

A New Use for Your

R E T I R E M E N T P L A N
A S S E T S

a donor's guide

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APPRECIATED PROPERTY

Learn how to uncover the value of your appreciated assets.

Like many Americans, you are probably aware that the accumulation of assets in your retirement plan can be the basis for a financially secure future. To preserve your retirement assets after your lifetime, consider the benefits of using them in a totally different way.

Retirement accounts are often exposed to income taxes and estate taxes, at a combined marginal rate that could rise to 65 percent or even higher on large, taxable estates. Yet many of these taxes can be avoided or reduced through a carefully planned charitable gift.

Other considerations come into play when deciding on using retirement plan assets for charitable giving. Upon death, your account can pass directly to a charitable organization as your primary beneficiary, or it can be transferred to a deferred giving arrangement that will pay an income for life to a family member, after which the remaining assets pass to the organization.

Alternatively, you can use these assets before you die to fund a deferred gift that is designed to pay a life income to yourself.

How Retirement Accounts Are Taxed

Qualified retirement plans are those that receive favorable income tax treatment during an employee's lifetime. No income tax is due on the funds as contributed, and no income tax is due on the earnings and appreciation while in the plan. You pay taxes on the funds only when you receive them. Such plans come in

many forms: a defined benefit or contribution pension plan, money purchase pension, profit-sharing plan, annuity plan, 401(k) or 403(b) plan, stock bonus plan, Employee Stock Ownership Plan (ESOP) or simplified employee pension (usually a SEP-IRA) from your workplace, and Keogh accounts and Individual Retirement Accounts (IRAs) you set up for yourself.

Generally, the undistributed balance of qualified retirement plans is fully includable in your gross estate for estate tax purposes. Because the funds in retirement accounts usually represent deferred compensation that has not been subject to income tax, giving the accounts to individual heirs exposes the funds to income taxes. Your retirement dollars can be seriously depleted by this double taxation.

A qualified retirement plan often makes a large, taxable distribution shortly after an employee's death. As a general rule, qualified plans other than IRAs will specify how quickly distributions must be made from the plan. In the case of an IRA, if the owner dies before reaching the required beginning date (i.e., the date a person must begin receiving distributions from his or her retirement plan), the plan benefits may be distributed over the life expectancy of a "designated beneficiary." The designated beneficiary refers to a person, not the owner's estate or certain trusts. If the IRA does not have a designated beneficiary, then the IRA must be distributed within five years. If the owner dies after the required beginning date, then the entire balance can be distributed over the owner's life expectancy or over the designated beneficiary's remaining life expectancy.

Beneficiaries who are not designated beneficiaries should have their share distributed to them by Sept. 30 of the year following the year of death. This allows the designated beneficiaries to stretch out the receipt of distributions from the plan over their lifetimes and, hence, defer the income taxes, too. Of course, the beneficiary always has the option to speed up his or her distributions or to take the balance in a lump sum at anytime.

Only a surviving spouse can roll over an inherited distribution to his or her own IRA, called a Spousal Rollover IRA, and further delay receiving distributions until his or her own required beginning date; all other beneficiaries must take distributions and are taxed according to the above rules.

Income in Respect of a Decedent

The Internal Revenue Code (IRC) labels amounts that were not previously included in a decedent's taxable income as items that generate "income in respect of a decedent" (IRD). In plain language, these are amounts that would have been taxed as income had the recipient lived long enough to receive them. In addition to qualified retirement plans, IRD items include accrued interest on Certificates of Deposit and savings bonds, unused vacation pay, nonqualified stock options, deferred payments of capital gains and other undistributed but earned income. Among all your assets, the largest IRD source will probably be your retirement accounts.

By donating retirement assets, those funds avoid both estate and IRD taxes, and you can be certain that 100 percent of the

balance of your retirement funds will support your philanthropic objectives.

Example: Bill is considering adding a charitable bequest to his will, with the residue of his estate passing to his children. Instead, he should name the charitable organization as beneficiary of his profit-sharing account. The death benefit passing to the organization will not only qualify for the estate tax charitable deduction but will also pass free of any income tax obligation. His children will benefit from this change because, rather than getting the profit-sharing account proceeds that are subject to income tax, they will receive other assets of his estate that are free of income taxes.

Continuing the example, suppose Bill owns stocks that have a low cost basis. He can secure a further tax advantage by leaving these to his children. They will receive a step-up in the income tax basis to the date-of-death value of the stocks. Since the basis is the amount from which any gain or loss will be figured when the children ultimately sell the property, this means there will never be a tax on the appreciation that occurred during his lifetime. The children will owe tax only on appreciation after the time of Bill's death.

How to Donate Your Retirement Account

The simplest way to leave the balance of a retirement account to us after your lifetime is to list us as the beneficiary on the beneficiary form provided by your plan administrator. Never make a beneficiary change, however, before discussing your desires with your professional advisor. For an IRA or Keogh plan you administer personally, notify the custodian in writing and keep a copy with your valuable papers.

If you are married, your surviving spouse is generally entitled by law to receive the entire amount in these qualified plans: money purchase pension, profit-sharing plan, 401(k) plan, stock

bonus plan, ESOP or any defined benefit or annuity plan (though not an IRA). In order for the assets to be given to a charitable organization, your spouse must sign a written waiver (even though you may designate a charitable organization as beneficiary on your employer's forms). Your spouse can sign the waiver after your death, if necessary. In that case, the document must also include a qualified disclaimer.

If you prefer to make your spouse the primary beneficiary of the retirement account, you can name us as the secondary or contingent beneficiary.

Perhaps you want your children to benefit from your retirement account, too. In that case, you might designate a specific amount to be paid to us, before the division of the rest among your children.

Tax Precautions and Options for Charitable Transfers

Being cautious in the way you designate your charitable bequest will ensure that you are not setting your estate up for some disadvantageous tax consequences.

Suppose your will provides that your retirement plan assets are to be used to fulfill a specific bequest to a charitable organization. A problem could arise if your estate was required to recognize the plan distribution as taxable income while not being able to claim an offsetting charitable income tax deduction. To sidestep this problem, your will could provide that payments to the charitable organization are to be made from your estate only to the extent that IRD items made payable

to charitable organizations are inadequate. Generally, the best way to avoid this problem is to omit any reference to the charitable contribution in your will and instead simply designate the charitable organization as the successor beneficiary on the retirement plan forms provided by your employer.

Once you reach age 70½ or the year you retire, if after age 70½, you are required to begin taking payments from your qualified retirement plans if you have not yet done so. However, owners of IRAs or those who own 5 percent or more of the business offering the retirement plan must take their minimum distributions at age 70½ even if they haven't retired. The date distributions must begin is called the Required Beginning Date.

Recent changes by the IRS make it much easier to name a charitable organization as the contingent beneficiary and still minimize the required distribution amount. Under these changes, designation of a charitable organization as the beneficiary of a portion of the plan benefits will not increase the employee's minimum required distribution, despite the fact that the organization would not qualify as a designated beneficiary. As stated earlier, it is preferable that the amounts are paid to the charitable organization before Sept. 30 of the year following the year of the employee's death.

Life Income for Survivor

Another tax-benefiting possibility is to transfer retirement assets at death to a tax-exempt deferred giving plan, such as a charitable remainder unitrust or a charitable remainder annuity trust. The trust's income beneficiary you designate will receive an income

generally for life, either a fixed percentage of the value of the trust assets as revalued annually or a fixed dollar amount. After his or her death, the remaining principal will support our work.

By naming a deferred giving plan as the ultimate beneficiary of your retirement account, income taxes can be deferred until paid to the income beneficiary you designate. This may offer the only income tax deferral opportunity for your heirs if your retirement plan requires an immediate distribution.

Example: After participating in her company's profit-sharing plan for many years, Anne estimates that when she dies, the account balance could be at least \$200,000. If she were to name her daughter, Sandy, as the beneficiary, the entire amount would go to Sandy as ordinary, taxable income, incurring federal income taxes of up to \$70,000 (ignoring any deduction for federal estate tax paid on the account). In addition, a federal estate tax of up to \$96,000 would be due if Anne's other assets equaled more than the amount exempt from estate tax. The federal estate tax would be deductible for income tax purposes, however, reducing the federal tax by up to \$31,000. Only \$65,000 of the \$200,000 would be left for her daughter after payment of federal income and estate taxes!

Instead, Anne creates a charitable remainder unitrust and names it as the beneficiary of her profit-sharing plan. She arranges for the unitrust to pay 7 percent of the value of the assets to Sandy each year for life. The net result is significant income tax deferral. The entire \$200,000 can be invested to produce investment income. The estate tax of up to \$96,000 on the value of Sandy's interest would typically be paid from other assets. The partial estate tax charitable deduction for the present value of the charitable remainder interest will reduce Anne's estate tax.

Precautions on Transfers to Deferred Giving Plans

As with charitable bequests, similar problems may arise with deferred giving plans. If the retirement plan is payable to the estate and then the will directs these dollars into a deferred giving plan, this strategy may result in the estate having to pay income tax on the retirement plan values paid to the estate. The estate, of course, is entitled to claim only a partial charitable deduction for the value of the remainder interest that will pass to the charitable organization.

Again, the simple solution is to make the deferred giving plan the beneficiary of all or a portion of the retirement plan assets so that the assets will bypass the estate's reportable income.

Draw Life Income From Charitable Rollover

So far, our discussion has related to arrangements after your lifetime, but you may use retirement plan assets to benefit yourself during your lifetime and us thereafter using a charitable remainder trust.

You arrange a lump-sum distribution from your qualified plan. Normally, this would occur after you reach age 59½. Then, you contribute the after-tax amount to a charitable remainder trust that assures you an income for life while committing the remaining assets to us after your lifetime. This results in an income tax charitable deduction that may partially offset the tax on the lump-sum distribution. (Each situation must be analyzed individually to determine the exact financial benefits. We recommend the counsel of a financial professional.)

Valuable Estate Planning Strategy

Donating the balance in a retirement plan account may be the most tax-effective means of supporting our mission. Please seek guidance from an attorney and other professionals who are thoroughly versed in this field of tax law.

The information in this publication is not intended as legal advice. For legal advice, please consult an attorney. Figures cited are based on current rates at the time of printing and are subject to change. References to estate and income tax include federal taxes only; individual state taxes may further impact results.