

Treacherous Waters: Using IRD for Charitable Bequests

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In IRS Chief Counsel Memorandum ILM 200848020 ¹ a trust was denied a charitable income tax deduction after it received taxable IRA distributions (income in respect of a decedent or "IRD")² and then distributed the amounts to charities. The ability of an estate or trust to claim a charitable income tax deduction may be further complicated by a new proposed regulation that provides that when a governing instrument specifies a source of income (such as IRD) to be used for a charitable income tax deduction, the instructions must have an economic effect independent of income tax consequences in order to be respected.³ This article will examine the challenges and strategies to successfully pay a charitable bequest with IRD.

A Charitable Income Tax Deduction For A Bequest Of IRD?

The Chief Counsel memorandum is a dramatic illustration of how a charitable bequest of IRD can go wrong. It addressed a situation where the decedent had left his IRA to a trust that benefitted his six children and several charities. The trust received distributions from the IRA for the charitable shares and the trustee immediately paid these amounts to the charities, leaving the six children as the only remaining beneficiaries of the trust. The IRS Chief Counsel's office concluded that the trust had taxable income from the IRA distribution but was not entitled to claim an offsetting charitable income tax deduction since the trust instrument contained no instructions to distribute income to a charity.

In order for a distribution of IRD to a charity to be deductible, it must meet the legal requirement for an estate or trust to claim a charitable income tax deduction. Normally an estate or trust is not entitled to claim a charitable income tax deduction for the payment of a standard charitable bequest,⁴ but there have been many instances where estates and trusts were able to claim charitable income tax deductions to offset taxable income from IRD.⁵ In order to claim a charitable income tax deduction, the charitable payments

must be traced⁶ to income and must generally be made pursuant to the terms of the governing instrument that require income to be paid to a charity.⁷ In ILM 200848020 there apparently weren't any instructions to distribute income to a charity and consequently the trust could not claim a charitable income tax deduction.⁸ Instead the IRD was taxed either to the trust or to the children if they received distributions of the trust's distributable net income ("DNI").⁹

Under what circumstances can an estate or trust claim a charitable income tax deduction to offset the taxable income from IRD? There is justification for such an income tax deduction under tax policy.¹⁰ What are the mechanics? What is the impact of the proposed regulation on this arrangement? Since there is no DNI deduction for a distribution to a charity,¹¹ a charitable income tax deduction is essential to get an income tax benefit.

Many wills and trust instruments indeed contain instructions that IRD must be used to satisfy a charitable bequest in the event that the estate or trust has IRD income. A typical provision is:

I instruct that all of my charitable gifts, bequests and devises shall be made, to the extent possible, from "income in respect of a decedent" (as that term is defined under the U.S. income tax laws) included in gross income and shall qualify for a charitable income tax deduction under Section 642(c) of the Internal Revenue Code of 1986 and any corresponding future tax laws.

If such instructions had appeared in the governing instrument analyzed in ILM 200848020, would the trust have been entitled to an offsetting deduction? Probably. What is surprising is that there is no legal authority on point where instructions in a governing instrument to make a charitable disposition of IRD assured a charitable income tax deduction, despite the increasing frequency and size of IRD in the estates of the nation's citizens (particularly retirement plan assets). There is no court case, regulation or ruling. Legal guidance would be very helpful since this situation will become increasingly common. By comparison, there is considerable legal authority, that without such instructions there would be a problem claiming a charitable

income tax deduction,¹² unless the entire estate -- or the remainder or residue of an estate -- was payable to a charity.¹³

How is this scenario affected by the proposed regulation that requires an independent economic effect? Ostensibly the regulations merely address the division of an estate's or trust's taxable and tax-exempt income amongst income beneficiaries, some of which include charities. They do not address whether a charitable income tax deduction will be allowed, denied or partially allowed/denied when a governing instrument contains instructions that all charitable bequests must be satisfied with IRD whenever that is possible.

Some of the provisions in the proposed regulation can be interpreted in a way that could cause concern. The proposed rule is that "a provision in the governing instrument ... that specifically provides the source out of which amounts are to be paid ... for such a [charitable] purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences."¹⁴ This suggests that instructions to use IRD for certain charitable dispositions might not be respected unless those dispositions had an independent economic effect. For example, there is no independent economic effect if a will provides for a \$100,000 charitable bequest and specifies that it should be "paid from IRD, if any exists." The charity will receive \$100,000 whether there is any IRD or not. Cautious estate planners may consider inserting instructions for charitable uses of IRD that have an economic effect.¹⁵

On the other hand, what are the sanctions for failure to have an independent economic effect? The proposed regulation states that the estate's or trust's income will instead be allocated between charitable and non-charitable beneficiaries using the same proportionate ratio of all classes of income of the estate or trust.¹⁶ Such a result wouldn't impose a hardship as long as the estate or trust could still claim a charitable income tax deduction. It wouldn't matter that the deduction was comprised of a mix of interest, dividends and IRD.

The legal uncertainty whether an estate or trust can claim a charitable income tax deduction for a charitable distribution of IRD has made alternative ways of structuring charitable bequests of IRD even more attractive. Rather than have IRD payable to an estate or trust that will make a charitable bequest, a better strategy is to bypass the estate or trust entirely and transfer the IRD directly to a charity or to a tax-exempt charitable remainder trust.

Big Picture: Two Ways to Make Charitable Bequests of IRD

IRD's classification as taxable income makes it an especially appealing source for funding a charitable bequest. By using taxable IRD payments to satisfy a bequest to a tax-exempt charity, an estate planner can distribute greater amounts of tax-free assets, such as stock or real estate that receive a step-up in basis, to family members.

There are generally two ways to structure a charitable bequest of IRD. The first is to have the IRD paid directly to a charity so that the charity, rather than an estate, trust or a beneficiary, recognizes all of the IRD income. If the estate or trust never recognizes any IRD income, there is no need for it to claim an offsetting charitable income tax deduction. The second way is to have an estate or trust receive the taxable IRD and then claim an offsetting charitable income tax deduction for the distribution of the IRD to a charity. As the IRS Chief Counsel memorandum illustrates, this strategy should only be undertaken if the estate planner is confident that such an offsetting deduction is assured. With the legal uncertainty concerning the circumstances when an estate or trust can claim such an offsetting charitable income tax deduction, the first alternative looks increasingly attractive for planning a charitable bequest of IRD.

How can IRD be transferred directly to a charity? The answer depends on the nature and source of the IRD. If the IRD is generated by the type of asset that normally goes through probate -- such as savings bonds,¹⁷ an employee stock option,¹⁸ or an installment sale note -- the solution can be an in-kind distribution of those assets to a charity so that it, rather than the estate, recognizes the income when payments are received.

The largest amounts of IRD are held in retirement accounts, which are trusts or custodial accounts that usually have their own beneficiary designations. The distributions pass outside of probate, unless the estate was designated as the beneficiary. Consequently, the most common way to transfer the IRD in a retirement plan directly to a charity is for the plan participant or the IRA owner to name a charity as a beneficiary of some or all of the retirement account on the beneficiary designation form provided by the plan administrator. In that case, the retirement account makes a payment directly to the charity and informs the charity that the payment is taxable income. The tax-exempt charity, of course, does not pay income tax upon the receipt of the distribution. This is the case even for a private foundation that must normally pay a 1% or 2% excise tax on its investment income.¹⁹ Under this scenario, the estate or trust never reports the income,²⁰ and consequently, never needs an offsetting charitable income tax deduction. This strategy works with other forms of IRD where a person has the ability to designate a beneficiary, such as a bequest of an interest in a nonqualified deferred compensation plan²¹ or of a taxable death benefit under an annuity contract.²²

If the individual in the Chief Counsel memorandum had named the charities directly on the IRA beneficiary form as beneficiaries of a percentage of the IRA assets, the income tax problem would have been avoided. The charities would have received their amounts directly from the IRA and the trust would have only received the income intended for the six children. There would be no need for the trust to claim a charitable income tax deduction. As long as the charities received their distributions before September 30 of the year that follows the decedent's death, the trust and the six children would be eligible to receive the IRA distributions over the life expectancy of the oldest child (a "stretch IRA").²³

An even safer alternative is to have a separate "charitable IRA" with one IRA administrator (where all beneficiaries of the IRA are charities and/or tax-exempt charitable remainder trusts) and one or more "family IRAs" with other IRA administrators. In that case there is no time pressure to make the charitable distributions before September 30 since the existence of the

charitable IRA has no impact on the mandatory distributions from any of the family IRAs. An individual can keep the asset levels of the charitable IRA and the family IRAs at the desired amounts by withdrawing more or less from each IRA, since an IRA Owner's mandatory lifetime IRA distributions can be taken from any single IRA rather than from every IRA.²⁴

It is even possible to divert payments after death to a charity from an IRA that is payable to an estate. This usually works when the charity will receive the residue of the estate and the personal representative has the power to make non-pro-rata distributions.²⁵ The Service concluded, however, that using retirement assets to satisfy a fixed dollar charitable bequest triggered taxable income to a trust, in which case a charitable income tax deduction is necessary to avoid a tax liability.²⁶

It is especially important for an estate or trust to avoid recognizing income when there is a bequest of IRD to a charitable remainder trust²⁷ or to acquire a testamentary charitable gift annuity for a beneficiary.²⁸ Any possible charitable income tax deduction would, at best, only partially offset the taxable income from the IRD.²⁹

Wrap-Up

The legal challenges and complexity for an estate or a trust to obtain a charitable income tax deduction for a charitable bequest of IRD is running smack into the locomotive of an increasing number of estates that have increasing amounts of IRD. Retirement plan assets appeared on 61% of all federal estate tax returns filed in 2007 and comprised nearly 7% of all reported assets (they were 11.4% of the assets reported by estates under \$3.5 million).³⁰ The corresponding percentages in 1997 were only 46% and 6.2%.³¹ Taxpayers and estate planners need greater certainty and simplicity when they leave retirement assets to an estate or trust with an expectation that those assets will be used to satisfy a charitable bequest.

The Service could improve the efficient administration of tax laws if it would issue a revenue ruling or other guidance that taxpayers could rely on for structuring such charitable bequests through their estates or trusts. In the

meantime savvy estate planners will advise their affluent clients to structure their estate plans to have IRD transferred directly to a charity or to a charitable remainder trust in order to avoid having an estate or trust recognize any income. It is Joe Middleclass who, without competent advice, will likely be caught in an income tax trap of having a retirement plan paid to an estate that will make a charitable bequest, thereby triggering an avoidable income tax liability, as evidenced by ILM 200848020.

FOOTNOTES

1. IRS Chief Counsel Memorandum ILM 200848020 (July 28, 2008). Such Chief Counsel memoranda have received a variety of designations in citations as either ILM (Internal Legal Memorandum), CCA (Chief Counsel Advice), CA (Counsel Advice) or CCM (Chief Counsel Memorandum). ILM appears most frequently and is therefore used in this article.

2. Rev. Rul. 92-47, 1992-1 C.B. 198.

3. Prop. Reg. 1.642(c)-3(b)(2), REG-101258-08, 2008-28 I.R.B. 111.

4. See Rev. Rul. 2003-123, 2003-2 C.B. 1200 for the general proposition that a trust cannot claim a charitable income tax deduction for a donation of trust principal as opposed to trust income. The concept is that a charitable bequest is a charitable disposition of property that the decedent owned on the date of death. By comparison, an estate's income is usually earned after the decedent's death. Thus a charitable bequest is usually deducted on an estate's federal estate tax return rather than the estate's federal income tax return.

5. See the examples cited in *infra* n. 13.

6. Although other deductions used to be subject to a tracing rule, the laws were changed in 1954 so that the charitable deduction is the principal deduction whose source must still be traced to income. The Tax Court explained the rules and the reason for them in *Van Buren v. Commissioner*, 89 T.C. 1101 (1987) at 1108-1109.

7. IRC Sec. 642(c)(1); Reg. Sec. 1.642(c)(1)(a)(1). See also Rev. Rul. 83-75, 1983-1 C.B. 114, in which a charitable lead trust's distribution of appreciated securities to a charity triggered income but the trust was entitled to claim a fully offsetting charitable income tax deduction. See also Private Letter Ruling 9044047 (Aug. 4, 1990).

8. The Chief Counsel's office reached a similar conclusion in ILM 200644020 (Dec. 15, 2005). A trust's use of an IRA to satisfy a fixed dollar charitable bequest was deemed to trigger taxable income to the trust but the trust could not claim an offsetting charitable income tax deduction since there were no

instructions in the governing instrument to leave income to charity.

9. IRC Sections 651, 652, 661 and 662.

10. There is indeed a tax policy justification for allowing an estate or trust to claim a charitable income tax deduction when it uses taxable IRD to satisfy a charitable bequest. IRD is different than other income. Whereas an estate's or trust's traditional income is earned *after* death and is *only* reported on an estate's income tax return, IRD is income that was earned *before* death and is potentially reported on *both* the estate's income tax return and as an asset on a decedent's federal estate return. Since IRD is potentially subject to double taxation on both the estate's federal estate tax return and on its income tax return, a properly structured charitable disposition of the IRD should conceptually qualify for an offsetting charitable deduction on both the estate tax return and the income tax return. It is a different situation than the tax deduction for an estate's administrative expenses, which can only be deducted on either the income tax return or the estate tax return, but not both. IRC Section 642(g). The potential double taxation of IRD justifies a potential double charitable deduction.

11. IRC Secs. 651(a) and 663(a); Rev. Rul. 2003-123, 2003-2 C.B. 1200.

12. See Rev. Rul. 2003-123, 2003-2 C.B. 1200, citing *Crestar Bank (Estate Of James A. Linen) v. IRS*, 47 F Supp 2d 670 (E.D. Virginia, April, 1999); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987); and *Riggs National Bank v. U.S.*, 352 F. 2d 812 (Ct. Cl. 1965).

13. It is possible for an estate to claim a charitable income tax deduction even in the absence of instructions to distribute income to a charity if the entire estate, or the remainder of an estate, will be paid to a charity. Reg. Sec. 1.642(c)-2(d) provides that an estate and certain trusts can claim an income tax charitable set-aside deduction if under the governing instrument the income will be devoted to a charitable purpose and the possibility for any non-charitable use is so remote as to be negligible. When an entire estate will be paid to a charity, the income will also be devoted to a charitable purpose. This result also applies when a charity will receive the residue of an estate. After all non-charitable beneficiaries have been paid in full, the only remaining

beneficiary of an estate is the charitable remainderman. The Service has permitted estates to claim charitable income tax deductions under these circumstances to offset taxable IRD income. Private Letter Rulings 200826028 (Mar. 27, 2008), 200526010 (Mar. 22, 2005), 200336030 (June 3, 2003), and 200221011 (Feb. 12, 2002) (IRAs and savings bonds); also 200537019 (May 25, 2005) (annuity contracts). See also *infra* n. 25 for how distributions from retirement plan accounts that are designated to be paid to an estate or a trust can instead be paid directly to charities so that the estate or trust has no taxable IRD income and, consequently, no charitable income tax deduction is necessary.

14. Prop. Reg. Sec. 1.642(c)-3(b)(2).

15. Examples include *Pay to charity XYZ all of the taxable retirement plan distributions that my estate receives -- or -- Pay the first \$300,000 of the taxable retirement plan distributions that my estate receives to charity ABC, and the rest of these distribution to my daughter, Natalie.* These examples are variations of illustrations presented by Natalie Choate in her well-written article "Choate on 1.642 and 1.642 Proposed Regs", *LISI Employee Benefits and Retirement PLanning Newsletter* #462 (August 14, 2008). These clauses have a substantial economic effect because the charity will only receive amounts if the estate indeed receives taxable retirement plan distributions. Furthermore, these clauses could "disinherit" other beneficiaries from receiving any or all retirement distributions payable to an estate. Hence, the clauses have an economic effect.

16. "In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes." Prop. Reg. Sec. 1.642(c)-3(b)(2).

17. Charitable bequests of savings bonds were analyzed in Rev. Rul. 80-118, 1980-1 C.B. 254 and Private Letter Ruling 9845026 (August 11, 1998). See also Reg. Sec. 1.691(a)-2(b), Ex. (3).

18. Private Letter Rulings 200002011 (Sept. 30, 1999) and 200012076 (Dec. 29, 1999) (employee stock options bequeathed to a charity by a will).

19. Private Letter Rulings 200425027 (Feb 27, 2004) and 9826040 (March 30, 1998). By comparison, if the IRD consists of interest from savings bonds or an annuity contract the tax does apply. Rev. Rul. 80-118, 1980-1 C.B. 254 (savings bonds) and Private Letter Ruling 200425027 (Feb 27, 2004) (annuity contract).

20. Neither the donor's estate nor heirs will recognize taxable income if retirement plan / IRA proceeds are paid directly to a charity or to a charitable remainder trust. Private Letter Rulings 200826028 (Mar. 27, 2008), 200652028 (Sep 13, 2006), 200633009 (May 16, 2006), 200618023 (Jan 18, 2006), 9723038 (March 11, 1997) (public charity); Private Letter Rulings 9838028 and 9818009 (private foundation); Private Letter Rulings 9901023 (Oct. 8, 1998) and 9634019 (May 24, 1996) (charitable remainder trust).

21. Private Letter Rulings 200002011 (Sept. 30, 1999) and 200012076 (Dec. 29, 1999).

22. Private Letter Rulings 200425027 (Feb 27, 2004), 200452004 (Aug. 10, 2004) and 200618023 (Jan 18, 2006).

23. Reg. Sec. 1.401(a)(9)-4, Q&A 4. If a trust is a beneficiary of an IRA, then if the trust pays all charitable bequests before September 30 following the year of the IRA owner's death, the trust may be able to receive "stretched-out" distributions from the IRA payable over the life expectancies of the trust's designated beneficiaries. See Private Letter Ruling 200740018 (July 12, 2007) where an IRA was payable to a trust to benefit cousins for life but there was also a pecuniary bequest to a charity. The charity received the entire amount before September 30 following the year of the IRA owner's death. The IRS concluded that the charity was no longer considered a beneficiary of the trust and that the IRA could make distributions to the trust based on the life expectancy of oldest cousin. The IRS did not rule on whether the trust could claim a charitable income tax deduction for the charitable payments.

24. IRS Notice 88-38, 1988-1 C.B. 524

25. The Service permitted an assignment of IRAs, 401(k) accounts, 403(b) accounts and annuity contracts to charities so that neither the estate nor other beneficiaries had to recognize any taxable income when the retirement accounts made their

distributions to the charities. Most rulings applied when the residue of the estate was payable to a charity. Private Letter Rulings 200826028 (Mar. 27, 2008), 200652028 (Sep 13, 2006), 200633009 (May 16, 2006), 200618023 (Jan 18, 2006), 200617020 (Dec 8, 2005), 200511174 (Feb 8, 2005), 200526010 (Mar. 22, 2005), and 200452004 (Aug. 10, 2004). Compare Private Letter Ruling 200234019 (May 13, 2002) (IRAs and 403(b) accounts where a portion of the estate went to charity).

26. ILM 200644020 (Dec. 15, 2005), described in *supra* n. 8.

27. Neither the donor's estate nor heirs recognized taxable income when retirement plan proceeds were paid after death directly to a charitable remainder trust. Private Letter Rulings 9901023 (Oct. 8, 1998) and 9634019 (May 24, 1996). For an article on the benefits and hazards of bequeathing retirement assets to a charitable remainder trust, see Hoyt, Christopher, "When A Charitable Trust Beats A Stretch IRA," *Trusts and Estates* (May 2002).

28. In Private Letter Ruling 200230018 (Apr. 22, 2002) an individual named a charity as the beneficiary of an IRA and left instructions with the charity to use the IRA proceeds to issue a charitable gift annuity. The estate recognized no taxable income on the transfer.

29. Only a partial charitable income tax deduction is allowed since a gift to a charitable remainder trust or to acquire a charitable gift annuity has a non-charitable component (the income stream to the beneficiary). An illustration of the tax nightmare is in Private Letter Ruling 20056024 (Apr. 6, 2005) where the income tax deduction to acquire a charitable gift annuity only partially offset the income tax generated by an IRA withdrawal.

30. IRS statistics on federal estate returns filed in 2007 can be found at <http://www.irs.gov/pub/irs-soi/07es01fy.xls>.

31. Computed from the table at <http://www.irs.gov/pub/irs-soi/97eslcge.xls> .