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TAX & TRANSACTIONS BULLETIN

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- IRS Issues Final Regulations on Income Taxation of IRAs and 401(k)s
- The Final Regulations are effective January 1, 2003
- With advance planning, owners of IRA and 401(k) accounts can reduce both income tax and estate tax

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INCOME AND ESTATE TAX PLANNING FOR THE FAMILY IRA AND 401(k)

Many U.S. taxpayers have accumulated significant wealth in their Individual Retirement Accounts ("IRAs") through either direct contributions or rollovers. A primary benefit of an IRA is deferral of income tax until assets are distributed out of the IRA. Effective January 1, 2003, IRS issued[1] Final Regulations on the income taxation of Individual Retirement Accounts.[2] These Final Regulations allow families additional opportunities to reduce both income tax and estate tax. With careful advance planning, the IRA owner may reduce tax on his Account and increase wealth for the family.

The Final Regulations provide a highly-favorable "Life Expectancy Rule." Under this new Life Expectancy Rule, IRA cash distributions to each recipient are based on that recipient's remaining life expectancy. Unlike prior rules which required fast IRA payouts, the Life Expectancy Rule permits slower IRA payouts stretched over a longer period of time. Slow payouts reduce current tax liability and allow IRA principal to compound tax-free. The Life Expectancy Rule[3] thus favors growth of the IRA Account, which benefits the owner's entire family.

Typically an owner will contribute to his IRA Account during his working years. After the owner attains age 70 ½, the IRA must begin making cash distributions to him.[4] The IRA will continue to make these payouts annually during the owner's lifetime. After the owner's death, the IRA must make payouts to the beneficiary. Although IRA principal grows tax-free, each cash distribution is taxable to the recipi-

[1]The Final Regulations were published in the Federal Register on April 17, 2002, and apply for calendar years beginning on or after January 1, 2003.

[2]The Final Regulations apply to individual retirement accounts, 401(k) plans, and all other defined contribution plans which maintain an individual account for the owner. These retirement vehicles are collectively referred to as "IRAs". (The Final Regulations do not apply to defined benefit plans which pay an annuity to the owner).

[3]During the Account owner's lifetime, required distributions are made annually based on the joint life and last survivor expectancy of the owner and a hypothetical beneficiary ten (10) years younger. This distribution period is considerably longer than if based solely on the owner's remaining life expectancy. The Life Expectancy Rule thus permits slow IRA payouts over a long period of time. Regulation 1.401(a)(9)-5(A-4). After the Account owner's death, required distributions are made annually based on the remaining life expectancy of the beneficiary. This rule applies even where the owner dies after his "required beginning date." Thus, the owner can designate a Grandchild as beneficiary and stretch IRA payouts over an extended period. Again, the Life Expectancy Rule permits slow IRA payouts over a long period of time. Regulation 1.401(a)(9)-5(A-5). See also PLR 200248030.

[4]The IRA must make payouts due to the "required minimum distribution rules." These rules require that payouts begin on the owner's "first distribution calendar year," which is the year the owner attains age 70 ½. These payouts must continue to be made each year during the owner's lifetime. Although the owner may defer his first year's payout until April 1 of the following year, this deferral will cause two payouts in that following year, possibly affecting the owner's tax bracket. Regulation 1.401(a)(9)-5(A-1(b)).

INCOME AND ESTATE TAX PLANNING FOR THE FAMILY IRA AND 401(k) (cont'd)

ent. Income tax planning for IRAs thus focuses on reducing the annual payout. By reducing the payout and retaining principal within the IRA, tax liability is deferred and the Account compounds tax-free.

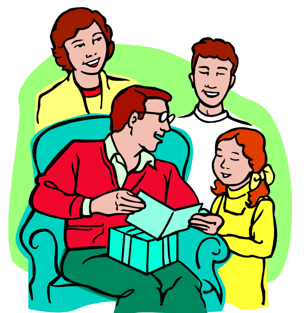
The Following Example Illustrates Income and Estate Tax Planning for the Family's IRA: Assume Dad is age 70. Mom is 64. Child is 38. Grandchild is 2. Dad contributes to his IRA over much of his lifetime, and the Account grows to a value of $1 Million. In the year he attains age 70 ½, Dad must begin receiving cash distributions from his IRA. These mandatory cash payouts to Dad are favorably based on his remaining life expectancy. Dad designates Mom as beneficiary of his IRA. When Dad later dies at age 72, Mom can rollover the IRA to her own IRA.

There are at least four (4) major tax advantages to Mom's rollover strategy. First, the IRA will qualify for the marital deduction and will pass to Mom free of estate tax. Second, Mom is not required to take distributions from her own IRA until she attains age 70 ½. Since Mom is only 66, she can defer income taxes on the IRA for over 4 years. Third, when Mom does attain age 70 ½, she must begin receiving cash payouts. However, Mom's required annual payouts as IRA owner are smaller than if she were a beneficiary, permitting additional tax deferral.[5] Fourth, as owner Mom can designate new beneficiaries for the IRA. For instance, Mom can divide her IRA into two (2) equal $500,000 Accounts. The first Account names Child as beneficiary. The second Account names Grandchild as beneficiary. After Mom's death, each IRA pays out over the life expectancy of its respective beneficiary. If Grandchild is only 8 years old when Mom dies, Grandchild's IRA will pay him cash each year for the next 75 years. Effectively, Mom has created a lifetime annuity for Grandchild. (If Mom does not want Grandchild to have immediate use of the money, she can set up a Trust with an independent Trustee to receive the IRA payouts for Grandchild's benefit). The income tax savings from this arrangement can be significant. Additionally, Child and Grandchild enjoy the financial security of receiving a lifetime annuity.

[5]Required distributions to the owner are actuarially based on the joint life and last survivor expectancy of the owner and a hypothetical beneficiary ten (10) years younger. This distribution period is considerably longer than if based on solely the owner's remaining life expectancy. Contrarily, required distributions to the beneficiary are actuarially based on solely the beneficiary's remaining life expectancy. Regulations 1.401(a)(9)-5(A-4), and 1.401(a)(9)-5(A-5). [Stated differently, if Mom failed to rollover the IRA account, her payouts as a beneficiary would be larger and would accelerate income tax liability].

ESTABLISHING THE FAMILY CHARITY: CHOOSING BETWEEN A PRIVATE FOUNDATION OR A SUPPORTING ORGANIZATION

Charitable goals often lead a Family to establish a charity organization. In setting up a 501(c)(3) organization, the Family must choose the type of legal entity. The Family usually prefers to retain some control over the entity, and thus will not form a pure public charity. Rather, the Family will decide to establish either a Private Foundation or a Supporting Organization.



A Private Foundation is managed solely by the Family members. It functions as a private charity. The Family members act as officers and directors and manage day-to-day activities. The Family members also decide which public charities receive cash distributions from the Foundation each year. A Private Foundation permits greater control by the Family, but is subject to strict operational constraints and a reduced income tax deduction for gifts of property.

ESTABLISHING THE FAMILY CHARITY: CHOOSING BETWEEN A PRIVATE FOUNDATION OR A SUPPORTING ORGANIZATION (cont'd)

A Supporting Organization[1] is a type of public charity. A Supporting Organization provides financial benefits to a related public charity. This related public charity is known as the "supported organization". For instance, a Supporting Organization may be established to provide benefits to The University of Michigan. Compared to a Private Foundation, a Supporting Organization permits less control by the Family (due to some control by the supported charity), but has more freedom from operational constraints and an enhanced income tax deduction for gifts of property.

A review of the rules governing Private Foundations and Supporting Organizations may assist the Family in making the right choice.

Private Foundations

An advantage of Private Foundations is the control retained by founding Family members. As trustees, the Family can invest and manage gifted assets. Two disadvantages of Private Foundations are reduced income tax benefits and certain operating restrictions.

A taxpayer's deduction for gifts to a Private Foundation is generally limited to cost basis. (There is an exception to this rule for gifts to a Private Foundation of appreciated publicly-traded stock, which may be deducted at fair market value). Additionally, gifts to a Private Foundation are generally deductible only up to 20% or 30% of the donor's adjusted gross income. The donor's unused deduction may be carried forward for 5 years. These rules reduce the income tax benefit of gifts to the Foundation.

Private Foundations are also subject to heightened scrutiny by the IRS. A Private Foundation is subject to numerous restrictions and excise taxes designed to prevent its officers and donors from personally benefiting from Foundation activities. These restrictions and excise taxes prohibit "Self-Dealing" by Foundation officers, donors, and insiders. Private Foundations are subject to the following Restrictions and Excise Taxes:

A. Investment Income. There is a flat 2% (in certain cases 1%) excise tax on a Foundation's investment income.

B. Distributions. There is an excise tax on the Foundation's failure to distribute income. A Private Foundation must distribute annually an amount equal to 5% or more of the value of its investment assets.

C. Prohibition Against Private Benefit – no part of the Private Foundation's net earnings can inure to the benefit of any private individual, including donors. The amount or extent of benefit is not the controlling factor. Violation results in loss of tax-exempt status.

D. Requirement that Private Foundation is Operated Exclusively for Charitable Purposes – prohibits donors, directors and officers from receiving personal benefits. This prohibition is broad and can apply even if there is no actual diversion of property or funds from the Private Foundation. Violation results in loss of tax-exempt status.

E. Prohibition Against Excess Benefit Transactions – prohibits any transaction in which an

[1] Code Section 509(a)(3).

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economic benefit is provided by the Private Foundation directly or indirectly to or for the use of any disqualified person, if the value of the benefit provided exceeds the value of the consideration received for providing such benefit. Violation results in excise taxes, and potential loss of tax-exempt status.

F. Prohibition Against Self Dealing – prohibits practically every type of economic transaction between the Private Foundation and its disqualified persons, including a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a Private Foundation. Violation results in excise taxes, and potential loss of tax-exempt status.

G. Prohibition Against Excess Business Holdings – the Private Foundation is permitted to own twenty percent (20%) of the voting stock in a corporation, reduced by the percentage of stock held by all disqualified persons. (The 20% threshold can rise to 35% where a 3rd person has effective control of the corporation.) Violation results in excise taxes, and potential loss of tax-exempt status.

H. Prohibition Against Investments Which Jeopardize Charitable Purpose – the Private Foundation is prohibited from making any investment which jeopardizes the carrying out of its charitable purposes. In short, the Private Foundation's assets must be used to benefit charity. Risky investments which benefit charity are permissible (e.g. interest free loans to needy students). Violation results in excise taxes, and potential loss of tax-exempt status.

I. Prohibition Against Making Grants to Non-Charity Organizations – a Private Foundation cannot make a grant to a Non-501(c)(3) entity unless: (i) the making of the grant itself constitutes a direct charitable act or the making of a program-related investment, or (ii) the grantee holds the grant moneys in a separate charitable fund continuously and the Private Foundation exercises expenditure responsibility over the grant.[2] Violation results in excise taxes, and potential loss of tax-exempt status.

Foundation managers and donors must scrutinize each transaction to ensure compliance with the Self-Dealing Rules. Penalties for non-compliance are severe. The reduced income tax benefits and close IRS scrutiny associated with Private Foundations may cause a Family to consider establishing a Supporting Organization as an alternative.

Supporting Organizations

The Supporting Organization enjoys certain advantages over the Private Foundation. The income tax deduction for gifts of long-term capital gain property to a Supporting Organization (or any other public charity) is set at fair market value. In addition, gifts to a Supporting Organization are deductible up to 50% of the donor's adjusted gross income.

A Supporting Organization is not subject to the onerous Self-Dealing Rules imposed on Private Foundations. Moreover, a Supporting Organization is not required to meet the various "math support" tests that many other public charities must satisfy. A Supporting Organization qualifies as a public charity regardless of whether its support comes from the general public or from a single donor.

[1]Code Section 509(a)(3).

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There is at least one potential difficulty in creating a Supporting Organization. The Supporting Organization must establish an ongoing relationship with the independent public charity identified as the supported organization. The founding Family may be required to invest considerable resources in forming and maintaining this relationship with the supported organization.

There are three types of Supporting Organizations. A "Type III" Supporting Organization is usually preferred since it permits maximum control by the founders. These founders must ensure that the Supporting Organization satisfies a battery of legal tests. A Type III Supporting Organization must satisfy the following five (5) legal tests:

I. Organizational Test – The Articles of Organization of the Supporting Organization must designate the supported organizations by name, and these designated supported organizations must be public charities.

II. Operational Test – The Supporting Organizations must engage solely in activities which benefit the supported organization. These activities include making payments to, or providing services or facilities for, individual members of the charitable class benefited by the supported organization.

III. Responsiveness Test – At least one (1) of the officers / directors of the Supporting Organization is elected or appointed by the supported organization. Also, the supported organization has a significant voice in the Investment Policies / Grantmaking / Asset Management of the Supporting Organization.

IV. Integral Part Test – The Supporting Organization must engage in activities to perform the functions of, or to carry out the purposes of, the supported organization and but for the involvement of the Supporting Organization, these activities would normally be performed by the supported organization.

V. Control Test – The Supporting Organization cannot be controlled directly or indirectly by disqualified persons. The definition of "disqualified person" includes substantial contributors to the Supporting Organization.

The founding Family may find that forming and maintaining a relationship with the supported organization requires a significant investment of their time and resources. In addition, the Supporting Organization must satisfy various legal tests. In some cases the Family may find it easier to simply establish a Private Foundation. However, successful formation of a Supporting Organization can provide significant income tax benefits and ease of operations – advantages which merit careful advance planning.

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