Charitable Tax Planning with Retirement Funds

Common Questions and Charitable Solutions

Are you putting away something to make sure your retirement is an enjoyable and comfortable one?

Most of us are. In recent years, total assets in private and public qualified plans have exceeded $10 trillion.

Individual retirement accounts (IRAs) comprise about a fourth of that total. The balance comes from 401(k) plans; private pension plans; and state, local, and federal government pension plans.

Saving for retirement is popular because of the favorable tax treatment for qualified plans. Contributions made through a salary-reduction plan are sheltered from taxation in the year they are made. Likewise, interest and investment income are exempt from income tax prior to distribution. Over time, this makes a tremendous difference in the total amount you accumulate, as the chart at right shows.

While your tax-deferred retirement-plan benefits are a great source of financial security during your lifetime, the downside is that the tax bill will hit in a big way if you leave retirement-plan benefits to your children, grandchildren, or other beneficiaries. Retirement benefits you leave to others are subject to

Qualified Plans: The Money Stacks Up

Joan, who's in the 35% tax bracket, has $10,000 to invest for 20 years. The income-tax exemption for interest and investment income in a qualified plan would make a BIG difference in her savings.

$10,000 Investment—Earning 7%

Investment
$24,349

Qualified Plan
$38,697

Accumulations in 20 Years

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estate taxes—as are all other assets you own—and income taxes as well. ***Reason:*** Contributions to qualified retirement plans are made with pre-tax dollars so their income taxation is deferred until you make a withdrawal or are taxed to your beneficiaries after your death. The income tax is never forgiven—merely delayed. ***Result:*** The combined tax hit can claim as much as 60% or more of these benefits.

Example: *Leo H has a $1,000,000 IRA as part of his overall estate of $4,500,000. His daughter, Jill, is the beneficiary. If Leo were to die in 2009, the tax consequences attributable to the IRA are as follows:*

IRA value	$1,000,000
Federal estate tax	$ 450,000
Federal income tax	$ 192,500
Total tax	$ 642,500
Available to Jill	$ 357,500

Frustrating, isn't it? Fortunately, there are solutions that can soften the tax bite. ***Charitable planning pointer:*** Consider using your retirement-plan benefits to fund a gift to charity, with the bequests to your heirs coming from other estate assets.

This booklet explores strategies you can employ to make sure your heirs keep more of your money.

Q How can I avoid sacrificing much of my retirement funds to taxes?

You will want to talk to your advisors about the best strategies for your particular situation, but here are some ideas you might consider:

■ ***Delay payment and defer tax.*** If you are married and haven't reached the required beginning date for distributions, you will most likely want your spouse to be the designated beneficiary. Should you die before the age of 70½, he or she can defer distributions until after you would have attained that age and, of course, will then pay income tax on withdrawals. **Advantage:** The estate tax on your accumulations can be deferred until your spouse's death and may never be assessed at all if they are substantially consumed during his or her life. **Disadvantage:** You lose control over the ultimate distribution of the assets.

■ ***Stretch payments and reduce annual tax.*** If you want a child to receive the remaining benefits, consider naming him or her as the designated beneficiary. **Advantage:** When you die, the required payments can be stretched out over the remaining life expectancy of the child. **Disadvantages:** If your estate and plan assets are large enough, the value of benefits passing to the child will be subject to estate tax. Plan assets withdrawn to pay estate taxes are subject to income tax.

■ ***Consider using retirement funds for charitable estate gifts.*** Under recent tax rules, it makes more sense than ever to use IRAs and other retirement funds for charitable gifts at your death. As before, you are likely to save more in taxes when you give these assets than you would if you made a gift of securities, real estate, or cash investments.

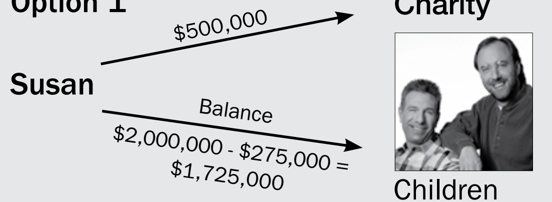
Q What happens if I have not named a designated beneficiary for my retirement funds?

Here, too, your entire benefits will have to be distributed to contingent beneficiaries named in the agreement or, absent that, to your estate within five years of your death or over your remaining life expectancy, depending on whether you die before or after your required beginning date for distributions (usually the age of 70½).

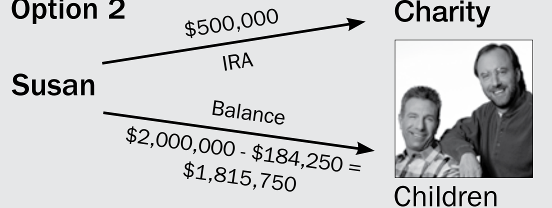
Which asset should Susan give?

$2,500,000 estate

$ 500,000 IRA
$1,000,000 appreciated stock
$ 400,000 cash investments
$ 600,000 home



Estate-tax savings	$225,000
Income-tax savings	-0-
Total tax savings	**$225,000**
Net cost of gift	**$275,000**



Estate-tax savings	$225,000
Income-tax savings	$ 90,750
Total tax savings	**$315,750**
Net cost of gift	**$184,250**

No allowance is made for administrative expenses that would reduce the estate tax. Susan dies in 2009.

Why would I save more in taxes by giving the retirement-fund benefits instead of other assets to charity?

Since the charity is tax-exempt, you can make a significant charitable gift at relatively little cost to your heirs.

Now there is the added benefit of greater simplicity. Under the new tax rules, all you have to do is name the charity as beneficiary of a portion of your IRA or qualified retirement funds. Following your death, that designated portion of the funds will be paid to the charity in a lump sum, totally tax-free. The balance can be paid to beneficiaries according to the schedule you and they elect, and the charitable gift will not affect that distribution schedule. ***Note:*** If family circumstances change, you can alter the percentages by completing a beneficiary-designation form. This does not necessitate a change in your will.

I like the idea of supporting a favorite charity, but I also want to provide for my spouse. Is there a way to do this?

Definitely! Consider *a charitable remainder trust with your spouse as payment beneficiary*. At your death, your plan's assets would be paid to the trust and your spouse would receive a stream of income for life.

Example: *John G establishes a charitable remainder trust while he is still alive, minimally funds it and, with his wife's consent, names it a beneficiary of his retirement-plan assets. At the time of John's death, those assets total $1,000,000. His wife, Mary, will receive payments for life based on the payout rate he selected. No estate tax is payable because the trust qualifies for both charitable and marital deductions. Likewise, no income tax is assessed*

on the $1,000,000 transferred to the trust because the charitable trust is a tax-exempt entity. Thereafter, the payments will be taxed, as received, to Mary in her tax bracket. At the end of Mary's life, the trust will terminate and its principal will be paid to us to support our work.

Q Any ideas on how I can provide for both my children and charity?

One way is to establish *a charitable remainder trust naming your children as beneficiaries.*

The total benefits for your children may be greater than if you had simply left them your retirement funds as a lump sum. This is demonstrated by the following:

Example: *A person dies in 2009 with a gross estate of $5,000,000 including $1,000,000 of retirement-fund assets directed to his children:*

	Lump-sum bequest	*Charitable unitrust*
Retirement assets	$1,000,000	$1,000,000
Estate tax	$ 450,000	$ 314,370[1]
Income tax (at 35%)	$ 192,500	-0-
Total tax	$ 642,500	$ 314,370[2]
Net to children	$ 357,500	*Payments for 20 years from $1,000,000*

[1]Factors in the charitable estate-tax deduction, unitrust with a 6% annual payout, payments for 20 years.

[2]Assumes estate tax paid from other estate assets.

Q In terms of the tax benefits, what type of asset is best for me to give to charity?

Retirement-plan assets may be the best way to fund a charitable gift. Consider giving all or a portion of your plan assets as an outright gift during your life.

Example: *Mary plans to make a $50,000 charitable gift to support our work. If Mary withdraws $50,000 from her IRA and contributes it to us, the charitable deduction for the gift offsets the income tax on the withdrawal, assuming it is all usable in one year.*

However, Mary saves even more taxes by contributing $50,000 of appreciated stock to us instead of the cash withdrawal of $50,000 from her IRA. She gets the same benefits as giving cash, and she avoids potential tax on the gain in the stock. If she wishes, she might use the $50,000 withdrawal to repurchase the stock, thus getting a stepped-up basis.*

*While the deduction ceiling is 30% of adjusted gross income rather than 50%, any excess can be carried forward for up to five years.

Still another possibility is simply to make an outright charitable gift of *all of your retirement funds at death.* Escaping all taxes, the gift cost may be as little as 30 cents on the dollar.

Q I'm already contributing the maximum allowable amount to my qualified retirement plan. Is there a charitable way to save more for retirement and possibly reduce taxes upon distribution?

Yes, as noted earlier, the tax-free accumulation of retirement funds ends at distribution, with the paying of ordinary-income tax at rates as high as 35%. ***Charitable alternative to a qualified plan:*** It is possible to create and invest a *charitable remainder trust* so that distributions to the beneficiary may be taxed largely as capital gain—at a lower tax rate. For taxpayers in the top ordinary-income-tax bracket, this can cut their tax rate to less than half (from 35% to 15%).

This option can serve as a potent retirement-planning tool and provide wonderful benefits to charity. However, the requirements and the administration for such a trust are very specific and complex. *It is important that you seek competent legal counsel before implementing this plan.*

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Example: *Bill T, 50, is self-employed and plans to retire in 15 years. For years he has been contributing the maximum amount allowable to his Keogh plan—he has invested wisely, and his plan is valued at more than $1,000,000. Even with no further contributions, Bill estimates that if the plan continues to grow at its present rate, it will provide a very comfortable retirement-income stream. However, he wants to continue to save for retirement and has recently become interested in several of our programs.*

After consulting with members of our staff and his own legal counsel, Bill decides to create a 5% charitable remainder unitrust that will pay him only ***net income.*** *The trust also provides that any shortfall in years when income is less than 5% of trust value can be made up in later years when net income exceeds 5%. Bill plans to make $30,000 annual contributions to the trust for the next 15 years.*

Since the trustee will invest for growth and forgo income during the years that Bill is funding the trust, Bill will receive little or no income for the first 15 years. After that—since the trustee has been given the power to allocate capital gain to income—once Bill retires the trustee can continue the investment strategy of investing for growth—but as assets are sold, allocate capital gain to income and make distributions that will be taxed at capital-gain tax rates and not at Bill's potentially higher ordinary-income-tax rates.

Result: *For each year that Bill contributes to the unitrust he will receive a charitable income-tax deduction for a portion of his gift. The deduction in the first year is almost $8,500 and rises to more than $13,500 in the fifteenth year. The total deductions over the 15-year period would be almost $164,000.*

If the trust grows at the rate of 10% per year, in 15 years the trust principal could be more than $950,000. When Bill turns 65, the trustee could begin selling a portion of trust assets, allocating the gain to income, and making payments to Bill. Assuming the trust continues to grow at the rate of 10% per year, the trustee may choose to realize capital gain equal to 10% of the trust's value and make payments to Bill of more than $95,000 per year. And since the payments are taxed at capital-gain tax rates, Bill could receive as much as $80,750 in after-tax income in contrast to the $61,750 he would receive in the 35% income-tax bracket. After about 5 years, when Bill's income shortfall from the first 15 years of the trust is made up, his income payments would fall to 5% of the annual value of the trust. At Bill's death, assets remaining in the trust would pass to us to continue the programs in which Bill had an interest.

Let Us Help

These are but a few planning ideas to help you provide for your retirement and for the future of your heirs—as well as reduce taxes and support our work.

We would be pleased to further discuss these ideas with you and to answer your questions. For a consultation or more information, please call our office.

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