

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 is 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. You might even consider 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. Since 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, the plan benefits must generally be distributed within five years or, in some cases, within one year. 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. The new regulations are a major improvement over prior law and allow designation of a beneficiary as late as the last day of the calendar year following the calendar year of the owner's death. Only a surviving spouse can roll over an inherited distribution to his or

her own IRA and benefit from further income tax deferral; all other beneficiaries are taxed according to the above rules.

Income in Respect of a Decedent

The Internal Revenue Code (IRC) labels estate assets 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 assets 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. Generally, the cost to individual heirs will be modest.

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.

For example, 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 new owner ultimately sells the property, this means there will never be a tax on the appreciation that occurred during his lifetime. The person who inherits the property 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 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 transferable to a charitable organization, your spouse must execute a written waiver (even though you may designate a charitable organization as beneficiary on your employer's forms). Your spouse can execute one 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 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 should provide that payments to the charitable organization are to be made from IRD items. A different 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, you are required to begin taking payments from your qualified retirement plans if you have not yet done so. The amount of your required minimum distribution changes if you choose to include a second life in the calculation

that determines the minimum amount—for example, if you include a child as a beneficiary. You could then take less of a distribution, leaving a greater balance to be inherited.

The new IRS rules make it much easier to substitute a charitable organization as the second beneficiary. This no longer creates a problem if you want to minimize the distribution amount. Under the new regulations, 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. This will be true whether the beneficiary designation is made before or after death. It may be preferable to make certain that the amounts are paid to the charitable organization before the end of the year following the employee's death.

It is also possible to name your son or daughter as beneficiary, in order to achieve a lower distribution, and us as contingent beneficiary, with the understanding between you and your child that upon your death your child will execute a qualified disclaimer so that the assets pass to the contingent beneficiary. This results in an estate tax deduction and your philanthropic wishes being fulfilled, but you must rely on your child's word to carry out your plan.

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 beneficiary you designate will receive an income for life, either a fixed percentage of the value of the trust assets as revalued annually or a fixed dollar amount. Thereafter, 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 over the life of 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 probable federal and state income taxes as high as \$44,000. In addition, a federal estate tax of \$100,000 would be due if Anne's other assets equaled more than the amount exempt from estate tax. Only \$56,000 of the \$200,000 would be left for her daughter after payment of all the 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 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 distributes to the estate and then the will distributes to a deferred giving plan, this may result in taxable income from the transfer of retirement assets to the deferred giving plan. 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.

There are currently no clear-cut precedents or tax rulings that address whether or not a testamentary (by your will) transfer of deferred compensation to a deferred giving plan causes the income beneficiary of the deferred giving plan to incur taxable income in the year of transfer rather than at the time of distributions. In fact, there are arguments both ways on this issue. If you are considering using your will to set up a deferred gift of your retirement assets, rather than directly naming a trust on your employer's forms, you may find it advisable to have your attorney obtain a ruling from the IRS before you proceed further.

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 they 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. 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 contribution 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

While donating the balance in a retirement plan account may be the most tax-effective means of supporting our mission, it is also a relatively new area of estate planning. 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.