

PRINTING SUGGESTIONS:

If you want to print out these slides, may I suggest:

#1 – AVOID PRINTING THE DARK BACKGROUND.

It makes it hard to read. Suggest using the print command “BLACK and WHITE”; avoid using “color”

#2 – PRINT SIX SLIDES PER PAGE. Slides contain a very large font. Six slides per page will conserve paper.

**INCOME TAX DEDUCTIONS FOR
CHARITABLE BEQUESTS OR I.R.D.**

**National Association of
Estate Planners & Councils**
Robert G. Alexander Webinar Series

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INCOME TAX DEDUCTIONS FOR CHARITABLE BEQUESTS OR I.R.D.

JUMP TO THE CONCLUSION:

Proposal: All wills and trust instruments should include boilerplate language that states something to the effect of:

I instruct my fiduciary that all of my charitable bequests (if any) shall be paid first with taxable income in respect of a decedent (if any), and second with any income generated by making the charitable bequest (if any), so that this trust [or estate] shall be entitled to claim a charitable income tax deduction for such transfer under Section 642(c) of The Internal Revenue Code of 1986, as amended, or under any corresponding section of future income tax laws.

INCOME TAX DEDUCTIONS FOR CHARITABLE BEQUESTS OR I.R.D.

WHY?

- Law: For a trust or an estate to claim a charitable income tax deduction under Section 642(c), there must generally be instructions in the governing instrument to distribute income to charity
- IRS rulings when IRD paid to charity: “No deduction since no instructions in gov. instrmt”
- Solution: Insert instructions in every gov. instrm

FREE ARTICLE:

Income Tax Deductions for Charitable Bequests of IRD

- Google search: **SSRN Hoyt IRD**

.pdf file; easy download; 11 page article; 32 footnotes

OTHER RESOURCES:

- Natalie Choate, *Life and Death Planning for Retirement Benefits*

www.ataxplan.com

- Keith Herman, *How to Draft Trusts to Own Retirement Benefits*

ACTEC Law Journal, Vol 39, No. 3 (Winter 2013), pages 207-267

INCOME TAX DEDUCTIONS FOR CHARITABLE BEQUESTS OR I.R.D.

- The basics : Charitable tax deductions
- IRD – What is it?
- Can a single charitable payment generate tax deductions on two separate tax returns?
- Does there have to be an “economic effect”?
- Pecuniary amounts trigger gain? Solution?
- Planning the charitable bequest
- Solutions when no instructions in governing inst

Charitable Tax Deductions

Will: “I leave \$100,000 to The College;
All income of estate: pay to my child”

- Form 706 - Charitable estate tax deduction
- Form 1041 - No charitable income tax dedn

LOGIC:

- A bequest is paid from assets owned at death
- Income is earned after death

Charitable Tax Deductions

Will: “I leave nothing to The College;
But pay all income of estate to College”

- Form 1041 - Yes charitable income tax dedn
- Form 706 - No charitable estate tax dedn

LOGIC:

- A bequest is paid from assets owned at death
- Income is earned after death

Charitable Tax Deductions

Will: “I leave \$100,000 to The College;

All income of estate: pay to my child”

- Form 706 - Charitable estate tax deduction
- Form 1041 - No charitable income tax dedn

Revenue Ruling 2003-123 - an estate will not be able to claim either a charitable *income* tax deduction **nor** a ***DNI*** deduction for a distribution of principal to a charity (e.g., a typical charitable bequest)

Charitable Tax Deductions

Will: “I leave \$100,000 to The College;

All income of estate: pay to my child”

- Form 706 - Charitable estate tax deduction
- Form 1041 - No charitable income tax dedn

Compare: **Administrative expenses**

-deduct either on estate T/R or estate's income T/R; cannot deduct on both

Income in Respect of Decedent

Amounts of income to which a decedent was entitled but which were not includible in gross income before the decedent's death. Sec. 691(a)

- Accrued savings bond interest
- Nonqualified deferred compensation
- Retirement plan accounts

Income in Respect of Decedent

Retirement Plan Accounts

- 1. Sec. 401 – Company plans (401(k))
- 2. Sec. 408 – IRAs
- 3. Sec. 403(b) & 457– (Charity/govt employers)
- 4. **Roth** IRAs & 401(k)/403(b)
(Tax-free; not taxable IRD) ^{7%}

Income in Respect of Decedent

IRD payable to an estate? Double tax:

- Form 706 - Pay estate tax — asset owned at death
- Form 1041 - Pay income tax — IRD is taxable income

* A single payment from a retirement plan to an estate will be taxed twice:

- first on the federal estate tax return
- again on the income tax return, since it is IRD

Income in Respect of Decedent

IRD payable to an estate? Double tax:

- Form 706 - Pay estate tax — asset owned at death
- Form 1041 - Pay income tax — IRD is taxable income
- * **Argument:** If IRD to charity, should be able to claim charitable deduction on both estate T/R and estate's income T/R, if governing instrument has the right instructions
- * Different from administrative expense dedn

Form 1041 Charitable Income Tax Deduction for Bequest of IRD?

Problem: There are situations when IRD was in fact distributed to a charity by an estate or trust, but the estate or trust was not allowed to claim a charitable income tax deduction to offset the income from the IRD.

Reason: The governing instrument failed to contain instructions to pay income to the charity.

Form 1041 Charitable Income Tax Deduction for Bequest of IRD?

- IRS Chief Counsel Memorandum ILM 200848020
- Decedent left his IRA to a trust that benefited his six children and several charities
- Trust received cash from IRA; paid entire charitable share, leaving the six children as the only remaining beneficiaries of the trust.
- IRS: “Taxable income from IRA, but no charitable deduction.” Reason: trust had no instructions to pay income to charities

Form 1041 Charitable Income Tax Deduction for Bequest of IRD?

Instruction in Will or Trust :

“If I make a charitable bequest, pay it first out of IRD, if any” (oversimplified) ..

Large dollar amount of IRD? Legal argument is strengthened if a separate checking account for IRD

- Only deposit IRD into that account
- Write all charitable checks from that account.
So charitable payments can be traced to IRD.

Form 1041 Charitable Income Tax Deduction for Bequest of IRD?

Instruction in Will or Trust :

“If I make a charitable bequest, pay it first out of IRD, if any” (oversimplified) ..

Will this instruction produce a charitable income tax deduction to offset the IRD?

- Case law and IRS rulings ?
- What about the “economic effect” regulation ?

Economic Effect Regulation

- A 2012 regulation provides that when a governing instrument identifies a specific source of income to be used for a charitable distribution, the provision will control only if it has an “economic effect independent of income tax consequences.”

Treas. Regs. Section 1.642(c)(3)(b)(2)

What Has An Economic Effect?

■ *Example of no economic effect:*

Instruction in Will or Trust :

“I make a charitable bequest of \$100,000.

Pay it first out of IRD, if any”

- This clause does not have an economic effect
- The charity will receive \$100,000 regardless of whether the estate has \$40k, \$30k, or no IRD

What Has An Economic Effect?

■ *Example of an economic effect:*

Instruction in Will or Trust :

“Pay all of the IRD of my estate to The Hospital”

- This clause has an economic effect
- The amount that the hospital will in fact receive will depend on the amount of the IRD that the estate collects: \$40k, \$30k, \$20k, or nothing

Economic Effect Regulation

- A 2012 regulation provides that when a governing instrument identifies a specific source of income to be used for a charitable distribution, the provision will control only if it has an “economic effect independent of income tax consequences.”
- That regulation governs the character of the income distributed to a charity from a trust’s or estate’s charitable income tax deduction, not whether an estate or trust is eligible to claim a charitable deduction at all.

Economic Effect Regulation

■ *Character* of income

	<u>Tax rate</u>
• Interest income	10% - 43.4%
• Dividend income	0% - 23.8%
• Long-term capital gains	0% - 23.8%
• Tax-exempt interest	zero %

Economic Effect Regulation

- *Character* of income to charity & trust

- History: Charitable lead trusts

Instruction: “pay first out of *taxable* income”

- Example: CLT pays \$70,000 to charity

Income: \$40,000 taxable interest and

\$40,000 tax-exempt interest (50-50)

- Conclude: Charity & trust 50-50 income

Economic Effect Regulation

Instruction in Will or Trust :

“If I make a charitable bequest, pay it first out of IRD, if any” (oversimplified)

- **NO ECONOMIC EFFECT** – Charity will receive the bequest regardless of how much or how little IRD there is
- But the impact is only on the character of the income that is distributed to the charity, retained by the trust, or distributed to other beneficiaries

Economic Effect Regulation

Instruction in Will or Trust :

“If I make a charitable bequest, pay it first out of IRD, if any” (oversimplified)

■ Facts: \$100,000 charitable bequest; \$20,000 IRD

Other income:\$20k dividends;\$10k tax-free interest

Income

40% - IRD (ordinary income tax rate – 39.6%)

40% - dividend (maximum tax rate of 23.8%)

20% - tax-exempt interest (no tax)

Economic Effect Regulation

Instruction in Will or Trust :

“If I make a charitable bequest, pay it first out of IRD, if any” (oversimplified)

- Facts: \$100,000 charitable bequest; \$20,000 IRD

Other income: \$20k dividends; \$10k tax-free interest

- Pay \$100k to charity (including \$20k IRD)

Pay \$ 30k to other beneficiary (daughter)

CHARITABLE INCOME TAX DEDUCTION?

- \$16k charit dedn (no char dedn for 20% tax-exempt interest)

Economic Effect Regulation

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■ Facts: \$100,000 charitable bequest; \$20,000 IRD

Other income: \$20k dividends; \$10k taxable interest

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Other income: \$20k dividends; \$10k taxable interest

- Pay \$100k to charity (including \$20k IRD)

Pay \$ 30k to other beneficiary (daughter)

CHARITABLE INCOME TAX DEDUCTION?

- \$20k charit dedn -- \$30k DNI distrib dedn

Economic Effect Regulation

Instruction in Will or Trust :

“If I make a charitable bequest, pay it first out of IRD, if any” (oversimplified)

CHARITABLE INCOME TAX DEDUCTION?

■ \$20k charit dedn -- \$30k DNI distrib dedn

Income

40% - IRD (ordinary income tax rate – 39.6%)

40% - dividend (maximum tax rate of 23.8%)

20% - taxable interest (maximum tax rate of 43.4%)

Economic Effect Regulation

Is there a way to have the character of the income that goes to the charity be 100% IRD and exclude dividend and other income?

Yes. This can be accomplished by drafting the charitable share to have an economic effect.

Economic Effect Regulation

Example: Client has \$1M IRA payable to a trust for a child, but would like to provide for a \$20,000 bequest to a charity with the remainder to benefit the child.

- Have Instruction in Will or Trust :

“All of the IRD that this trust receives should be paid to Charity ABC, but the maximum amount that Charity ABC shall receive is \$20,000 in the event that this trust receives more than \$20,000 of IRD.”

- Clause has an economic effect, since charity might receive less than \$20k if less than \$20k of IRD.

Economic Effect Regulation

- Facts: \$20,000 charitable bequest; \$20,000 IRD
Other income: \$20k dividends; \$10k tax-free interest
- Pay \$20k to charity (just the \$20k of IRD)
Pay \$30k to other beneficiary (daughter)

CHARITABLE INCOME TAX DEDUCTION?

- \$20k charitable deduction – 100% is IRD
- \$30k DNI distribution deduction
 - * \$20,000 of dividends -- \$10,000 tax-exempt interest

Pecuniary Amount

If an estate or trust distributes appreciated property to satisfy a pecuniary obligation, the estate or trust has a taxable gain as if it had sold the property. Treas. Regs. Section 1.661(a)-2(f)(1); *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir.1940).

Pecuniary Amount

Example: “Pay \$100,000 to my nephew”

- Facts: Estate or trust owns stock with a cost basis of \$80,000 that is now worth \$100,000
- The \$100,000 stock is distributed to nephew
- Conclude: distribution triggers taxable gain of \$20,000.

Pecuniary Amount

Example: “Pay \$100,000 to my nephew”

- Facts: Estate or trust owns stock with a cost basis of \$80,000 that is now worth \$100,000
- The \$100,000 stock is distributed to nephew
- Conclude: distribution triggers taxable gain of \$20,000.
- **Somebody will pay tax on \$20,000:**
 - Estate or trust,
 - or
 - nephew [if capital gain is distributed to nephew]

Pecuniary Amount - Charity

Example: “Pay \$100,000 to The College”

- Facts: Estate or trust owns stock with a cost basis of \$80,000 that is now worth \$100,000
- The \$100,000 stock is distributed to College
- Conclude: distribution triggers taxable gain of \$20,000.

Pecuniary Amount - Charity

Example: “Pay \$100,000 to The College”

- Facts: Estate or trust owns stock with a cost basis of \$80,000 that is now worth \$100,000
- The \$100,000 stock is distributed to College
- Conclude: distribution triggers taxable gain of \$20,000.
- **But can avoid tax on gain if it is distributed to tax-exempt college**
 - Rev. Rul. 83-75 (charitable lead trust, with instructions to distribute income to charity)

Pecuniary Amount - Charity

Example: “Pay \$100,000 to The College”

- Facts: Estate or trust owns stock with a cost basis of \$80,000 that is now worth \$100,000
- The \$100,000 stock is distributed to College
- Conclude: distribution triggers taxable gain of \$20,000.
- **But can avoid tax on gain if it is distributed to tax-exempt college**
boilerplate: *and second with any income generated by making the charitable bequest ..*

Pecuniary Amount - Charity

- IRS Private Letter Ruling 201438014 (May 5, 2014)
- Trust contains *pecuniary* bequests to two charities
- Probate court agrees to reform trust to qualify for favorable income tax treatment
- **IRA distributions** pay the pecuniary bequests

IRS CONCLUDES:

- Use of IRA assets to pay pecuniary obligations triggers taxable income to trust
- IRS will not respect probate court reformation

Pecuniary Amount - Charity

Could they have avoided tax if there had been instructions in the governing instrument to distribute such income to the tax-exempt charity?

- Rev. Rul. 83-75 (charitable lead trust)
- Boilerplate: *and second with any income generated by making the charitable bequest*

PLANNING

TWO WAYS TO MAKE A CHARITABLE BEQUEST FROM A RETIREMENT ACCOUNT

#1 – NAME CHARITY AS
BENEFICIARY OF THE ACCOUNT

#2 – *PAY ACCOUNT TO ESTATE OR
TRUST THAT THEN MAKES A
CHARITABLE BEQUEST*

PLANNING

- Hazard: Other beneficiaries cannot do *stretch IRA* if charity is beneficiary?
- Solutions:
 - * cash out charity's share by Sept 30
 - or
 - * separate account for charity

PLANNING

- Hazard: Other beneficiaries cannot do *stretch IRA* if charity is beneficiary?
- Even better solution:
Have a separate IRA with 100% of beneficiaries as charities; other IRA for family members, trusts, others
-- avoid worries over Sept 30 deadline, etc

PLANNING

ADMINISTRATIVE HEADACHE –

The Patriot Act, etc

- IRA administrators need to retitle decedent's IRA to new beneficiary; new social security number, etc
- Some refuse to cut check to charity without CFO's name, address & personal social security number

PLANNING

TWO WAYS TO MAKE A CHARITABLE BEQUEST FROM A RETIREMENT ACCOUNT

#1 – NAME CHARITY AS
BENEFICIARY OF THE ACCOUNT

*#2 – PAY ACCOUNT TO ESTATE OR
TRUST THAT THEN MAKES A
CHARITABLE BEQUEST*

PLANNING

Want to Avoid: Estate or trust has taxable income from receiving IRA distribution, but maybe there is no offsetting charitable income tax deduction when the IRA check is given to a charity.

Solutions:

#1 – Drafting “pay bequests from IRD...”

#2 – Plan “B” – post-mortem strategies

POST-MORTEM – WHAT TECHNIQUES AVOID INCOME TO THE ESTATE?

Solution #1 – Keep IRD off of estate's
or trust's income tax return

“Distribute” the IRA to charity

- Document (or state law) allows “non-pro rata” distribution of assets
- Residue of estate to charity ? IRS PLRs

POST-MORTEM – WHAT TECHNIQUES AVOID INCOME TO THE ESTATE?

Solution #2 – Get a charitable income
tax deduction to offset the IRD

- Was document drafted to get a deduction? (*I instruct that IRD etc..*)

INCOME TAX DEDUCTIONS FOR CHARITABLE BEQUESTS OR I.R.D.

All wills and trust instruments should include boilerplate language that states something to the effect of:

I instruct my fiduciary that all of my charitable bequests (if any) shall be paid first with taxable income in respect of a decedent (if any), and second with any income generated by making the charitable bequest (if any), so that this trust [or estate] shall be entitled to claim a charitable income tax deduction for such transfer under Section 642(c) of The Internal Revenue Code of 1986, as amended, or under any corresponding section of future income tax laws.

INCOME TAX DEDUCTIONS FOR CHARITABLE BEQUESTS OR I.R.D.

And include instructions to get the desired outcome in case boilerplate language might conflict with another provision:

This provision shall take precedence over any general provision in this governing instrument or under state law, such as the traditional policy that capital gains are to be retained by a trust or an estate rather than distributed to a beneficiary. If, however, there is a specific conflicting provision in this governing instrument (such as an instruction that all of this trust's [or estate's] income in respect of a decedent should be paid to a single charity or an instruction requiring retirement plan distributions to be paid only to "designated beneficiaries" after a specified date), then such provision will control over this provision.

POST-MORTEM – WHAT TECHNIQUES AVOID INCOME TO THE ESTATE?

Solution #2 – Get a charitable income
tax deduction to offset the IRD

- Was document drafted to get a deduction? (*I instruct that IRD etc..*)
- Residue of *estate* to charity?
Pay charity in LAST YEAR. Income tax deduction since 100% of income goes to charity.

FREE ARTICLE:

Income Tax Deductions for Charitable Bequests of IRD

- Google search: **SSRN Hoyt IRD**

.pdf file; easy download; 11 page article; 32 footnotes

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