaries must take based on an 11.2 year life expectancy reduced by one year each year. The distribution for the year after her death will thus be based on a 10.2 year life expectancy.

- Except for the required minimum distribution to the participant for the year of the participant's death (which the spouse must take if the participant did not), the surviving spouse may also take a lump sum distribution and transfer it to an IRA rollover account in her own name as owner. However, if she is 70½ or older, the minimum annual distribution to her must be made for the year of the rollover and, because it is a required minimum distribution, it may not be rolled over.

- If the spouse rolls the IRA, then her designated IRA beneficiaries will be determined as of September 30 of the year following the year of her death. They will take distributions as follows: (i) If she has a single younger beneficiary, then over the life expectancy of that younger sole beneficiary determined as of the beneficiary's birthday in the calendar year after the year of the spouse's death and reduced by one year in each subsequent year; (ii) if there are multiple younger individual beneficiaries named, then in the same manner, but with respect to the life expectancy of the oldest beneficiary; or (iii) if the sole beneficiary is the same age or older than she was, then over the participant's remaining life expectancy, based on the age the surviving spouse/participant would have attained by December 31 of the year of death.

- The election by the surviving spouse to roll the IRA over "is permitted to be made at any time after the distribution of the required minimum amount for the account for the calendar year containing the individual's date of death." (Treas. Regs. Sec. 1.408-8, Q&A 5).

C. **Multiple Individual Beneficiaries**

If, as of the end of the year following the year of the participant's death, the participant has more than one designated beneficiary, and the IRA or plan has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy fixes the period over which payout must occur. This is the same as under the old rules. Under the 2002 rules, such separate accounts or shares may be set up at any time prior to December 31 of the year after the year of death.

> Example: Liz named both her 58 year old nephew and her 22 year old granddaughter as equal co-beneficiaries of her IRA. Distributions to both of them will be based on the nephew's life expectancy because he is older. Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 7(a)(1). However, if Liz had split her IRA into two IRAs -- one for each beneficiary -- or if her personal representative does so by December 31 of the year after Liz's death, then each would take distribution over his or her own life expectancy. Treas. Reg. Sec. 1.401(a)(9)-8, Q&A 2 and 3.

The final regulations stipulate that, where separate accounts are established post-mortem, investment results must be allocated pro rata from date of death to the date of establishment of the accounts. Treas. Reg. Sec. 401(a)(9)-8, Q&A 1 & 2.

Note: It is not clear how the deadline of December 31 of the year after the IRA owner's death for establishing separate accounts affects the determination of the identities of the designated beneficiaries on the preceding September 30th. This question can be avoided if separate accounts are established post-mortem but before September 30th of the calendar year after the year of death.

D. **No Designated Beneficiary**

A designated beneficiary must be an individual. If the participant names his estate or a charity as beneficiary, for example, he is treated as having no designated beneficiary. If the participant does not complete a beneficiary designation form and the governing document defaults to his estate as beneficiary, there is also no designated beneficiary. Under the 2002 rules, where there is no designated beneficiary and the participant dies after his RBD, the distributions must be made over the participant's remaining life expectancy using his age as of his birthday in the calendar year of his death. In subsequent years, the applicable distribution period is reduced by one year for each calendar year which has elapsed since the date of death. Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 5. Under the old rules, if the participant elected to recalculate life expectancy and died with no designated beneficiary, full distribution had to be made by December 31 of the year after the year of death.

E. **Death Before the RBD**

1. For a participant with a designated beneficiary, the same rules apply to post-death distributions whether he dies before or after the RBD. The "5 year rule" has been eliminated.

2. If a participant has no designated beneficiary and dies before his RBD, this is the only case where the "5 year rule" still applies. If there is no designated beneficiary as of September 30th of the year following the year of death, full distribution must be made by December 31 of the year in which falls the fifth anniversary of the date of death.

Here is the table for measuring the remaining years of required distribution using either (i) the remaining life expectancy of the participant or (ii) the life expectancy of the designated beneficiary, as applicable. (Table V of Reg. 1.72-9, as required by Treas. Reg. Sec. 1.401(a)(9)-5, Q&A 6):

Year	Life Expectancy	Year	Life Expectancy	Year	Life Expectancy	Year	Life Expectancy
5	76.6	35	47.3	65	20.0	95	3.7
6	75.6	36	46.4	66	19.2	96	3.4
7	74.7	37	45.4	67	18.4	97	3.2
8	73.7	38	44.4	68	17.6	98	3.0
9	72.7	39	43.5	69	16.8	99	2.8
10	71.7	40	42.5	70	16.0	100	2.7
11	70.7	41	41.5	71	15.3	101	2.5
12	69.7	42	40.6	72	14.6	102	2.3
13	68.8	43	39.6	73	13.9	103	2.1
14	67.8	44	38.7	74	13.2	104	1.9
15	66.8	45	37.7	75	12.5	105	1.8
16	65.8	46	36.8	76	11.9	106	1.6
17	64.8	47	35.9	77	11.2	107	1.4
18	63.9	48	34.9	78	10.6		
19	62.9	49	34.0	79	10.0		
20	61.9	50	33.1	80	9.5		
21	60.9	51	32.2	81	8.9		
22	59.9	52	31.3	82	8.4		
23	59.0	53	30.4	83	7.9		
24	58.0	54	29.5	84	7.4		

Year	Life Expectancy	Year	Life Expectancy	Year	Life Expectancy	Year	Life Expectancy
25	57.0	55	28.6	85	6.9		
26	56.0	56	27.7	86	6.5		
27	55.1	57	26.8	87	6.1		
28	54.1	58	25.9	88	5.7		
29	53.1	59	25.0	89	5.3		
30	52.2	60	24.2	90	5.0		
31	51.2	61	23.3	91	4.7		
32	50.2	62	22.5	92	4.4		
33	49.3	63	21.6	93	4.1		
34	48.3	64	20.8	94	3.9		

F. **Non-Spouse Beneficiary Rollovers from Qualified Plans**

1. The Pension Protection Act of 2006 ("PPA") added new Section 402 (c)(11) to the Code. This section provides that beginning in 2007 any non-spouse designated beneficiary can roll over any inherited *qualified retirement plan,* 403(b) plan or 457 plan to an "inherited IRA".

2. Prior to the enactment of Section 402(c)(11) a non-spouse beneficiary had no way to roll over a lump sum distribution from an inherited plan, such as a 401(k) or another qualified employer retirement plan. Before the PPA, the tax laws seemed to give such a beneficiary the right to withdraw the plan proceeds gradually over his or her life expectancy, thus enjoying continued tax deferral after the participant's death. However, most employers did not offer this life expectancy payout as employers do not want to be in the business of administering pension funds for descendants of deceased employees.

3. Under the PPA, a non-spouse beneficiary of a qualified plan can roll plan distributions to an "inherited IRA," which is actually a newly created IRA in the name of the deceased participant payable to the beneficiary as beneficiary. Such an inherited IRA would be titled as: "Tom Smith as beneficiary of John Smith."

4. Non-spouse beneficiaries, like surviving spouses, cannot roll over the participant's final MDR. Non-spouse beneficiaries of a rollover inherited IRA generally take distributions over their own life expectancies.

5. The non-spouse beneficiary rollover provision does not allow heirs to change the identity of decedent's beneficiary. An heir cannot name a new beneficiary of an inherited IRA.

6. A trust "for the benefit of" designated beneficiaries is also able to do these rollovers after the participant's death. In Notice 2007-7, the IRS said its existing rules used to determine "see-through trust" status would also be used to determine whether a trust named as beneficiary would qualify to roll over inherited proceeds to an "inherited IRA."

7. In Notice 2007-7, explaining the PPA provisions for non-spouse beneficiary rollovers from qualified plans to inherited IRAs, largely gutted Section 402(c)(11):

- Plans are not required to offer beneficiary requests for transfers to an inherited IRA, and many will choose not to do so.

- If the five year rule applied to the plan proceeds, it will also apply to the inherited IRA.

The notice establishes a general rule that whatever minimum distribution rules applied to the benefit when it was in the inherited retirement plan (including the five-year rule) will also apply to the "inherited" IRA to which the inherited plan benefit is transferred.

Theoretically, that should not be a problem. After all, under the Code it is impossible for the five-year rule to apply when benefits are left to an individual "designated beneficiary," and the new non-spouse beneficiary rollover is available only for benefits left to a designated beneficiary. However, in reality this is a problem, because under IRS regulations, it is possible for the five-year rule to apply even when benefits are left to a designated beneficiary. This can happen, for example, if the plan mandates the five-year rule for all benefits of participants who die before the RBD.

Notice 2007-7 allows only one way out of this general rule--one way for a beneficiary in a mandatory five-year-rule plan to switch over to the life expectancy payout method. Unfortunately, this "special rule" in Notice 2007-7 seems to apply only to a beneficiary who completes his or her rollover in the year after the year of the participant's death. Thus, for any beneficiary who is currently holding benefits in an inherited plan that is subject to the five-year rule, Notice 2007-7 seems to close the door on the possibility of switching over to the life expectancy method by means of a rollover to an "inherited" IRA unless the decedent died in 2006 or later.

8. Here are the planning implications of Notice 2007-7 for clients in three possible situations:

- *Beneficiaries who can roll over to an inherited IRA and enjoy a life expectancy payout under the IRA*: Despite the limitations of Notice 2007-7, the new beneficiary rollovers will definitely help some beneficiaries. Here is who will be able to use Section 402(c)(11) to transfer an inherited qualified retirement plan, 403(b), or 457 plan benefit to an "inherited" IRA by direct rollover (and take a life expectancy payout from the IRA)--provided, according to Notice 2007-7, that the inherited (transferor) plan permits such beneficiary rollovers:

    - Any beneficiary who inherited from a decedent who died after his or her RBD, regardless of when that death occurred and regardless of what payout options were available under the plan.

- Any beneficiary who inherited from a decedent who died before his or her RBD, where MRDs under the inherited plan were determined under the life-expectancy-of-the-beneficiary method, regardless of when that death occurred and regardless of what payout options were available under the plan.

- Any beneficiary who inherited from a decedent who died in 2006 or later, before his or her RBD, where MRDs under the inherited plan were determined under the five-year rule and the beneficiary has the benefit transferred to the "inherited" IRA by the end of the year after the year in which the participant died. In this case, the beneficiary must take out of the plan (and not roll over) the minimum required distribution for the year after the year of the participant's death, determined as if the life expectancy method did apply to the plan benefits.

▪ *Beneficiaries who cannot roll over to an "inherited" IRA and/or can roll to an "inherited" IRA but cannot receive a life expectancy payout from such IRA.* According to Notice 2007-7, Section 402(c)(11) will not help the following designated beneficiaries:

- Any beneficiary of an inherited plan that does not permit non-spouse beneficiary rollovers, regardless of whether the participant died before or after his or her RBD.

- Any beneficiary who inherited from a decedent who died before his or her RBD, where MRDs under the inherited plan are determined under the five-year rule and the beneficiary does not succeed in having the benefit transferred to the "inherited" IRA by the end of the year after the year in which the participant died.

9. As before the PPA was enacted, a client who has funds in an employer plan should consider rolling his or her benefits over to an IRA as soon as the client is able to do so (e.g., upon termination of employment) if there is any possibility that such benefits will pass to a non-spouse individual beneficiary (or see-through trust) upon the client's death. Because of Notice 2007-7, it is clear that we cannot count on the beneficiaries' having the ability to roll the inherited benefits to an IRA after the client's death.

IV. CHARITABLE GIFTS OF RETIREMENT PLAN PROCEEDS

A. IRD Passing to Charity

1. Charitable gifts of retirement plan proceeds and other income in respect of a decedent (IRD) have become popular because IRD left to charity can escape both estate and income taxation. If the gift is properly structured, the decedent’s estate will be entitled to an estate tax charitable deduction under IRC Section 2055(a) for the amount

of IRD passing to charity. Moreover, if a tax-exempt charity is the beneficiary of the retirement plan, the charity pays no income tax on the retirement plan proceeds it receives.

2. As a general rule, if the client's estate is large enough to provide both for individual heirs and for charitable gifts, the best strategy is to leave individual beneficiaries the non-IRD property, which receives a stepped up basis at death so is not double taxed, and leave the retirement plan proceeds to charity.

3. Example: Assume that Mary is a widow with one child, Tom, who is in a 45% combined federal (35%) and state (9.3%) top marginal income tax bracket. Her estate of $2 million consists of a $1 million rollover IRA, her house valued at $750,000 and $250,000 of marketable securities. She has her full estate tax credit available. Mary wishes to benefit both her son and her local community foundation.

Table 1: Mary leaves 50% of each asset to Tom and 50% to her community foundation and dies in 2003.

Asset	Community Foundation	Tom
50% IRA	500,000	500,000
50% house	375,500	375,000
50% securities	125,000	125,000
Gross bequest	$1,000,000	$1,000,000
Less income tax on IRA	-0-	(225,000)
Net bequest	$1,000,000	$775,000

Table 2: Mary leaves the entire IRA to her community foundation and the house and securities to Tom and dies in 2003. The income tax on the IRA is avoided, so Tom receives $225,000 more. Of course, this benefit will remain valuable even if the estate tax is repealed.

Asset	Community Foundation	Tom
IRA	$1,000,000	
House		$750,000
Securities		250,000
Gross bequest	$1,000,000	$1,000,000
Less income tax on IRA	-0-	-0-
Net bequest	$1,000,000	$1,000,000

These examples and tax concepts are simplified to illustrate the potential tax savings offered by a charitable gift of retirement plan proceeds. In the real world, this type of planning is full of traps for the unwary. To avoid those traps, the donor's advisor must understand the basic rules that apply to retirement plan distributions.

B. **Income Tax Deduction for Federal Estate Tax on IRD**

When IRD passes to an individual, estate or taxable trust, the proceeds are subject to both estate and income taxes. The beneficiary pays the income taxes as IRA distributions are made, at the beneficiary's income tax rates. The double tax is ameliorated, though, because the beneficiary may deduct, for federal income tax purposes, the federal estate tax on the IRD in the plan participant's estate. IRC Sec. 691(c).

C. **Outright Testamentary Charitable Gifts of Plan Proceeds**

An outright testamentary gift of retirement plan proceeds to charity is easy to implement since the charity need only be named as the plan beneficiary on a beneficiary designation form. This approach is an inexpensive strategy too, since no special documents are required so no legal fees are involved.

1. **Charity as Sole Plan Beneficiary**. Under the old rules, even when a charity was to receive 100% of the plan proceeds, simply naming the charity as the recipient on the beneficiary designation form often was not the best approach. Naming the charity as the primary beneficiary of 100% of the plan did avoid estate and income taxation of the proceeds. However, this approach could also decrease the amount passing to charity. If the participant named a charity as the plan beneficiary prior to her required beginning date, she was deemed to have no designated beneficiary. As a result, the required distributions she had to take during her life were based on her sole life expectancy. This forced the participant to take larger annual payments than she may have needed or wanted, and it left less to pass to charity at her death.

Under the 2002 rules, unless the participant has a spouse more than 10 years younger than she, the participant takes distributions over her own life expectancy plus that of a person 10 years younger than she, regardless of whether she has a designated beneficiary. Having a charity named as beneficiary no longer accelerates the participant's lifetime distributions.

2. **Multiple Plan Beneficiaries with Charity as a Beneficiary: How to Make the Beneficiary Designation**. Under the old rules, if the participant designated both a charity and one or more individuals as plan beneficiaries, he could be treated as having no designated beneficiary. As a result, if the participant died before the required beginning date, the entire plan balance might have had to be paid out by December 31 of the calendar year in which occurred the fifth anniversary of the participant's death. If the participant survived the required beginning date, distribution might have had to be made by December 31 of the year after the year of the participant's death.

This result could be avoided by dividing the IRA into two separate IRAs, with one payable to the participant's charitable beneficiary and one payable to the participant's child. The distribution to charity was a lump sum, but since the charity was tax exempt, there was no accelerated income tax. The child was able to take distributions based on life expectancy and thus defer the income tax. Another solution that practitioners

thought (but were not certain) worked was to specify a fraction or percentage to pass to charity, rather than a dollar amount.

Under the 2002 rules, naming a charity to receive a portion of the proceeds, whether a fraction, percentage or dollar amount, no longer accelerates distributions to individuals who are beneficiaries of the same plan. Now, the designated beneficiary is not determined until September 30 of the year after the year of death. If the charity is cashed out by that date, the individual beneficiaries can stretch out their payments as if no charity had been named.

<u>Example</u>: Max has a $500,000 IRA. His beneficiary designation at his death *before* his RBD specifies that the first $100,000 is to pass to charity and the balance to his only child.

Under the old rules, and also under the 2002 rules if the charity is not cashed out by September 30 of the year after the year of the death, both the charity and the child must receive full distribution by December 31 of the year in which the fifth anniversary of Max's death occured, because Max is treated as having no designated beneficiary.

<u>Example</u>: Same as above, but Max dies after his RBD.

Under the old rules, if Max had elected to recalculate his life expectancy and died after his RBD with no designated beneficiary, full distribution had to occur by December 31st of the year after the year of death.

Under the 2002 rules, if the charity is not cashed out by September 30th of the year after the year of Max's death, Max is treated as having no designated beneficiary, and distribution must occur over Max's remaining life expectancy using his age as of his birthday in the year of his death.

<u>Note</u>: Under the 2002 rules, if the charity is cashed out before the September 30th date, the child can take distribution over the child's life expectancy, whether Max dies before or after his RBD.

D. <u>Payment to Estate or Living Trust With Charity as Beneficiary</u>

If the right to receive plan proceeds is *specifically bequeathed* to charity under a Will or living trust, the result, for income tax purposes, should be the same as if the charity were designated as the plan beneficiary. IRC Section 691 will impose income tax on the IRD, which is payable by the recipient beneficiary. If the beneficiary is a tax-exempt charity, it will receive the proceeds tax-free. In order to obtain this result, the plan proceeds must be specifically bequeathed to the charity, and the estate or living trust must assign to the charity the right to receive the proceeds. See PLR 200234019.

1. If the right to receive the plan proceeds is specifically bequeathed to a charity but the proceeds are actually paid to the estate before the estate can assign to the charity the right to receive the IRD, the estate will be subject to income tax on the IRD. IRC Section 642 allows the estate or living trust an income tax deduction for charitable gifts

which are required by the governing document to be paid out of income. Since the IRD is income for income tax purposes (though it is principal for fiduciary accounting purposes), a specific bequest of the retirement benefits to charity meets this requirement. Therefore, the estate's income tax deduction for the distribution will offset its income tax liability with respect to the proceeds. However, the IRC Section 642 deduction is available only if the proceeds are received by the estate and paid by it to the charity in the same calendar year.

2. If the Will or living trust includes a pecuniary charitable gift and the executor or trustee decides to (but is not required to) satisfy that gift with plan proceeds payable to the estate or trust, the estate or trust will pay income tax on the proceeds and will have no offsetting charitable deduction.

E. **Pledges**

Retirement plan proceeds generally should not pass to charity in satisfaction of an enforceable pledge made by the participant during life.

1. Whether a charitable pledge unfulfilled at death is a debt enforceable against the estate of the decedent who made the pledge depends upon state law. In California, a written pledge is an enforceable debt if there was consideration from or reliance by the charity; an oral pledge is generally not enforceable.

2. If plan proceeds, which are income to the estate for income tax purposes, are assigned by the estate in satisfaction of a charitable pledge, the estate must realize and pay tax on that income. See John T. Harrington Estate, 2 TCM 540, Dec. 13,405(M) (1943). Similarly, if a charity is named as a beneficiary of the plan in satisfaction of an enforceable pledge, then, although IRD passing directly to charity would normally be income of the charity, the estate is deemed to have received the IRD from the decedent because the payment of the IRD to the charity canceled the estate's debt to the charity. See Treas. Reg. Section 1.691(a)-2(a)(1). If the estate is not subject to estate tax, the estate pays income tax in the IRD and has no offsetting deduction.

3. The exception to the general rule that proceeds should not be used to satisfy a pledge is where the participant's estate would be subject to estate tax due to inclusion of assets valued at as least as much as the amount of the pledge. If the estate is subject to estate tax, an IRC Section 2053 estate tax deduction should be available for the full amount of the pledge as a valid debt of the decedent, and this will offset the income tax payable by the estate if the pledge is satisfied with proceeds in the tax year in which the estate or living trust receives them:

Example:

Gross estate (death in 2008)	$ 4,600,000
IRA payable to charity in satisfaction of pledge	600,000
Federal income tax on IRA payable by estate (35%)	210,000
Tentative federal estate tax	$1,170,000
Federal estate tax after $600,000 Section 2053 deduction	900,000
Federal estate tax savings from deduction	270,000
Estate tax savings ($270,000) less income tax on IRA ($210,000) = net savings	$ 60,000

Bottom Line: Avoid use of plan proceeds to satisfy a pledge if the participant's estate will not be subject to estate tax, such as the estate of a married participant with a "zero tax" marital deduction gift, an estate valued at under the estate tax applicable exclusion amount, or an estate all of which is passing to charity. Even then, the tax result would be better if the estate did not have to pay any income taxes on IRD and were still entitled to a Section 2053 deduction for the amount of the pledge as an enforceable debt of the decedent.

F. Estate Tax Charitable Deduction

A full IRC Section 2055(a) estate tax charitable deduction will be available to the participant's estate for the amount of plan proceeds passing to a charity as beneficiary, if not in satisfaction of a pledge. The beneficiary may be a public charity, private foundation or donor advised fund, or a charitable remainder trust, with only the remainder interest deductible as to the latter.

G. Donor Advised Fund as Beneficiary

Retirement plans may be made payable to a donor advised fund at a community foundation.

1. The participant could then designate his children as the advisors, to make recommendations regarding charitable grants from the fund. These recommendations must be only advisory, and the community foundation must have power to veto them. However, establishing a donor advised fund is a quick, easy way to involve the children in philanthropy.

2. Some clients start a donor advised fund with "seed money" during life, so that they and their children may share this philanthropic experience. Retirement plan

proceeds then augment the fund on the death of the second parent to die. The donor receives an income tax deduction for lifetime additions to the fund, which is a public charity for purposes of percentage limitations on income tax charitable deductions. The estate of the second to die of the participant and his spouse receives a 100% estate tax charitable deduction for plan proceeds passing to the donor advised fund on the surviving spouse's death.

H. **Private Foundation as Beneficiary**

A client may wish to name his family foundation as the plan beneficiary.

1. As with donor advised funds, many private foundations are started small during the client's lifetime, with the retirement plan proceeds added on the death of the second spouse to die. Additions at death qualify for the unlimited estate tax charitable deduction. Lifetime contributions of non-retirement plan assets to the foundation are subject to the private foundation percentage limitations on the income tax charitable deduction.

2. If the funding is to occur by disclaimer, care must be taken to insulate the disclaimant from grantmaking decisions. The IRC Section 2518 regulations specify that a disclaimer is not valid if the disclaimant can direct the ultimate beneficial enjoyment of the property. Prior to the 2002 rules, planners could avoid the client's having no designated beneficiary by naming an individual as the primary beneficiary and the foundation as the contingent beneficiary, so the foundation could be funded by disclaimer. If a child is the designated beneficiary of the plan and disclaims all or a portion of the proceeds, which then pass to the family foundation, the child will render the disclaimer invalid if the child participates on grantmaking decisions with respect to those funds as a member of the board of the private foundation. To avoid this result, the plan proceeds could be placed into a segregated foundation sub-account as to which the disclaimant has no vote.

3. The foundation does not recognize taxable income when it receives the proceeds. PLR 9341008. Moreover, the plan proceeds are not considered net investment income of the foundation so are not subject to the 2% excise tax on investment income under IRC Section 4940. PLR 9838028. The proceeds are includible in the participant's gross estate under IRC Section 2039(a), but the estate gets an estate tax charitable deduction under IRC Section 2055(a) for the full amount of the proceeds passing to the foundation.

I. **Testamentary Gift to a Charitable Remainder Trust**

1. If a charitable remainder trust (CRT) is the beneficiary of retirement plan proceeds, the proceeds will be paid to the CRT in a lump sum after the participant's death. However, since the CRT is a tax-exempt trust, there will be no immediate income tax on the proceeds. The IRD ordinary income will later pass out to the individual beneficiary or beneficiaries as the unitrust or annuity amount is paid to them.

2. A testamentary CRT for the benefit of a spouse may be desirable, particularly in a second marriage situation. The entire value of the CRT will qualify for the

estate tax marital deduction under IRC Section 2056(b)(8) at the first death, and the entire value qualifies for the estate tax charitable deduction under IRC Section 2055(a) at the surviving spouse's subsequent death. See PLR 9253038.

3. If a testamentary CRT is established to benefit children, the participant's estate will pay estate tax on the actuarial value of the children's interest in the CRT as of the participant's death, but the estate will be entitled to a charitable deduction for the remainder. The estate tax on the children's interest cannot be paid from CRT assets. The distribution of the plan proceeds to the CRT constitutes IRD and is includible in the CRT's income in the year received but is not taxable unless the CRT also has unrelated business taxable income. Rev. Rul. 69-297, 1969-1 C.B. 131; Rev. Rul. 75-125, 1975-1 C.B. 254.

4. Distributions from a CRT to the individual beneficiaries are characterized under a four-tier rule. The distributions are characterized *first* as *ordinary income* to the extent the CRT has ordinary income in the current year or undistributed from prior years; *second*, as *capital gains* to the extent of the CRT's gains in the current year or undistributed from prior years (first short-term and then long-term); *third*, as *tax-free income* to the extent of the CRT's tax-free income in the current year or undistributed from prior years; and *fourth*, as *return on principal*. IRC Section 664(d). The IRS takes the position that, when IRD passes to a CRT, it is ordinary income, and all distributions to the individual beneficiary are treated as ordinary income until the full amount of the IRD has been distributed from the CRT. See PLR 9634019. Thus, although the contribution of proceeds to the CRT is considered principal under state law, the taxable nature of the IRD causes its classification as first-tier ordinary income rather than fourth-tier principal for federal tax purposes.

5. IRC Section 691(c) allows an income tax deduction for federal estate taxes paid on IRD. The IRC Section 691(c) deduction is allowed to the recipient of the IRD. This deduction may never be usable where retirement plan proceeds pass to a CRT: The donor's estate tax on the actuarial value of the annuity or unitrust interest of a non-spouse individual CRT beneficiary must not be paid from the CRT; it is typically paid by the donor's estate or living trust. Moreover, the CRT cannot use the deduction since it is a tax-exempt trust, and the CRT has no apparent way to pass it out to the individual beneficiary.

6. In PLR 199901023, the IRS takes the position that individual beneficiaries of a CRT cannot prorate the IRC Section 691(c) deduction over the years as they receive CRT distributions. The IRS ruled in this PLR that plan proceeds distributed to a CRT on the death of the participant are included in the gross income of the CRT under IRC Section 691(a)(1)(B). The IRD is ordinary income under the four-tier rule when distributed to the individual beneficiaries. The CRT takes into account the IRC Section 691(c)(1)(A) deduction for federal estate taxes on the IRD in determining the amount of first-tier ordinary income distributed to the individual beneficiaries. The first-tier income attributable to plan proceeds is the amount of the IRD net of the Section 691(c)(1)(A) deduction. Thus, although the Section 691(c)(1)(A) does not benefit the tax-exempt CRT and cannot be directly passed through to the beneficiaries, the deduction reduces the

amount of first-tier income the beneficiaries receive. The deduction is reported by the CRT on Form 5227, its Split Interest Trust Tax Return.

7. It is best to establish the CRT during the participant's life and name it as the direct beneficiary of the plan proceeds. If the proceeds are paid to the participant's estate or living trust, and the executor or trustee is required to use the proceeds to fund a CRT established under the Will or living trust, the estate gets an estate tax charitable deduction for the value of the charitable remainder but may not get the IRC Section 642(c) income tax deduction, unless it assigns to the CRT the right to receive the proceeds, in which case the IRD never becomes income to the estate. The IRC Section 642(c) deduction will be available only for a net income or net income with makeup CRT, not a standard pay. Treasury Regulation Section 1.642(c)(2)(d) denies the deduction if corpus can be invaded other than for charity. It is therefore best to keep the IRD off of the estate's income tax return altogether, or the estate may have the income with no offsetting income tax deduction.

J. **Pooled Income Fund as Beneficiary**

A pooled income fund is not tax exempt. It usually avoids income taxation by distributing all of its net investment income to its donors. A pooled income fund can retain long term capital gains without paying income tax on them by claiming an income tax charitable deduction for the long term capital gain allocated to principal for the benefit of charitable remaindermen. There is no such deduction under IRC Section 642(c)(3) for IRD. IRD paid to the pooled income fund is principal under state law but income for federal income tax purposes. The result is a "trapping distribution," and the pooled income fund must pay income tax on the IRD. For this reason, plan proceeds should not be made payable to a pooled income fund.

K. **Lifetime Gifts of Retirement Plan Proceeds to Charity**

1. If a client wishes to contribute IRA funds to charity during her lifetime, she must make a withdrawal from her IRA, pay the income tax on that ordinary income, and then make the contribution. Few clients will choose to take lifetime plan distributions so the proceeds can then be contributed to charity. The donor's deduction would almost always be less than the amount of the contribution, due to the annual charitable deduction percentage limitations and the 3% phase-out of itemized deductions under IRC Section 68.

However, if your client is forced by the minimum distribution rules to take plan distributions she does not need, the client could donate to charity the excess that she does not need and could claim a charitable deduction to offset her income tax liability.

2. For 2006 and 2007, the PPA permitted IRA owners beginning at age 70½ to make outright charitable gifts totaling up to $100,000 from their IRAs directly to eligible charities, by means of a direct transfer from the IRA custodian to the charity. The custodian could also give the IRA owner a check made out to an eligible charity, which the owner could then deliver to the charity.

- The IRA owner did not have to report the distribution as taxable income and was not entitled to claim a charitable income tax deduction for the gift.

- "Eligible charities" included public charities other than donor advised funds and supporting organizations.

- This provision expired on December 31, 2007. Congress failed to act on a one-year or two-year extension of this provision. It is possible that in 2008, we will get legislation either extending the PPA's rule that expired on December 31, 2007 or even expanding the rule to allow such direct charitable transfers from IRAs by participants age 59½ or older (rather than 70½), with no $100,000 annual limitation, and to life income vehicles such as charitable remainder trusts as well as by direct transfer to the public charity. The charitable sector is lobbying for passage of such legislation.

Conclusion

Charitable gifts of retirement plan assets can offer great tax benefits while also meeting a client's philanthropic goals. Care must be taken, though, in designing beneficiary designations and counseling the client about the options available. This outline is not intended to be an exhaustive discussion of all pertinent issues and planning strategies but, rather, to be an overview of basic rules and some of the more common and important planning considerations.

* * *

The 2002 Regulations can be retrieved at no cost from the following web sites:

http://deathandtaxes.com/mrdreg.htm

http://www.ira-web.com/newreg.htm

http://www.ataxplan.com

Appendix A

IRS Notice 2007-7, regarding non-spouse rollovers of qualified plan proceeds and explanation thereof.

Appendix B

Independent Sector Charitable IRA Rollover Fact Sheet