Retirement Plan Assets

Leaving More to Your Family and Charity

Retirement planning. It's a hot topic that is becoming hotter as millions of baby boomers continue to approach and enter retirement.

Today, a record number of people are participants in tax-favored retirement plans, such as IRAs, 401(k)s or Keogh plans. And for many individuals, retirement plan assets comprise the largest component of their estates.

While just about all of us are concerned with accumulating retirement assets, fewer of us have thought about the ultimate distribution of those assets and the tax consequences of that distribution. The taxation can be surprisingly harsh, depleting much of the retirement savings.

As more people coordinate their financial, estate and gift planning, a technique that is rapidly gaining acceptance is the strategic use of "tax-plagued" retirement plan assets to make charitable gifts. Many people have found that they can reduce taxes and leave more for both family members and favorite charitable organizations by creatively using such retirement plan assets.

Let's look at some commonly asked questions about the charitable use of retirement plan assets. The answers may encourage you to explore the benefits of this planning technique.

Why give retirement plan assets to charity? Isn't their purpose to provide for a secure retirement?

At first glance, it may seem inappropriate to make a charitable gift of assets originally intended for retirement purposes. It's not the best choice for everyone, but for others, especially those whose retirement plan assets have grown substantially over the years, charitable giving may offer an attractive option. Taxes can needlessly eat up a large percentage of your retirement plan. A planned gift to a qualified charitable organization may reduce or eliminate those taxes and, at the same time, better provide for family members. The key is to integrate your giving with your overall financial and estate planning.

Why are retirement plan assets so heavily taxed?

To encourage individuals to save, the law allows you to make tax-deductible and pre-tax contributions to retirement plans such as IRAs or 401(k) plans. What's more, assets in these accounts are allowed to grow income tax free.

The downside comes, however, when the individual withdraws the retirement plan assets. The withdrawals are generally taxed as ordinary income. Moreover, withdrawals made before age 59½ are subject to a 10% penalty tax unless certain exceptions apply. If you don't begin to take withdrawals after you reach age 70½—whether you need the money or not—you trigger another penalty tax.

The gloomiest scenario occurs if you die with undistributed retirement plan assets. Unless you leave them to a surviving spouse, the assets may be subject to federal and/or state estate taxes. Worse yet, these assets also may be subject to federal and state income taxes when distributed to heirs. The combined taxes can deplete the retirement account by more than half. Beneficiaries are often caught off-guard by this unfortunate reduction of their inheritance.

Why are retirement plan assets subject to income taxes for heirs?

The tax law classifies certain assets as IRD (income in respect of a decedent). While the term sounds complicated, IRD simply refers to an asset that would have been taxed as income had the decedent lived.

Examples of IRD include deferred compensation, post-death bonuses, payments on accounts receivable, income from the exercise of stock options, unused vacation pay, interest on savings bonds or CDs, and other forms of accrued but unreceived income. Of such assets, retirement accounts are often the largest IRD component of an estate.

Since IRD assets have not yet been taxed as income, they become subject to taxation when received by beneficiaries. For income tax purposes, IRD is eventually taxed to the person who accesses the decedent's account. The tax bite taken out of retirement benefits can be quite significant.

How can I integrate charitable gifts of retirement plan assets with my financial and estate planning?

Of course, you should only look into this option if you already have a genuine desire to make a major gift to our organization. Assuming such a desire, rather than leave retirement plan assets to your family, use those assets to make your gift and leave other assets—ones that are not "tax plagued," such as appreciated securities—to family members. The upshot is that family members will still get an inheritance but won't have to deal with the tax liability on your retirement plan assets.

Example: Roger, a widower, plans to leave a charitable bequest to us in his will with the remainder of his estate to go to his children.

It may make more sense for Roger to make his charitable gift out of his retirement plan assets and leave other assets to the children. Even though the retirement plan assets are considered IRD, the charity will not owe any tax when converting these assets to cash because of the charity's tax-exempt status. Roger can leave other non-IRD assets, such as highly appreciated securities, to his children through his will. They will not have to pay federal income tax when they receive those assets, even though the appreciation during Roger's life has never been taxed.

What kinds of retirement plan assets can I use to make a charitable gift?

First, the assets must be part of a qualified retirement plan or IRA. A qualified retirement plan is one that receives favorable income tax treatment during the participant's life. You pay no income tax on the contributed funds or on their growth in value while they are in the plan. You pay income tax only when you withdraw the funds.

Second, the assets should be part of a defined contribution plan. Defined benefit plans pay a specific benefit to retirees. Since the payments terminate with the beneficiary's death, there is usually nothing available to leave to charity. On the other hand, when a participant in a defined contribution plan dies, there is often an undistributed portion still in the plan. That undistributed portion can be transferred to other beneficiaries, including a favorite charitable organization.

You can effectively use individual accounts in profit-sharing plans, money-purchase pension plans, 401(k) plans and traditional IRAs for charitable purposes. Our development staff will be happy to answer any questions you may have about the appropriateness of using your retirement plan to make a charitable gift.

Can I use Social Security benefits to make charitable gifts?

Social Security benefits are an integral part of just about everyone's retirement planning. While you cannot have Social Security benefits directed to a charity, you can certainly use some or all of the payment after you receive it to make a charitable gift.

How do I donate retirement plan assets?

The easiest way to donate retirement plan assets is to designate us as a beneficiary. All you need do is contact the administrator of your plan. The administrator will send you the correct forms to sign. If you are married, your spouse must waive his or her right to survivor benefits from the plan (though this is not the case for IRAs).

When you designate us as a beneficiary, as with a charitable bequest, you have considerable flexibility. You can give a specific amount or percentage to us and the rest to other beneficiaries. You can name your spouse as the primary beneficiary and us as the secondary beneficiary. There are many possibilities.

Another option is to have your retirement plan assets transferred at death to a charitable remainder trust. If your spouse is the trust beneficiary, it's possible (by combining this strategy with the unlimited marital deduction) to eliminate all federal estate taxes attributable to the retirement account.

Example: George creates a testamentary charitable remainder unitrust in his will that will pay his wife Barbara 5% of its value annually for as long as she survives him. At her death, the remaining trust assets will pass to our institution. He directs that the trust be funded with his IRA account. Since Barbara's interest qualifies for the estate tax marital deduction and the charity's remainder interest qualifies for the estate tax charitable deduction, the entire value of the trust will be deductible from George's estate.

It's also possible to use a testamentary charitable remainder trust to provide for certain non-spousal beneficiaries. For example, you can designate that your beneficiary receive a lifetime income from the trust (either a fixed or variable income) with the remainder interest going to us. Your estate will get an estate tax charitable deduction for the present value of our remainder interest in the trust.

Also, keep in mind the income tax advantages gained by naming a charitable remainder trust as the beneficiary of an IRA. When the IRA funds are transferred to the charitable remainder trust, the trust pays nothing in income taxes because it is a tax-exempt entity. The full amount of the IRA can be invested in income-producing assets by the trustee without any difficult IRA distribution rules to follow.

How can I benefit from a gift of retirement plan assets?

Contact us to explore the possibilities. Contact your financial advisors, also, to learn more about the complex and constantly changing tax laws on retirement plans. Our development staff is prepared to work with you and your advisors to ensure that your gift generates the best personal and financial benefits.

Please don't hesitate to contact our development office if you have questions about how to coordinate your charitable giving with your plans to preserve more dollars for yourself and your intended beneficiaries.

Tax information provided herein is not intended as tax or legal advice and cannot be relied on to avoid statutory penalties. Always check with your tax and financial advisors before implementing any gift.

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