The Charitable Remainder Unitrust as a Supercharged Retirement Plan

Many professionals and executives have found themselves frustrated by limitations on the amounts they can set aside annually in qualified retirement plans and IRAs. These individuals generally are looking for tax relief during their years of high income and for a supplementary retirement savings vehicle that permits tax-free growth of their nest egg.

The retirement unitrust, sometimes referred to as a “charitable IRA,” can be a useful planning tool for those with philanthropic goals. It is possible to set up such an arrangement through a flip unitrust [Reg. §1.664-3(a)(1)(i)(c)(2)]. With proper planning, such a trust could provide:

- An income tax deduction for part of the funds or property transferred to the trust, based on the age of the donor at the time of the contribution and the percentage payout selected (minimum 5%, maximum 50%).
- Deferral of much – perhaps all – of the trust income until the donor retires. Principal could grow more rapidly because the trust is tax exempt.
- Payment of substantial income after retirement, reflecting growth of principal within a tax-exempt trust.
- An important gift to charity when the trust ends.

The trustee would invest initially in growth investments that would swell the trust principal but pay very little income until the donor retires. At retirement, the trust would switch to a fixed payout percentage based on a larger trust value.

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Exceeding All Expectations

Berkeley Hope Scholars (formerly the Cal Independent Scholars Network) is the academic retention program at UC Berkeley that supports all incoming freshman, transfer, graduate and continuing students who are current and former foster or probation youth or were orphaned before the age of 18. As a unit of the Centers for Educational Equity & Excellence (CE3), the goal is to provide students with a variety of resources and a continuing system of support while attending UC Berkeley. Founded in 2005 with one student, the Berkeley Hope Scholars program has delivered direct services to more than 140 students. Currently, they are 60 students strong! To learn more about how your clients can support Hope Scholars, please call 800.200.0575 or e-mail ogp@berkeley.edu.
Donors have the option of making additional contributions to charitable remainder unitrusts. An executive or professional might contribute $25,000 a year to a retirement unitrust, without the $6,000 contribution ceiling that applies to traditional IRAs. The donor could deduct a portion of each contribution. The deductible portion of the annual contribution would grow each year as the donor gets older.

One feature of a flip unitrust is that accumulated deficiencies in payouts prior to the switch are lost when the trust begins fixed payments. One option might be for the trustee to sell some growth stock a year or two prior to the flip, allowing make-up payments.

A married donor might want to establish the retirement unitrust for two lives (to include the life of the surviving spouse). Alternatively, a donor could have the trust last for only his or her life and use some of the tax savings and income from the unitrust to purchase life insurance payable to family beneficiaries. The insurance could replace the trust assets contributed to the unitrust. If estate taxes are an issue, the insurance proceeds could pass free of federal estate tax if the policy is purchased within an irrevocable life insurance trust.

A charitable IRA can also be arranged as a deferred payment charitable gift annuity, with significant deductions during a client’s working years and complete deferral of any income until some future year chosen by the donor.

UC Berkeley Planning Pointer:

Check the Box on IRA QCDs

We know that most of you are familiar with the advantages to your clients of making qualified charitable distributions (QCDs), also known as charitable IRA rollovers, from their IRAs. But did you know that some financial institutions offer their clients the convenience of check-writing privileges on their traditional and rollover IRA accounts? If so, they can write and send checks directly to the qualified charity without the hassle of making the request through their IRA custodian at their respective financial institutions. For your clients who desire more control over their charitable giving, this is the perfect solution, right?

Actually, your clients need to proceed cautiously for these reasons:

- The charity must cash the check and the check must clear by December 31 in order to meet your clients’ required minimum distributions (RMDs) and the QCD deadline for that year. This differs from the traditional rule – called the Mailbox Rule – that applies when the check is mailed directly from the IRA custodian. Under the Mailbox Rule, the date of mailing to the charity is deemed the date of delivery if there are no restrictions on the time or manner of payment and the check is honored when presented. When your clients write a check from their IRA checkbook, the custodian won’t know they’ve made a donation until the charity cashes the check. If it doesn’t cash the check until the following year, it won’t count as a QCD, or your clients’ RMD, for that year. Therefore, it’s a good idea for your clients to start the process well before the end of the year.
- Because of these timing issues, your clients should select a financial company that allows them to view their accounts online. This service will let them keep control over the amount of money they are withdrawing from their accounts through check-writing. It will also show them when checks are cashed and alert your clients of any potential complications during the process.
- Your clients should be aware that checks from an IRA account may not be accepted by all financial institutions; and

- Your clients should confirm that they aren’t automatically having tax withheld, because the distribution isn’t taxable.
ESOPs and Charity: A Good Blend

Some small business owners have found that an employee stock ownership plan (ESOP) can be the ideal way to transfer ownership of the company while postponing the capital gains tax on the sale of the shares. The owner sells shares of the company stock held at least three years to the ESOP and defers the capital gain by reinvesting the proceeds in shares of stock of domestic corporations within 12 months. The basis in the qualified replacement property (QRP) is the same as the basis in the shares sold to the ESOP. Gain is recognized when the QRP is sold [Code §1042(e)(1)].

The client can defer the capital gain even further – or avoid it entirely – with gifts of QRP to charity. Under Code §1042(e)(3), the capital gain recapture rules do not apply to transfers of the QRP by gift, including gifts to charity. The IRS has ruled that a transfer of QRP to a charitable remainder trust is a gift that does not trigger the capital gain (e.g., Letter Rulings 9438012, 9438021). When the QRP is sold by the trustee of the charitable remainder trust, the gain is sheltered within the tax-exempt trust. The donor/beneficiary is taxed on the capital gain under the four-tier system of Reg. §1.664-1(d)(1), meaning a portion of the payout will be taxed at favorable capital gains tax rates.

Charity Not Too Charitable to Life Tenant

Paul Senez, a long-time family friend of Josephine Kennedy, was given a life estate in her home at her death. Senez had lived in the house for 40 years. He was required to pay ordinary maintenance expenses. At his death, the house was to be sold and the proceeds given to the Orange Catholic Foundation for the benefit of abused children and the needy elderly.

Kennedy's niece, Rosie Mary Arvizu, was trustee. When Kennedy died at age 100, Senez was in failing health and showing signs of dementia. Although it was contrary to language in the trust, Arvizu spent about $44,000 of trust assets to pay property taxes and association dues to avoid foreclosure on the home. She reasoned that paying the expenses would ultimately benefit the trust by avoiding penalties and foreclosure. In addition, she used another $4,000 to pay Senez's personal expenses. Arvizu said that Kennedy had stressed to her that she was to care for Senez. The Foundation sought to remove Arvizu as trustee and recover damages for breach of trust. The Foundation argued Senez should have been evicted when he could not pay the expenses. The trial court denied the request, noting that, while technically correct that Arvizu should not have used trust funds for Senez's expenses, it was “unrealistic and not particularly charitable” to expect her to do so. The California Court of Appeals agreed, finding that the trial court did not abuse its discretion. There was substantial evidence that Arvizu, who did not personally benefit from her actions, acted reasonably and in good faith. Further, the court found that the delay in selling the residence actually inured to the benefit of the Foundation, with the home appreciating in value by more than the cost of the expenses and lost rent, resulting in no damages to the Foundation (Orange Catholic Foundation v. Arvizu, G055189).
Cutting the Tax Cost of a Roth IRA Conversion

Roth individual retirement accounts have had tremendous tax and financial appeal since their inception in 1997.

- All withdrawals are tax free five years after the first contribution or conversion, if the account owner is 59½ or older, has died or become disabled, or uses the distribution (up to $10,000) for “qualified first-time homebuyer expenses.”
- Unlike traditional IRAs, there are no mandatory annual distributions after age 70½, so savings can be left to grow tax free until needed or passed to heirs. (However, individuals named as Roth IRA beneficiaries must take required minimum distributions.)

Roth IRAs historically have been off-limits to taxpayers above certain levels of income. For 2019, individuals cannot fully fund a Roth IRA if their modified adjusted gross income exceeds $122,000 ($193,000 for joint returns). But taxpayers of any income level can convert traditional and “rollover” IRAs to Roths and guarantee that future withdrawals will be free of income tax, both for themselves and their beneficiaries.

The Roth IRA conversion may be especially helpful to people who have rolled over 401(k)s and other plans into IRAs when they retired or changed jobs. The drawback is that funds transferred out of regular IRAs are generally treated as taxable income.

The decision to convert to a Roth IRA depends on a variety of factors, such as a client’s current and projected income tax rates, age, capability of paying the “conversion tax” (without dipping into IRA funds) and the ability to let the Roth account grow undisturbed as long as possible. Of course, if there has been a significant decline in the value of a client’s traditional IRA due to a market decline, the tax cost of converting to a Roth IRA may be more manageable.

Clients who wish to assist charitable organizations might find the timing right for contributions that offset, in whole or in part, the cost of a Roth IRA conversion. One appealing gift vehicle for this purpose is the deferred payment charitable gift annuity. For example, a 60-year-old IRA owner planning to convert $25,000 from a traditional IRA to a Roth IRA might transfer $65,000 to charity in exchange for a gift annuity that will begin payments at age 70. The donor will receive annual payments of $5,265 (8.1%) and is entitled to an immediate charitable deduction of more than $31,000, helping offset taxes on the Roth IRA conversion. A portion of the gift annuity payments may be tax free, as are any withdrawals from the Roth IRA after five years.

Charitable remainder trusts can also provide significant deductions and considerable flexibility in a donor’s tax and financial planning.

Clients planning to convert large IRAs also might consider establishing grantor charitable lead annuity trusts that make payments to charity for few years, with assets then returning to the donor. The deduction helps offset the tax on the IRA conversion.

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