

CHARITABLE GIFTS
FROM INDIVIDUAL
RETIREMENT
ACCOUNTS

a donor's guide

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HOW TO MAKE CHARITABLE GIFTS FROM **Individual Retirement Accounts**

Thanks to the success of tax-deferred investments within qualified retirement plans, many people have found that they have sufficient funds for retirement and that they will probably have funds left for distribution to heirs and charitable causes they wish to support. Recent changes in the distribution laws governing Individual Retirement Accounts (IRAs) have made it possible to keep more of your tax-deferred dollars intact for heirs, and they have made it easier to give all or part of IRAs to charitable organizations you wish to help.

You can make a charitable gift from your IRA either during your lifetime or as a bequest at death. An IRA can be a very attractive source for making a charitable gift since distributions from an IRA are usually taxable.¹ The income tax sting can be eliminated during your lifetime with an offsetting charitable income tax deduction. Upon a person's death, it is possible to structure a charitable bequest in such a way that the taxable IRA payments are made directly to a tax-exempt charitable organization so neither the estate nor the heirs will have to report any taxable income from the IRA distributions.

Making a Charitable Gift During Life

You can make a charitable gift from an IRA during your lifetime, but the tax laws will require you to first report the distribution

¹The only exceptions are distributions from a Roth IRA, which are usually tax free, and distributions of nondeductible contributions that were made to a conventional IRA.

on your income tax return and then claim an offsetting charitable income tax deduction. Several bills have been proposed in Congress that may permit tax-free lifetime transfers from IRAs to charitable organizations in the future, but until such a law is enacted, every lifetime distribution from your IRA will have to be reported on your income tax return.

By way of background, any distribution from your IRA—even if it is paid directly to a friend or a charitable organization rather than to you—will trigger taxable income to you in the year of distribution. Under current law, a person cannot make a gift from an IRA during his or her lifetime without reporting the distribution as taxable income on his or her income tax return. The advantage of making a gift to a charitable organization, though, is that there will be an offsetting charitable income tax deduction so that virtually no tax will be due from the distribution. In the year you make the gift, the charitable deduction is limited to 50 percent of your adjusted gross income. You can, however, carry it over for five additional years if necessary.

Example: Martha instructs her IRA administrator to write a check for \$15,000 to her sister and another check for \$20,000 to a charitable organization.

Although the checks may have been issued directly from the plan to the sister and the charitable organization, at the end of the year Martha will receive a Form 1099-R from the plan, which states that she must report \$35,000 of income. She can, however, claim a \$20,000 charitable income tax deduction for the charitable contribution of \$20,000.

A Better Strategy: Donate Stock and Keep Your IRA Distribution

Usually the best tax-saving strategy for lifetime charitable gifts is to contribute publicly traded stock or mutual funds instead of cash or an IRA distribution. Gifts of appreciated stock and mutual funds are a very effective way to offset the tax liability you would usually incur from receiving IRA distributions. The greatest tax savings occur with gifts of appreciated stock or mutual funds that you have held for more than one year (where the sale would have produced a long-term capital gain) since you can deduct the market value of the gift instead of just the cost basis.

Example: Joanne owns \$10,000 of XYZ stock she purchased years ago for \$2,000. She also receives a \$10,000 distribution from an IRA because she is over the age of 70½ and is required to receive distributions. If she gives the \$10,000 IRA distribution to a charitable organization, she will have an offsetting \$10,000 charitable income tax deduction. She will pay virtually no tax on the IRA distribution.

Joanne would be better off, however, contributing the stock to the charitable organization rather than giving the \$10,000 IRA distribution. Either gift will produce a \$10,000 income tax charitable deduction, but by giving the stock she will forever avoid paying a long-term capital gains tax on the \$8,000 of appreciation. If she wants, she can repurchase the same XYZ stock for \$10,000, and then her basis in the stock would be \$10,000 instead of the original \$2,000.

IRAs as Charitable Bequests

An IRA can be one of the best assets to use for a charitable bequest. While normally an inheritance is exempt from income tax, distributions from an inherited IRA to the beneficiary are usually fully taxable. The payments are classified as “income in respect of a decedent” (IRD). IRD is the exception to the rule that most inheritances are exempt from the income tax.

Example: Assume Grandpa would like to treat his two grandchildren, Patty and Michael, equally. Upon his death, he leaves Patty \$100,000 of stock that he had purchased for \$60,000. He leaves his \$100,000 IRA to Michael. When Patty receives her \$100,000 of stock, she will not have to pay any income tax. In fact, she gets a “stepped-up” basis in the stock so that if she sells the stock for \$100,000 she will pay no income tax.

By comparison, when Michael receives the \$100,000 from the IRA, the entire amount will be subject to income tax because all IRA distributions are taxable, even after death. Consequently, Grandpa did not treat his two grandchildren equally since Michael will have less money than Patty after Michael pays the income tax liability.

If you are planning to make a charitable bequest, you should consider leaving the taxable IRA assets to your favorite charitable organization so your family and friends will receive more of the other tax-free assets (e.g., cash, stock and real estate). The organization will not be worse off. It is tax-exempt and will be able to keep the full amount of every IRA distribution without paying any income taxes.

Estate Taxes and Your IRA

Whereas the highest current estate tax rate is 49 percent, inherited IRAs are subject to an even higher tax rate because each distribution will trigger an income tax liability. For most taxable estates over \$2 million, the combination of federal income and estate tax rates on IRA assets exceeds 65 percent. If your state has an income tax, those assets could be facing a total tax rate of nearly 70 percent!

A bequest of your IRA assets to a charitable organization avoids *all* estate and income taxes. The organization will keep 100 percent of the IRA assets and will apply them to a charitable purpose you choose. How does this work? First, your estate will be able to claim a charitable estate tax deduction since the IRA will be transferred to a charitable organization. Second, if you name the charitable organization as the beneficiary on the IRA forms and if the IRA is distributed directly to the organization after your death, then neither your estate nor your heirs will have to report any taxable income from the distribution! Instead, the charitable organization will have to report the income. This leads to the third point: Since the organization is tax-exempt, it will not have to pay any income tax when it receives the distribution. Thus, instead of having the government decide how to spend nearly 70 percent of your IRA assets, you can apply 100 percent of those assets to a charitable purpose that is important to you.

How to Make a Charitable Bequest of An IRA

The best way to make a charitable bequest of your IRA assets is to name your favorite charitable organization(s) as the beneficiary on your IRA beneficiary designation forms. Please note: Your will does *not* govern your IRA. An IRA is a separate trust or custodial account that usually passes outside of probate. The most important document, therefore, is the beneficiary designation form you receive from the IRA administrator.

If you would like to leave some of your assets to a charitable organization and the rest to other people, such as family members or friends, then extra steps may be advisable. There are explicit rules for mandatory distributions from your IRA after you reach age 70½ and after you die.

One alternative, which serves under both the old and the new rules, is to establish a separate IRA account for the charitable organization. The best way to accomplish this is through a “direct rollover” or a “trustee-to-trustee transfer,” which avoids the 20 percent withholding tax that normally applies to IRA rollover distributions.

New IRS rules allow another, more attractive alternative. Now, naming a charitable organization as a beneficiary is much less likely to have an adverse impact on the amount of these mandatory distributions. It is no longer necessary to establish multiple IRAs, some for charitable organizations and some for individuals, to avoid the problem of accelerating distributions over the individuals’ lifetimes.

During your lifetime, the minimum distributions of your IRA are the same whether or not a charitable organization is named as beneficiary. After your lifetime, however, the administrator must “cash out” the organization’s share of the account before Sept. 30 of the year that follows the year in which death occurred. By doing so, it will leave only noncharitable beneficiaries and will give them greater flexibility than if the charitable organization were still a beneficiary. Overall, this cash-out strategy permits a charitable organization to be a beneficiary of part or all of any IRA or retirement plan account without causing problems to other beneficiaries, such as children.

IRA Distributions

Once you attain age 70½, you are subject to the required distribution rules and must begin receiving amounts from all of your IRAs or face a 50 percent penalty tax. You can always take out more than the required amounts—they are merely the minimum to avoid the penalty.

While the Treasury has simplified the rules for determining your minimum distribution amounts, it has also aided the ability to enforce the distribution rules. Every IRA administrator is required to report to both you and the IRS the amount of the minimum required distribution for each calendar year.

The amount of your distribution is now determined by one uniform table, unless you are married to someone who is 10 years younger than you. The new table allows for the smallest minimum payout, letting more of your IRA accumulate tax-deferred.

With the recent changes, and more tax changes on the horizon, you should see a competent tax advisor before you take any action. With good planning you can make a major charitable gift of your IRA at a very small cost to your family and friends.

Possible Taxes on IRAs

The combination of federal estate and income taxes on an IRA can exceed 65 percent. State income taxes can bring the total to more than 70 percent.

Example: Assume that Kathryn's total taxable estate is \$3.2 million and that all of it will be transferred to her sole heir, her daughter. Assume that the probate estate will pay the entire estate tax regardless of how her daughter acquired the assets (e.g., joint tenancy, etc.). If \$100,000 in an IRA is immediately distributed to the daughter, and the daughter is in a 35 percent marginal income tax bracket, then the combined estate and income taxes on the \$100,000 of IRA assets would be \$68,530. The amount is calculated as shown in the following chart.

Beginning Balance in IRA	\$100,000
Minus Total Estate Tax Paid by the Probate Estate	(49,000)

COMPUTATION OF TAX ON DISTRIBUTION

Gross Taxable Income	\$100,000
Reduced By §691(c) Deduction for Federal Estate Tax	
Total Estate Tax	\$49,000
State Tax Credit*	(4,800)
Deduction for Federal Estate Tax **	(44,200)
Net Taxable Income ***	\$55,800
Times Income Tax Rate	x 35%
Net Income Tax on Income In Respect Of Decedent	(19,530)
NET AFTER-TAX AMOUNT TO DAUGHTER	\$31,470

* The deduction for estate tax attributable to income in respect of a decedent is only for the federal estate tax; the Section 2011 state tax credit (9.6 percent for an estate over \$3.1 million) has therefore been eliminated. Treas. Reg. Section 1.691(c)-1(a).

** The deduction is an itemized deduction on Schedule A that is claimed on the last line of the form (“other miscellaneous deductions”). It is not subject to the 2 percent of adjusted gross income (AGI) limitation that most miscellaneous deductions are subject to. Sec. 67(b)(7).

*** The net taxable income from the IRD will actually be greater than this amount. The IRD will increase the recipient’s AGI by \$100,000, which will decrease the recipient’s itemized deductions by 3 percent, which would be \$3,000 in this example. Sec. 68. The 3 percent reduction was omitted from this calculation in order to simplify the computation.

The information in this publication is not intended as legal advice. For legal advice, please consult an attorney. Figures cited in examples 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.