

Estate Planning Using Retirement Assets and Other Income in Respect of a Decedent

To encourage savings for retirement, the tax laws permit deferral of income tax on compensation set aside for retirement until the funds are withdrawn. As a result of this incentive, especially when coupled with a strong stock market, retirement assets may constitute a substantial portion of a client's estate. This issue of *Professional Notes* discusses the uses of retirement plan assets for clients with charitable interests, as well as for those who may not have considered charity as part of their estate plan. Because of its flexibility—in the assets it accepts and the services it offers—The New York Community Trust is an ideal recipient of retirement assets for both kinds of clients.

Taxes on Retirement Plan Assets and Other IRD

Under current law, the beneficiary of an estate generally does not pay taxes on his or her inheritance (although the estate pays a tax) and also receives the bequeathed property with a step-up in basis to the property's date-of-death valuation. But a taxpayer who inherits what is called "income in respect of a decedent" (IRD)—items of income that would have been taxable to the decedent had he lived—must pay income tax on the gift, even though the value of the asset was taxable in the estate. This income tax liability will not be affected by any of the proposals for reform or repeal of estate taxes.

Retirement plan assets are one example of IRD, and are particularly important because they may constitute such a significant portion of a client's estate. Non-statutory stock options and deferred compensation also may give rise to IRD. Other examples of IRD are installment sale payments and interest on certain savings bonds.

Currently, the maximum federal income tax rate is 35 percent. When coupled with New York State's maximum rate of 7.7 percent (to say nothing of New York City's income tax), a significant part of IRD assets will be "lost" to taxes.

Use of Retirement Plan Assets for Charity

IRD can be used by the charitably inclined client to vastly improve tax planning. Clients can earmark IRD assets for a charity such as The New York Community Trust, eliminating any income tax.

In other words, substantial taxes can be saved by simply changing the allocation of assets among charitable beneficiaries and other heirs. As the chart on the next page shows, providing for retirement plan assets (as opposed to other assets) to go to charity results in a larger bequest to family and other non-charitable beneficiaries. Even taking the estate tax out of the equation, more is available for noncharitable beneficiaries if the bequest to charity uses IRD.

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Only “account” type retirement plans—which include IRAs, 401(k)s, 403(b)s, and defined contribution plans—can be used for charitable gifts. “Account” type plans are not unlike savings accounts; upon the death of the participant or surviving spouse, the account balance becomes an asset of the estate. IRAs are the retirement plans most frequently used for charitable gifts because of their popularity and because the IRA owner is free to name any beneficiary. “Annuity” plans, such as defined benefit plans, generally cannot be used because payments terminate on the participant’s or surviving spouse’s death, leaving nothing for charity.

This tax reduction strategy also is available for other types of IRD property left to charity. The Internal Revenue Service has ruled that deferred compensation payable to charity upon the taxpayer’s death, and “nonstatutory stock options” (so called because they do not meet the requirements for special income tax treatment under Code Section 421¹) bequeathed by will to charity, will give rise to IRD in the hands of the charity, and not to the estate. Because the charity is exempt from tax, no income tax will be payable on the IRD. Consequently, a person who holds nonstatutory stock options may choose not to exercise the options (which would give rise to taxable income), so that the options can pass to charity at his or her death.

Charitable Remainder Trusts

Another way to sidestep taxes on retirement plan assets is to create a charitable remainder trust (CRT) with those assets. The CRT provides for a charity, such as The New York Community Trust, as the remainderman, with noncharitable heirs as income beneficiaries. As with an outright distribution to charity, no income tax should be payable when the plan assets are distributed to the charitable remainder trust, which is tax exempt.

It is critical that a charitable remainder trust be structured and invested to avoid unrelated business income because it is only tax exempt in a year in which the CRT does not have unrelated business income. Even one dollar of unrelated business income could make all income and gain of the CRT taxable.

Estate Tax Considerations

Estate tax considerations also encourage leaving IRD assets to charity. Although there is much talk about estate tax repeal, it may be premature to write off the estate tax. The federal estate tax currently has a maximum rate of 48 percent. Leaving pension assets to charity not only eliminates the income tax that otherwise would be due, but generates a corresponding charitable deduction that reduces the taxable estate.

The New York Community Trust is the ideal recipient of retirement plan assets for clients with charitable interests, as well as for those who may not have considered charity as part of their estate plan.

Where pension or other IRD assets are transferred to a testamentary CRT, under current law the estate will receive a charitable deduction equal to the actuarial value of the charitable remainder. This value will depend on the term, payout percentage, and type (unitrust or annuity trust) of CRT.

A married client may want to transfer retirement plan assets to the surviving spouse first, and then to charity. The marital deduction assures that no estate tax applies to the transfer to a spouse. (A spouse

may have a legal interest in the retirement assets and so may be required to consent to a transfer to a CRT or to charity.) Since neither unmarried clients nor surviving spouses can take advantage of the marital deduction for estate tax purposes, they ought to consider allocating retirement plan assets or other IRD to a CRT or directly to charity.

Planning Tips

- Under current law, if pension assets are assigned during the donor’s lifetime, the assignment will trigger recognition of the income to the donor. If an IRA owner makes a withdrawal from an IRA and transfers that amount to charity, he or she must include the amount in income and claim a charitable deduction.² Because of rules that reduce itemized deductions for taxpayers with income over a certain level (\$139,500 in 2003), the charitable deduction frequently does not offset the income.

- Even if an estate distributes retirement plan assets to pay a charitable bequest, it can still end up with taxable income. To avoid this result, the will or beneficiary designation should provide that the retirement assets or other IRD go to charity. Where desired, a fixed dollar cap may be used to limit the amount of such a bequest (“I bequeath \$100,000 of my IRA to ABC charity”). Moreover, the will should expressly grant the executor complete discretion to pay bequests with any asset. In a private letter ruling, the IRS ruled that where a will expressly permitted the executor to exercise discretion to allocate any asset to any beneficiary, the assignment of the decedent’s retirement accounts in satisfaction of a request to charity did not result in taxable income to either the estate or the individual beneficiaries.

- It generally is recommended that pension assets be allocated to charity through the account’s beneficiary designation, rather than through the will. However, it is important to keep track of such designations because the designation in a retirement plan takes precedence over the terms of a will. For example, the District Court for the Eastern District of New York has held that a beneficiary of an IRA account was entitled to the account proceeds despite the fact that the beneficiary was separated from the decedent and had begun divorce proceedings, and the

¹All “Code” references are to the Internal Revenue Code of 1986, as amended.

²Under one tax proposal, this would be changed so that an IRA owner who is 59-1/2 years old (or 70-1/2 in another proposal) could disregard the amount withdrawn and contributed to charity in calculating income.

decedent's new will eliminated all bequests to the beneficiary.

- Under regulations finalized in 2002, a participant may change beneficiaries at any time until his or her death without affecting the minimum distribution. However, the period over which the remaining retirement assets will be distributed to the successor beneficiary upon the death of the account owner will be affected by that beneficiary's life expectancy.

- If there are two beneficiaries, the distributions generally will be measured by the shorter life expectancy. Where charity is one of the beneficiaries, distributions will use the decedent's remaining actuarial life expectancy, because charity is not considered to have a life expectancy. If the second beneficiary otherwise would have (and wants to take advantage of) a longer life expectancy, charity's entire interest should be distributed before September 30th of the calendar year following the year of death.

CARE Act

Both the CARE Act (S.476), passed by the Senate in 2003, and H.R.7, passed by the House, would have permitted the outright gift of an IRA during the owner's lifetime without tax consequences. Under these bills, a taxpayer who is at least 70½ years old would not include in income a distribution from an IRA if the distribution is made directly to charity; the contribution would not be deductible. The proposals also would have allowed the contribution of an IRA to a CRT for taxpayers over 59½ (or 70½ in the case of House version), again with no deduction or income at the time of the transfer to the CRT, although income distributed by the CRT to the income beneficiary would be taxable. It seems unlikely that either of these bills will become law this year, but passage in 2005 would offer significant planning opportunities.

Estate Planning Using Retirement Assets

Example: A dies in 2004 leaving an estate of \$6 million, including \$1 million in her IRA. **Column 1** assumes A leaves her whole estate to her children. **Column 2** assumes A leaves \$1 million to The New York Community Trust, having named her children as beneficiaries of her IRA. **Column 3** assumes A provided for charity by designating The Trust as the beneficiary of her IRA.

	Estate to Children Nothing to Charity	\$1 million to Charity Balance of Estate (incl. IRA) to Children	\$1 million IRA to Charity Balance to Children
1. Taxable Estate	\$6,000,000	\$5,000,000	\$5,000,000
2. Federal + NYS Estate Tax	\$2,528,100	\$1,958,700	\$1,958,700
3. IRD Subject to Tax	\$1,000,000	\$1,000,000	0
4. Deduction for Federal Estate Tax attributable to the IRA*	\$450,200	\$452,200	N/A
5. Net income subject to tax (line 3 minus line 4)	\$549,800	\$547,800	0
6. Federal + NYS Income Tax (line 5 x 45% Assumed Rate)	\$247,410	\$246,510	0
Summary:			
7. Estate Taxes (Line 2)	\$2,528,100	\$1,958,700	\$1,958,700
8. Income Taxes (Line 6)	\$247,410	\$246,510	0
9. Total Taxes (Line 7 + Line 8)	\$2,775,510	\$2,205,210	\$1,958,700
10. Assets to Charity	0	\$1,000,000	\$1,000,000
11. Assets to Children (\$6 Million Estate minus line 9 minus line 10)	\$3,224,490	\$2,794,790	\$3,041,300

*Under Section 691(c), the deduction equals the Federal estate tax on the taxable estate, including the IRA, less the Federal estate tax on the estate, excluding the IRA.

Conclusion

Many people automatically name individuals as beneficiaries of their retirement plans. When they do, they are transferring to heirs assets that are subject to income (as well as estate) taxes. They would be better served by leaving assets not subject to income tax to their heirs and retirement plan assets to charity. Confronted with the choice of “giving” more than 45 percent of retirement plan assets to the Internal Revenue Service and local taxing authorities at death or leaving 100 percent to charity, even clients who have not thought about providing for charity may want to rethink the allocation of assets in their estates. The New York Community Trust is the ideal recipient of retirement plan assets. A fund can be established with the family name, or any other name the donor selects. For a donor who wants to help his community, and ensure that time will not make his gift obsolete, an unrestricted fund offers maximum flexibility. A donor with a particular area of concern, such as children or the environment, may select a field-of-interest fund. Designated funds allow the donor to specify the institution(s) to benefit. An advised fund enables children or grandchildren to participate in selecting charitable organizations to receive grants after the donor’s death.

For more information, call: Jane L. Wilton, general counsel, at 212-686-2563.

For further reference, see:

Code §401: Qualified Pension Plans
Code §408: Individual Retirement Accounts
Code §691: Income in Respect of Decedents
Code §2053(c): Deductions from Gross Estate
Code §2518(b): Qualified Disclaimers
Code §4980A: Excise Tax on Excess Retirement Accumulations
Treas. Reg. §1.454-1(c)(1): Transfers of Savings Bonds
Prop. Treas. Reg. §1.401(a)(9)
Freedman v. Freedman, 116 F. Supp 2d 379 (E.D.N.Y., 2000)
Sanford J. Schlesinger, “Charitable Estate Planning with Retirement Benefits and Related Life Insurance Planning,” 31 *NYSBA Trusts and Estates Law Section Newsletter* No. 2, 4 (1998)
Christopher R. Hoyt, “Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues and Opportunities,” 13 *Virginia L. Rev.* No. 4, 641 (1994)
Christopher R. Hoyt, “Charitable Gifts from Donors’ Retirement Plan Accounts,” 133 *Trusts & Estates* 8, 20 (August 1994)
PLR 200234019
PLR 200012076
PLR 200002011
PLR 9845026

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About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of more than \$1.8 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee—three-tenths of 1%, i.e., 30 basis points; investment fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor’s grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

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