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Your Questions Answered: Charitable Tax Planning with Retirement Funds

Here are some common questions we get asked when it comes to tax planning with retirement funds:

- How can I avoid sacrificing much of my retirement funds to taxes?
- How can my spouse receive income from my charitable gift of retirement funds?
- How can I provide for my children and fulfill my charitable plans?
- Is there a way to save more for retirement, reduce taxes upon distribution of retirement funds, and make a charitable gift?

This guide describes charitable solutions for each of the situations above. First, let's examine the tax issues that occur with accumulation of retirement funds.

Most of us are putting something away to make sure our retirement is an enjoyable and comfortable one. Total assets in all types of retirement plans are more than $27 trillion, and IRAs make up approximately $8.6 trillion of that total.

Saving for retirement by making contributions through a salary-reduction plan is popular because such contributions are sheltered from taxation in the year they are made. Likewise, interest and other investment income are exempt from income tax prior to distribution. This makes a tremendous difference in the accumulation of funds over time.

While your tax-deferred retirement-plan benefits are a great source of financial security during your lifetime, retirement benefits you leave to your

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children, grandchildren, or other beneficiaries are subject to income tax. That is because contributions (except to a Roth IRA) were made with pre-tax dollars, so the income taxation is deferred until you make a withdrawal or until distributions are made to your beneficiaries following your death. The income tax is never forgiven—merely delayed.

Depending on the size of your estate, the funds in your retirement account at your death may also be subject to federal estate tax. Here are two examples of what a beneficiary (other than a spouse) might receive from a retirement fund with a balance of $1 million—both if your estate is large enough to be subject to estate tax and if it is not:

Retirement funds not subject to estate tax (i.e., do not exceed $11.2 million in 2018)

IRA value	$1,000,000
Federal income tax (37%)	$ 370,000*
Available to beneficiary	$ 630,000

Retirement funds subject to estate tax (i.e., estate is more than $11.2 million plus value of retirement funds)

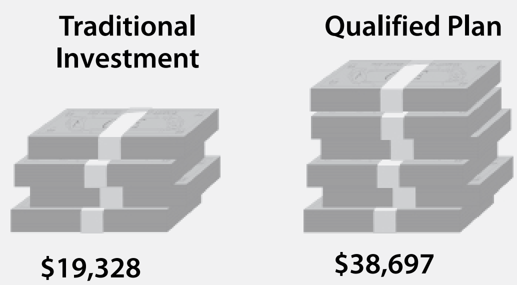
IRA value	$1,000,000
Federal income tax	$ 222,000**
Estate tax (40%)	$ 400,000
Total tax	$ 622,000
Available to beneficiary	$ 378,000

*The income-tax bracket of beneficiaries is presumed to be 37%.
**An income-tax deduction is allowed for federal estate tax paid. If you live in a state with a state estate tax, total tax could be larger.

Qualified Plans: The Money Stacks Up

Compare the results of contributing $10,000 of your salary to a qualified retirement plan with receiving the $10,000, paying tax on it, and investing the balance in a fully taxable account. Suppose you are aged 45 at the time, nothing is withdrawn until you are 65, and the retirement fund and your taxable account both have a constant return of 7%. Suppose further that the average tax rate on the investment account, considering that it consists of interest, dividends, and capital gain, is 20% and that your marginal income-tax bracket at the age of 45 is 35%.

$10,000 Investment Earning 7%



Accumulations in 20 Years

As this differential demonstrates, it is generally a good idea to invest as much as you can in an IRA or qualified retirement plan.

Frustrating, isn't it? Fortunately, there are solutions that can soften the tax bite, and some of them include charitable gifts. Read on to explore strategies you can employ to make sure your heirs keep more of your money while fulfilling your philanthropic objectives.

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

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, your surviving spouse has a choice: (1) treat the IRA as his or her own, in which case the distributions must begin no later than when he or she reaches the age of 70½, or (2) not treat it as a spousal IRA and start distributions no later than when you would have reached 70½. In either case a deferral of payments allows the account to build tax-free for a while longer.

If your surviving spouse substantially consumes the retirement funds during his or her life, little if anything would be subject to estate tax. The disadvantage of making a spouse the beneficiary of your entire retirement fund is that you lose control over the ultimate distribution of those assets.

Stretch payments and reduce annual income tax. If you are not survived by a spouse and you have a child, you could name him or her as the designated beneficiary. The payments can then be stretched out over the child's remaining life expectancy. Then the applicable income-tax rate would probably be lower than if the child received the entire funds in a lump sum.

Use retirement funds for charitable estate gifts. If you plan, at the end of your life, to make gifts to charities as well as to heirs, you are likely to save more in taxes if you give retirement-fund assets to charity and give securities, real estate, or cash to heirs. The heirs would get a stepped-up basis in the stock and real estate and thus be taxed only on the post-gift gain, but they would be taxed on every dollar of retirement funds unless the funds derived from a Roth IRA. The retirement funds would pass to the charity free of both income tax and estate tax.

To arrange such a charitable gift to support our work, you merely request a change-of-beneficiary form from your retirement-fund administrator and name us beneficiary of all or a percentage of whatever remains in your plan. We would receive our share in a lump sum, and the balance can be paid to the noncharitable beneficiaries according to whatever schedule they elect. If family circumstances change, you can alter the percentages by completing a new beneficiary-designation form. This does not necessitate a change in your will.

I like the idea of making a charitable gift of retirement funds, but I want my spouse to receive income from all of those funds. Is there a way to do this?

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

Example: John creates a charitable remainder unitrust and names it beneficiary of 50% of his IRA and names his wife Marjorie beneficiary of the other 50%. The trust will pay Marjorie 6% of trust assets, as revalued annually, for the duration of her life. Then the trust will terminate, and the remainder will be distributed to our organization. At John's death, $1 million remains in his IRA, so $500,000 is paid to the

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unitrust. Marjorie will receive $30,000 the first full year of the trust, an amount that will increase in value if the trust assets grow in value. When the IRA funds are distributed to the unitrust, they are subject to neither estate tax nor income tax. The payments from the unitrust will be taxed to Marjorie as ordinary income, but IRA distributions are also fully taxable unless it is a Roth IRA. At the end of Marjorie's life, the trust will terminate and its principal will be paid to us to support our work.

How can I provide for my children and fulfill my charitable plans?

One way is to establish a **charitable remainder trust naming your children as beneficiaries**. You could have the payments made to them for the duration of their lives (unless they are too young for the trust to qualify) or for a period of years not exceeding 20. A portion of the funds paid to the trust (the value of the children's income interest) would be subject to estate tax if the value of your estate exceeds the exemption level, but none of the funds would be subject to income tax when paid to the trust. This means that the entire amount paid to the trust can be reinvested to generate income.

This arrangement ensures a future gift to a charity while providing for children. It also preserves for family and charitable purposes assets that would have otherwise been consumed by taxation.

The total benefits for your children may be greater than if you had simply left them your retirement funds as a lump sum. See the following chart.

Bequest vs. Charitable Remainder Unitrust

Tom leaves an estate that is significantly larger than the federal estate-tax exemption, so it will be subject to estate tax. This chart compares (1) leaving an additional $1 million after-tax to the children and (2) contributing the $1 million to a charitable remainder unitrust that will pay income to the children for 20 years.

	Lump-sum bequest	**Charitable unitrust**
Retirement assets	$1,000,000	$1,000,000
Estate tax	$ 400,000	$ 254,188*
Income tax	$ 222,000‡	-0-
Total tax	$ 622,000	$ 254,188†
Net to children	$ 378,000	Payments for 20 years less income tax on those payments

*Factors in the estate-tax charitable deduction, unitrust with a 5% annual payout, payments for 20 years.
†Assumes estate tax paid from other estate assets.
‡Assumes children in a 37% tax bracket.

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

Yes, you could create and fund a **charitable remainder trust** so that distributions to the beneficiary may be mostly taxed at a lower capital-gain tax rate. For taxpayers in upper ordinary-income tax brackets, this can significantly cut their tax rate.

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

Example: Bill, 55, is self-employed and plans to retire in ten years. He has long been contributing the maximum amount allowable to his retirement 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 probably provide a very comfortable retirement-income stream. However, he wants to accumulate still more 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 the 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 ten years.

Following the ten-year period the trustee can begin selling some of the trust assets, which will have grown in value. The trust agreement contains a provision allowing the capital gain realized on the sale of these assets to be paid to Bill to the extent it does not exceed the total unitrust percentage amounts not paid to him during the growth period. The tax rate Bill pays on these distributions of gain will be less than the rate he would pay on ordinary income.

Making a Lifetime IRA Gift

Possibly, you would like to make your charitable gift of retirement funds now and see the results of your gift. If you are over the age of 70½ and have an IRA, you can advise your IRA administrator to transfer to charities up to $100,000 per year from your IRA without having the amount transferred added to taxable income—but having it count towards your mandatory distribution. The annual limit refers to transfers to all charities combined, not $100,000 per charity.

With the enactment of the new tax law, which took effect January 1, 2018, this option may be even more attractive because of the doubling of the standard deduction. Increasing the standard deduction means fewer people may itemize, and the IRA charitable rollover is a perfect gift vehicle for non-itemizers.

Let Us Help

These are but a few ideas to help you plan 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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