Untaxingly Yours

Junk Money: Pitfalls and Opportunities

By Brian T. Whitlock

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Forty years ago, in August of 1983, the State of Washington Public Power Supply System (WPPS) suffered a "Whoops" of epic proportions when they defaulted on $2.25 billion dollars of bonds that had been issued to finance the construction of two nuclear power plants. The nuclear construction projects had been abandoned 18 months earlier in response to protests by environmental activists. The financial fallout was devastating to bond issuers and bondholders nationally. Many public utilities (bond issuers) were forced to offer exceptionally high-interest rates in order to compensate bondholders for the risk of default on similar bond issues. Outstanding bonds with more traditional market rates became nearly worthless in the hands of bondholders as the financial markets reacted to the possibility of default. Overnight, the outstanding securities became known as "Junk Bonds."

My mentor, Irving L. Blackman, a CPA and an attorney, saw the similarities between Junk Bonds and the assets that many of our wealthy estate planning clients held, namely, tax-deferred retirement plans and annuities. Irv referred to these assets as "Junk Money" because although they appeared at first glance to have significant value, they nevertheless were burdened by future income, estate, and generation-skipping taxes. Tax planners know these assets by their income tax classification as "Income in Respect of a Decedent" (IRD).[1]

This column will focus on the pitfalls and opportunities involving both income tax and wealth transfer planning related to Junk Money.

The Balancing the Scales of Income Tax Policy

The U.S. Income Tax System is generally built on underlying principles of fairness. When income tax deductions are granted to a person, there is typically an offsetting amount of gross income that is recognized by either the same taxpayer at a later date (*i.e.*, tax-deferred income) or another taxpayer (*e.g.*, when compensation is deductible by an employer and taxable to the employee). In a sense, it is as if the U.S. Income Tax System employs a giant scale of "tax justice" (a system of balanced outcomes) when it comes to determining the tax consequences of various transactions and transfers of property. Using the analogy of the "Scales of Income Tax Policy," it is easy to recognize that today's tax-deferred income will generally be subject to income taxation at some future point in time.

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"The Benefits of Dying" Don't Extend to IRD

I often joke with clients that "there is a benefit to dying—all your capital gains disappear." Code Sec. 1014 generally provides a "step-up" (or a tax-free increase) basis to property that is acquired from a deceased person, provided that the property was includable in the Gross Estate of the deceased and thus potential subject to a Federal Estate Tax.[2] This "step-up" in basis, to the fair market value of the property at the decedent's date of death, can be valuable in eliminating capital gains attributable to investment assets and avoiding the recapture of depreciation attributable to business assets.[3]

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Unfortunately, the "step-up" in basis (sometimes referred to as the "raised basis") rules of Code Sec. 1014 are limited by statute. They do not apply to "all" property held by the deceased. Code Secs. 1014(c) and 1014(b)(9)(A) specifically exclude IRD and annuities described in Code Sec. 72 from the step-up rules. As a result of the exclusion, the appreciation and deferred income associated with IRD will be generally taxable to the person(s) that receive the proceeds from such assets.

The Burdens of "Junk Money"

Taxpayers should be advised to carefully weigh the timing and nature of their lifetime distributions, as well as their choice of post-mortem beneficiaries, when it comes to their Junk Money assets.

The IRD of deceased taxpayers is potentially subject to multiple taxes, including a federal estate tax of 40%, a federal income tax (with a max rate of 37%), a generation-skipping tax of another 40% (if the named beneficiary is a person two or more generations below the deceased), and possibly even state income and death taxes (depending upon the residency of the decedent and the beneficiary).

The impact of the multiple taxes is mitigated in part by a potential federal income tax deduction[4] for the federal estate taxes, but no offset is available for any state death taxes or the potential generation-skipping tax. The burden of these multiple taxes can significantly reduce (and possibly eliminate) the value of the bequest of IRD.[5]

Managing Lifetime Distributions of Qualified Plan Assets

The SECURE 2.0 Act of 2022 permits taxpayers born after 1959 to postpone taking required minimum distributions (RMDs) until as late as age 75 years.[6] RMDs are calculated each year based on the actuarial life expectancy of the account owner multiplied by the fair market value of the aggregate value of all of their qualified plan assets. While most planners believe that it is best to always defer income, taxpayers should consider the following advantages to taking distributions before they are required:

First, the taxpayer may be in a lower income tax rate (now rather than later) due to business losses or net operating losses.

Second, if the taxpayer tithes or regularly donates to their church or other charitable organizations, after age 70½ years,[7] they should consider making qualified charitable distributions (QCD) of up to the maximum of $100,000.[8] Not only is giving pre-tax income more efficient than giving after-tax savings, but if the taxpayer's itemized deductions are limited for any reason, the exclusion of the QCD from the taxpayer's gross income will be far more valuable than any potential income tax deduction.

Finally, the exclusion of the QCD from the taxpayer's state and local taxable income may lower the taxpayer's income tax where they reside in a state that does not offer a state income tax deduction for charitable contributions.

Pre-Mortem ROTH-IRA Conversions

Although Code Sec. 691(c) permits an income tax deduction for federal estate taxes paid by the decedent's estate on IRD, there is no parallel deduction for any state death taxes that may have been paid by either the deceased or the family on IRD.

Eighteen jurisdictions continue to assess a tax on inherited wealth. These jurisdictions include: Connecticut, Hawaii, Illinois, Iowa, Kentucky, Maine, Massachusetts, Maryland, Minnesota, Nebraska, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Vermont, Washington, and the District of Columbia. The threshold for taxable estates in most cases is often far below the Federal Unified Credit equivalent amount. Taxpayers in these 18 jurisdictions who are of advanced age would be well advised to consider converting their tax-deferred retirement assets into ROTH independent retirement accounts (ROTH-IRAs) while they are alive. At the time of conversion, the federal and state income taxes will be due and payable. The payment of the income tax dollars will remove the income tax dollars from the potential tax on inherited wealth that is imposed by their local jurisdictions, thus granting them a *defacto* estate tax deduction for the income taxes paid, saving the deceased's family state transfer taxes.

Private Foundations *vs.* Donor-Advised Funds

A private foundation is a qualified charitable organization that is typically established by a family or a business to continue the charitable wishes of the donor(s) over many years. The foundation is generally created under State law as a corporation, an association, or a trust. Operating foundations are directly involved in the implementation and management of a charitable project. Non-operating foundations typically raise funds, invest those funds, and make grants from the income and principal to public charities and operating foundations. Private foundations must register and receive a letter of determination from the Internal Revenue Service (IRS) in order to receive tax-deductible contributions. Private foundations must also register at the office of the State Attorney General in each state in which they intend to operate or solicit funds. Private foundations must file annual reports with both the IRS (IRS Form 990-PF) and each State's Attorney General Office. Where donations are made to private foundations, registration and reporting requirements will persist throughout the life of the private foundation. The legal and accounting costs of organizing and operating a private foundation can be a significant annual cost.

Donor-advised funds (DAFs) are dedicated charitable accounts, similar to foundations. DAFs are typically created by banks and investment management firms to pool the charitable gifts of numerous customers and clients. DAFs maintain separate segregated accounts for each donor. The managers typically offer investments in the form of low-load (*i.e.*, commission) or no-load mutual funds, and they assist donors with their grantmaking to public charities, by researching potential donees and offering both recognized and anonymous giving options. The sponsor of the DAF assumes all of the reporting and record-keeping responsibilities. DAFs generally provide a low-cost turnkey alternative to private foundations.

Neither private foundations nor DAFs are eligible to receive qualified charitable distributions (QCDs) during the lifetime of an individual IRA owner. However, both entities may receive transfers from IRAs and other qualified plans following the donor's death without any restrictions.

Charitable Gifts at Death

There are two important considerations to charitable giving at the time of death. The first issue involves "what to give," and the second consideration is "how to give."

"What to give" is fairly straightforward. As we have previously discussed, at death taxpayers generally have two kinds of assets: after-tax assets and capital assets that will receive a stepped-up basis, and IRD assets that are burdened with income and death taxes postmortem. As a general rule, after-tax and capital assets are best left to family and friends at death, especially if there are no estate tax considerations. Pre-tax (IRD) assets will yield a greater benefit to its recipient, however, if they are transferred post-mortem to qualified charitable organizations, because the IRD in the hands of the charities will escape both income tax[9] and estate tax.[10]

Charitable Trusts and the Role of the State's Attorney General Office

The question of "how to give" can be a bit more nuanced. There are two ways to effectuate charitable giving at death. One generally requires some form of oversight and approval. The second can be relatively straightforward and inexpensive.

State constitutions and legislatures generally assign the role of protecting the "public interest" to the Attorney General in each such State. The Attorney General protects the rights of public by assuring that dollars that are claimed

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as charitable gifts and bequests in wills and trusts in fact eventually make their way into the hands of the listed charities. Earlier, in the context of Private Foundations, we mentioned the registration and reporting requirements of public charities and private foundations that solicit funds. Private Foundations must report to not only the Internal Revenue Service, but also to the Attorney General in each State in which they operate.

Many states also impose registration and reporting requirements on the executors of wills and the trustees of trusts that contain gifts to charitable beneficiaries under Charitable Trust Acts in those states.[11] When local probate court proceedings are required, notice must generally be given to not only the charities but also the State's Attorney General's Office. Appearances are required to be filed with the probate court, and a sign-off from the Attorney General's Office is required before charitable transfers may be completed by the executor or the trustee.

In addition to giving notice to the public charity, who then becomes an interested party in the probate proceeding, the necessity of providing formal accountings and securing receipts from charitable beneficiaries imposes heightened administrative burdens on the fiduciaries.

Some of the angst and anxiety surrounding registration and reporting, especially for small charitable gifts, can be circumvented or avoided, entirely, if these modest charitable transfers are not made through wills and trusts. Instead of listing a public charity in a Last Will and Testament or in a Trust Agreement, the client would be well advised to name the public charity as a beneficiary of a portion of an Individual Retirement Account or an annuity. The requirement of registering and reporting to the Attorney General would be eliminated if the funds pass pursuant to a beneficiary designation with the bank or investment company. Similarly, if instead of creating a Private Foundation, the charitable transfer was made to a DAF, the registration and reporting requirements imposed on the donor and their family would be relatively non-existent.

Stretch IRAs

The assets that are invested within qualified retirement plans and IRAs are generally not subject to income tax until they are distributed to the beneficiary. Prior to the enactment of the SECURE Act,[12] individual beneficiaries of qualified plans were permitted to stretch the distribution period of inherited IRAs over the entire life expectancy of the beneficiary. The old rules permitted the beneficiary to continue to invest the inherited IRA of a person who died before 2020 to stretch the RMDs out over their entire actuarial life expectancy.

Following the enactment of the SECURE Act, the designated beneficiaries of retirement accounts of persons dying after 2019 must now generally distribute the entire balance of the inherited IRA within 10 years of the IRA owner's death. There are limited exceptions to the 10-year rule for persons who are disabled or minors, but for all practical purposes, the traditional Stretch IRA is dead.

Charitable Remainder Annuity Trust IRAs—A Stretch Alternative

Code Sec. 664(d)(1) defines a Charitable Remainder Annuity Trust (CRAT) as a trust from which a sum certain (which is not less than 5% nor more than 50% of the initial net fair market value of all property placed in the trust) is to be paid, not less than annually, to one or more persons living at the time of creation of the trust for a term of years (not in excess of 20 years) or life. Following the termination of the annual payments, the remainder interest in the trust is to be transferred to a qualified charitable organization.

CRATs are usually funded during the donor's lifetime with highly appreciated assets. When the applicable federal interest rate is greater than 5%, CRATs can provide the donor the ability to (1) defer the capital gains tax on the sale of the highly appreciated assets, (2) reinvest the proceeds tax-free, and (3) receive an annuity stream of income over a term of years (not to exceed 20 years) or the life of the donor or others.[13]

CRATs can also be funded at death for the benefit of a person other than the donor.[14] If a CRAT is funded with 100% of the proceeds of an IRA, the 10-year distribution rules can be circumvented, and a variation of the Stretch IRA can be created with an additional charitable component. The CRAT-IRA may defer all of the income tax on the proceeds of the IRA, reinvest the proceeds tax-free, and distribute an annuity stream of income to the income beneficiary of the CRAT over that person's lifetime. Following the death of the income beneficiary, the remainder of the CRAT will pass to qualified charitable beneficiaries tax-free.

CRATs are not simple to administer. They are deemed to be equivalent to private foundations and thus subject to annual filing requirements with the IRS, and frequently,

they are also required to register and report to the State's Attorney General. Nevertheless, if there is a large IRA balance, and the donor wants to stretch its benefits (distributions) out over the lifetime of the individual beneficiaries (*i.e.*, more than 10 years), then a CRAT-IRA may be an interesting alternative.

Summary

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ENDNOTES

[1] Code Sec. 691—Income in Respect of a Decedent.

[2] Code Sec. 1014.

[3] Code Sec. 1014(f) requires the basis of the property to be consistent with the value of the property reported on the federal estate tax return of the deceased transferor.

[4] Code Sec. 691(c) provides some mitigation to the income tax burden suffered by taxpayers. It allows the taxpayer recognizing the income to claim an income tax deduction for any federal estate tax paid by the decedent's estate on the same income. The deduction is equal to the amount that bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all items described in Code Sec. 691(a)(1).

[5] In theory, the combination of federal and state taxes could exceed 100%.

[6] SECURE 2.0 is part of the Consolidated Appropriations Act, 2023 (P.L. 117-328, December 2022). Taxpayers who were born before July 1, 1949, were required to take RMDs after age 70½ years; taxpayers born on or after July 1, 1949, and before December 31, 1950, are required to take RMDs beginning at age 72 years; and taxpayers born after January 1, 1951, and before December 31, 1959, are required to take RMDs beginning at age 73 years.

[7] Although SECURE 2.0 raised the required beginning date for minimum distributions, it did not increase the age for QCDs beyond age 70½ years.

[8] Code Sec. 408(d)(8) excludes Qualified Charitable Distributions from qualified retirement accounts from the gross income of the account owner. For years beginning after 2023, the $100,000 limitation of QCDs will be indexed for inflation.

[9] Code Sec. 642(c) grants estates and trusts an income tax charitable deduction for amounts includable in gross income.

[10] Code Sec. 2055 grants decedent's estates an estate tax deduction for transfers to public, charitable, and religious uses.

[11] California, Florida, Illinois, Michigan, Missouri, Nebraska, New Hampshire, Minnesota, Oklahoma, Pennsylvania, Texas, just to name a few.

[12] Setting Every Community up for Retirement Enhancement (SECURE) Act of 2019 (P.L. 116-94, December 2019).

[13] If a person other than the donor is named as a beneficiary of lifetime CRAT, then gift tax may be due on the present value of the beneficiary's annuity interest.

[14] The present value of the non-charitable beneficiary's annuity interest will be taxable transfer subject to potential estate and inheritance tax.

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