Scripps Heritage Planner

An Income, Estate and Gift Tax Newsletter for Professionals
from the Office of Gift Planning at Scripps Health Foundation

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Where the Money Is: Lifetime Charitable Gifts of Retirement Assets

IN THIS ISSUE:

- Taking a Distribution, Making a Gift
- More Effective Giving with Lump-Sum Distributions
- Loans of IRA Assets to Charity
- Integrating Capital Gains with Retirement Distributions

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Upcoming Gift Planning Seminars

The Current State of Discount Valuations
Thursday, May 8, 2014

Trust Modification: Can You Turn Back Time?
Wednesday, June 11, 2014

July 2014 Topic and Presenter to Be Announced
Wednesday, July 2, 2014

All presentations will take place from noon to 1:30 pm at the Founder's Room, Schaetzel Center for Health Education

Scripps Memorial Hospital La Jolla
9888 Genesee Avenue
La Jolla, CA 92037

See back cover for further information about these educational opportunities.

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David E. Williams
Senior Director of Gift Planning
858-678-6359
williams.dave@scrippshealth.org

Natalie Ganz
Director of Gift Planning
858-678-6344
ganz.natalie@scrippshealth.org

Where the Money Is: Lifetime Charitable Gifts of Retirement Assets

In medicine, Sutton's law refers to the principle of going straight to the most likely diagnosis. Going to the heart of the matter is forever linked with bank robber Willie Sutton, who, when asked why he robbed banks, famously replied, "Because that's where the money is."[1]

Put Willie Sutton in the 21st century and he surely would have found that "the money" is in financial services—especially retirement vehicles. Americans hold trillions of dollars in retirement accounts, representing 34% of all household financial assets.[2] Nearly all retirement funds are held in these arrangements:[3]

- $5.7 trillion in Individual Retirement Accounts (IRAs)
- $5.3 trillion in defined contribution (DC) plans
- $5.2 trillion in federal, state and local government pension plans
- $2.8 trillion in private-sector defined benefit (DB) plans

Since retirement assets are truly "where the money is," it's worth examining how individuals can use these funds to make lifetime gifts through techniques that not only benefit a favorite charity, but do so in a manner that eases a donor's tax burden. Except where specifically noted, this discussion applies to all IRAs and qualified plan assets, including 457(b) deferred compensation arrangements and 403(b) tax-deferred annuities.

Taking a Distribution, Making a Gift

Prior to 2014, the law permitted a donor to make a Qualified Charitable Distribution (QCD) of up to $100,000 from an IRA directly to charity in a lifetime rollover without taxation. As of the publication date, Congress had not extended this provision for tax years after 2013. Thus, under current law, an inter-vivos transfer of retirement assets to charity is first considered a taxable distribution.

Retirement plan assets provide a ready source of funds, but taking a distribution and then gifting it to charity is the same as making a cash gift, since retirement plan distributions are usually taxable as ordinary income. Nonetheless, like simple gifts of cash, these distributions still:

- Reduce the donor's taxable estate
- Provide a current income tax deduction for a cash donation (or a deduction for the present value of the remainder interest to the charity if the donor directs the money to a charitable remainder trust or charitable gift annuity)

EXAMPLE: Willie takes a $200,000 distribution from his IRA, which constitutes ordinary income and is fully taxable. If Willie contributes the distribution to a CRT designed to pay him an income for life, his current year tax deduction is based on the present value of the charitable remainder interest. If the remainder interest is 30%, that means a full 70% of Willie's distribution remains subject to ordinary income tax rates.

This is not necessarily a bad result, but Willie could do better with a testamentary transfer of IRA assets. His IRA assets are taxable in his estate after death, whereas a charity pays no income taxes and could keep every dollar. Plus, the bequest would create both estate tax and income tax charitable deductions for his estate.

More Effective Giving With Lump-Sum Distributions

Gifts of retirement distributions do not provide the highly beneficial tax results that donors can achieve using other strategies—unless a donor is eligible to receive a lump-sum distribution from an employer-sponsored retirement plan.[4] Let's examine two of these strategies.

Gifts of Employer Stock

Qualified plans frequently offer employer securities as an investment and allow an in-kind distribution of this stock. Highly appreciated employer stock with net unrealized appreciation (NUA) presents an opportunity for a large charitable deduction.

When a donor receives a lump-sum distribution of employer stock that has a significant amount of NUA, the distribution always generates a long-term capital gain.[5] However, a donor can give the stock to a deferred charitable giving arrangement and claim an income tax deduction based on the appreciated value of the stock rather than its much lower tax basis. The donor doesn't need to hold the stock for more than one year after distribution to qualify for long-term capital gain status, as is usually the case.[6]

EXAMPLE: Roger receives a lump-sum distribution of IBM shares worth $200,000, although the IBM plan purchased them for only $20,000. Roger only has to recognize

$20,000 of income until he sells the stock, at which point he will have to recognize the $180,000 of NUA as income.[7] If he holds the stock for one week and sells it for $205,000 (a further appreciation of $5,000), then he will have a $180,000 long-term capital gain attributable to the NUA and a $5,000 short-term capital gain from the additional appreciation.[8] If he gifted the stock worth $205,000, the charitable income tax deduction would be based on the $200,000 value, which includes the $180,000 long-term capital gain but excludes the $5,000 short-term capital gain.[9]

A natural candidate for this strategy is a donor who participates in an employee stock ownership plan (ESOP). An ESOP can be used by C or S corporations, although certain tax benefits are not available to S corporations—most notably, the rule that allows sellers of stock to defer recognition of the gain on the sale if certain requirements are met.

When a plan allows, an employee who leaves the company can receive the vested interest in the ESOP in the form of employer securities. Distributions from ESOPs can result in significant net unrealized appreciation, thereby generating a large deduction if the employee donates the stock directly to charity.[10]

A donor can give S corporation stock to a charity but not to a CRT or a pooled income fund.[11] While this provides an opportunity for S corporation business owners to make charitable gifts of stock, both the donor and the charity face daunting issues. The donor:

- faces questions related to giving ownership rights to a charity
- must receive a "contemporaneous written acknowledgment" from the charity in order for the tax deduction to be successful[12]
- is required obtain a qualified appraisal on any gift of stock worth more than $10,000 and file IRS Form 8283 with his or her income tax return[13]

As for the charity, all of a charity's income attributable to S corporation stock will be subject to the unrelated business income tax (UBIT), including gain from the sale. In addition, if the charity sells or disposes of the stock within three years of receipt, the charity must notify both the IRS and the donor of the sale price on Form 8282.[14]

10-Year Forward Averaging

An older investor who takes a lump-sum distribution from a qualified plan in cash may be eligible for 10-year forward averaging.[15] The charitable giving strategy in this setting is to pay the low 10-year rate and contribute the remainder to charity while taking a sizable charitable deduction in the process. However, there are a number of conditions that must be satisfied:

- the plan participant must have been born before January 2, 1936
- the distribution must be from a qualified plan (but not an IRA or 403(b) plan)
- the entire plan balance (not including employee contributions) must be distributed in one taxable year as a single distribution or series of distributions, and no part of the distribution can be rolled over
- the plan participant must have been in the plan for at least five years before the distribution
- the plan participant cannot have used the income averaging provision for any previous distribution after 1986

The lump sum must be distributed:

- on account of the employee's death, disability (if self employed), or separation from service[16]
- after the employee reaches age 59 1/2

Once lump-sum treatment is elected, all distributions from qualified plans to the recipient for that taxable year must use lump-sum treatment. Failure to include all lump-sum distributions in the election will invalidate the election for any distributions. An individual is allowed only one forward-averaging election.

Taxing Lump-sum Distributions

"Lump sum" is a term of art in the world of qualified plans and refers to the distribution, within a single tax year, of a plan participant's entire balance from an employer's qualified pension, profit-sharing, or stock bonus plans.[17] All of the participant's accounts under all the employer's plans must be distributed in order to be eligible for lump-sum treatment.

The following options are available to qualifying lump-sum distributions:

- treat the entire distribution as ordinary income
- treat the part of the distribution from participation before 1974 as a capital gain and the part of the distribution from participation after 1973 as subject to tax under the 10-year averaging rules or as ordinary income
- roll over all or part of the distribution (tax is deferred on the part rolled over, while any part not rolled over is treated as ordinary income)

Taxes are deferred on all or part of a lump-sum distribution by requesting a "direct rollover" (trust-to-trust transfer) of the taxable portion into an IRA or eligible retirement plan (typically a qualified plan of another employer that expressly allows for such incoming transfers). Any rollover, however, eliminates the possibility of using the special tax rules described above for any later distribution. Most taxable lump-sum distributions are subject to a mandatory income tax withholding of 20%.

Loans of IRA Assets to Charity

Donors can loan IRA assets to charity without causing a taxable distribution (though also without any charitable deduction). Three strategies exist involving a loan from an IRA to a charity:

- a loan where a charity uses loaned funds to acquire a life insurance policy on the IRA owner (the approach approved by the IRS in Private Letter Ruling (PLR) 200741016)[18]
- a loan with a bequest of the promissory note, and
- a loan where the donor makes a cash gift of the required minimum distributions (RMDs)

Let's take a look at each of these strategies in more detail.

IRA Loan with Life Insurance

This type of transaction, known as the "Charitable IRA" or CHIRA, was first approved by the IRS in PLR 200741016.[19] A CHIRA involves a loan of IRA assets to a charity, where the charity uses part of the money to purchase life insurance on the life of the IRA owner. The life insurance policy serves to secure the promissory note in the event of the IRA owner's death prior to full repayment of the loan.

When the IRA owner passes away, the charity receives the proceeds of the insurance policy and, if necessary, pays off the note to the IRA. If the IRA owner leaves the IRA to family members, the owner has benefitted the charity with any earnings on the fund during the owner's life. If the IRA owner bequeaths the IRA to the charity, the charity receives both a lifetime and a testamentary benefit.

EXAMPLE: Anna directs her IRA to lend $200,000 to her favorite charity—a large, well funded institution. The charity allocates $100,000 to pay premiums on a new policy on Anna's life, and $60,000 to pay the required annual interest on the $200,000 loan. This leaves $40,000 for the charity to use immediately. At Anna's death, the charity receives $200,000, which it uses to pay off the principal of the loan. Any excess remains with the charity. Since the charity makes the interest payments directly to the IRA, they are considered tax-deferred gain. Anna's spouse could then inherit the IRA when she dies and either maintain it or roll the proceeds into another IRA in his own name.[20]

Use of this strategy requires the parties to the transaction to overcome several hurdles.

Prudence. The loan of IRA assets to the charity must be considered a prudent investment. Although IRAs are not subject to the stringent ERISA-based rules imposed on qualified plans, fundamental standards of trust law can be used as a guide. Prudent investors must, for example, consider matters related to the rate of return on an investment and whether the investment poses an unreasonable risk of loss. Also, an IRA owner must consider maintaining a certain level of cash liquidity—if too much money is tied up in illiquid investments, such as real estate, cash flow could be restricted in retirement or funds might not be available to make required minimum distributions.

Prohibited Transaction. Generally, a prohibited transaction is any improper use of an IRA by the IRA owner, the owner's beneficiary, or any "disqualified person." Disqualified persons include, among others, the IRA owner's family members and the fiduciary. The following are examples of prohibited transactions:

- borrowing money from the IRA
- selling property to the IRA
- receiving unreasonable compensation for managing the IRA
- using the IRA as security for a loan
- buying property for personal use (present or future) with IRA funds

An IRA owner may make a loan to a public nonprofit provided that it does not constitute a transaction with a "disqualified person" under IRC §4975(c)(1)(B). Provided the relationship between a donor and a nonprofit charity is appropriate under the definition, the IRS will permit a loan of IRA funds. When specific questions arise as to allowable IRA investments, it is always possible to obtain an IRS private letter ruling (PLR) beforehand.

Insurable Interest. A basic requirement for all types of insurance is the person or entity (here, the charity) that buys an insurance policy must have an insurable interest in the subject of the insurance (here, the IRA owner). For life insurance, the insurable interest only needs to exist at the time the policy is purchased. For purposes of establishing a CHIRA, this consideration must be evaluated carefully, preferably by an attorney or other insurance expert, before extending a loan from an IRA to a charity.

Impermissible Investment in Life Insurance. The CHIRA transaction cannot be considered to involve an impermissible investment by the IRA in life insurance. This rule reflects Congress' intent that IRA funds should be invested so as to provide inflation-protected returns.[21]

Reasonable Rate of Return. With respect to the interest rate, the IRS publishes a revenue ruling each month that lists the applicable federal rate (AFR) for loans. Typically, a loan from an IRA to a nonprofit will be a long-term loan with annual payments; therefore, the AFR for annual payment long-term duration loans should be the interest payment on the charitable IRA loan.

IRA Loan Plus Bequest

This technique is simpler as it doesn't involve the purchase of life insurance. The IRA owner makes a loan of IRA assets to charity over a number of years exceeding the owner's lifespan, then bequeaths the loan amount to the charity. As with the other techniques, the loan must overcome the hurdles mentioned above to be permissible.

EXAMPLE: John, age 75, owns an IRA worth $2 million. He desires to loan a favorite charity $1 million to assist with the charity's capital building campaign. John makes the loan in return for a 40-year note with interest-only payments of 5%. Since the charity has substantial assets and an endowment, the unsecured note is deemed to be a prudent investment for the IRA.

The charity uses the $1 million to finish the new facility and makes an annual 5% interest payment ($50,000) to the IRA custodian. John uses these annual payments to take his RMDs. John designates the charity as the primary beneficiary of $1 million of the IRA, and at death the $1 million note will be returned to the charity.

Because John is 75, survival to age 115 is unlikely. Nonetheless, if John were to survive, the charity would need to repay the $1 million to the IRA custodian at that time.

Gift of Required Minimum Distributions

A potential "benefit to charity with life income" strategy is described in PLR 200741016 (the standard loan "hurdles" apply to this transaction as well). This PLR involved a loan from an IRA to a charity with the interest payments used to pay the RMDs. The donor withdrawing the RMDs then made a simple cash gift each year to the charity.

Provided that a donor does not exceed the 50% of adjusted gross income deduction limit, such a gift would be fully deductible in the year of donation.

Integrating Capital Gains with Retirement Distributions

Usually, donors are better off contributing appreciated long-term capital gain property during life rather than making gifts with distributions from retirement plans. However, donors can combine retirement plan distributions with gifts of capital assets and accomplish a favorable income tax result.

Example: June owns $150,000 of Apple stock she purchased for $25,000. She also receives a $150,000 taxable required minimum distribution from her 401(k) plan. June is better off donating the stock to charity rather than the 401(k) distribution. Though either gift would produce a $150,000 income tax charitable deduction, giving the stock forever avoids long-term capital gains tax on the $125,000 of appreciation.[22]

In the combination strategy, June can donate the stock, then use her 401(k) distribution to buy more Apple stock with a fresh cost basis. In this way, the charitable deduction from the gift of the original stock can be used to offset the taxable 401(k) distribution—a nearly tax-free step-up in basis in the stock position.

Conclusion

Often, charitably minded clients who want to make major donations will have concerns about where the money will come from or whether there will be enough money left in the estate to cover future expenses. In these cases, we can return to Sutton's law and look first to the obvious. There is a significant amount of money sitting in retirement accounts, and many people are required to take annual distributions whether they need that money or not.

When a person has created a comfortable retirement through personal savings and Social Security, retirement assets can provide interesting planning opportunities for making lifetime charitable gifts. The law respecting distributions from retirement plans is highly complex and creating charitable gifts with these assets is not a matter for the faint of heart. Nonetheless, given the highly favorable results that donors can enjoy with the right plan, it is a strategy worth considering when the time arrives.

Endnotes

1 http://medical-dictionary.thefreedictionary.com/Sutton%27s+law. Willie Sutton, responsible for bank robberies totaling some $2 million, denied having said this; see, http://www.snopes.com/quotes/sutton.asp.

2 http://ici.org. As of June 30, 2013.

3 Id. Given current market levels, these figures are most likely significantly understated.

4 Not all plans allow lump-sum distributions. Spousal consent may be required.

5 Reg. Section 1.402(a)-1(b)(1)(i); Rev. Rul. 81-122, 1981-1 C.B. 202

6 IRS Notice 98-24; PLR 199919039 (IRS sanctioned a contribution of appreciated stock to a Charitable Remainder Unitrust)

7 IRC §402(e)(4)(B)

8 See PLR 199919039

9 IRC §170(e)(1)(A)

10 Donors contemplating gifts of appreciated employer stock should obviously refrain from diversifying investments where allowed under the 2006 Pension Protection Act.

11 Small Business Job Protection Act; Public Law 104-188; August 20, 1996

12 IRC §170(f)(8); Reg. Section 1.170A-9(e)(13)

13 Reg. Section 1.170A-13(c)(2)(ii)

14 IRC §6050L and Reg. Section 1.6050L-1

15 IRC §402(e)(4)(D)(i)

16 See IRS Form 4972 (and instructions) for eligibility requirements.

17 For the purposes of determining the identity of the employer maintaining the plans making the lump-sum distribution, all employers required to be aggregated under IRC §414(b)(c) or (m) are treated as a single entity.

18 A PLR cannot be relied upon as authority by anyone other than the taxpayer to whom it was issued, but does provide insight as to how the IRS may view similar transactions.

19 In PLR 200741016 the donor directed his IRA to lend money to a church, attended by the donor, in return for a 20-year promissory note paying 5% annually. The note provided for a balloon payment of the principal after 20 years (or upon death, if earlier). To provide collateral for the note, the church bought a life insurance policy on the life of the IRA holder, owned by the church, so that if the donor died prior to the full payment of the note, the death benefit would provide the remaining payments owed, and the rest would go to the church. The loan payments from the church to the IRA would provide the needed cash for the donor to take required minimum distributions from the IRA. The IRS approved this arrangement since the church was large and had substantial assets. The unsecured note was deemed to be a prudent investment for the IRA with a reasonable rate of return. Moreover, since the IRA owner was a regular donor to the church, under state law the church had an insurable interest in the life of the IRA owner. Finally, because the charity owned and controlled the insurance policy and was also beneficiary, the IRA was not making a prohibited life insurance investment under IRC §408(a)(3).

20 Non-spouse beneficiaries do not have the same options as surviving spouses.

21 At the time the rule was imposed, debate amongst some congressional representatives centered around the conjecture that with so much money potentially involved in IRAs, a total ban on life insurance was needed to protect the average consumer from the intense marketing and sales pressure of the life insurance industry.

22 IRC §170(b)(1)(C)(iv)

Upcoming Gift Planning Seminars

Complimentary lunch and validated self-parking are provided.
MCLE credit is offered and available for those who qualify.

All presentations will take place at: Founder's Room, Schaetzel Center for Health Education
Scripps Memorial Hospital La Jolla • 9888 Genesee Avenue • La Jolla, CA 92037

To make a reservation: email giftplanning@scrippshealth.org or call 858-678-7120

The Current State of Discount Valuations

Thursday, May 8, 2014 Noon – 1:30 pm
By Reservation Only – Deadline: Friday, May 2, 2014

Presented by: Philip M. Schwab, ASA, Managing Director, FMV Opinions, Inc.

With the discount battlefield constantly changing, this presentation covers the latest Tax Court decisions and IRS promulgations and strategies. It also covers current discount data to help you plan for your client. This presentation is designed to provide participants with insight into the issues raised by the Tax Court relative to the valuation of asset holding entities and operating businesses.

Trust Modification: Can You Turn Back Time?

Wednesday, June 11, 2014 Noon – 1:30 pm
By Reservation Only – Deadline: Friday, June 6, 2014

Presented by: Frederick R. Vandeveer, Partner, McKenna Long & Aldridge LLP

Have you ever reviewed a trust agreement, lamented how it was drafted or the fiduciaries that were appointed, and wished you could "turn back time" to change those terms? Our presenter will explore how, sometimes, we may be able to do just that. Issues such as options for revocable and irrevocable trusts, judicial and non-judicial trust modifications, *cy pres*, and decanting trusts will be covered.

July 2014 Topic and Presenter to Be Announced

Wednesday, July 2, 2014 Noon - 1:30 pm
By Reservation Only – Deadline: Friday, June 27, 2014

Scripps

David E. Williams
Senior Director of Gift Planning
858-678-6359
williams.dave@scrippshealth.org

Natalie Ganz
Director of Gift Planning
858-678-6344
ganz.natalie@scrippshealth.org

Please visit us online at **scrippsheritage.org** where you will find many helpful tools and links to tax laws and articles. If you are not already receiving our weekly eNewsletter, you may sign up easily on our web site.