

THE BENEFITS OF NAMING A CHARITY AS THE BENEFICIARY OF A RETIREMENT ACCOUNT

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I Introduction:

Many of our clients have accumulated a significant amount of wealth in their retirement accounts ranging from IRAs to employer sponsored 401(k)s, profit sharing plans and 403(b)s to name a few. While the intention in establishing these accounts is to save for retirement, many of our clients end up with unconsumed balances in these accounts at the time of death. Therefore, these accounts have become a significant vehicle for wealth transfer.

While tax deferral makes retirement accounts a tremendous vehicle for retirement savings, tax deferred retirement accounts are not an ideal asset to pass on to non-charity beneficiaries. Unlike most assets that are passed on along with a step up in basis, most retirement accounts are considered income in respect of decedent meaning a non-charity beneficiary gets stuck with the deferred income tax burden following the death of the account owner.

If the beneficiary of a retirement account is a tax-exempt charity, the charity can take a tax-free withdrawal of the account balance following the account owner's death. Since the untaxed balance in these accounts at the time of the account owner's death will never be subject to income tax when left to charity, there is often no better asset available to satisfy our client's charitable objectives. Most plans allow the account owner to carve out a specific dollar amount or percentage for charity. The client may also be able to set up a separate retirement account for a charity by splitting up an existing account or creating a new account.

The fact that our clients are often not aware of the benefits of designating a charity as a beneficiary of their retirement accounts makes it imperative that we keep this simple planning tool in mind as an option for those clients who wish to make charitable gifts at the time of their deaths.

By leaving tax-deferred assets to charity, the client will be free to designate assets receiving a basis step up to non-charity beneficiaries through their Wills, Revocable Trusts or payable on death accounts. It is imperative that we assist our clients not only with determining their estate planning objectives, but also that we assist them in achieving these objectives in the most tax efficient manner possible. Leaving the

appropriate asset to the appropriate beneficiary is the first step toward a tax efficient transfer of our client's accumulated wealth.

- II. Will naming a charity as beneficiary have any impact upon required minimum distributions during the account owner's lifetime?

Under the old distribution rules when a charity was named as a beneficiary, the account owner was treated as having no designated beneficiary for purposes of determining lifetime distributions. Thus, naming a charity as beneficiary of a retirement account would result in the employee taking required minimum distributions over his or her own life expectancy as opposed to a joint life expectancy of the account owner and another person. This was true even where individuals were named as co-beneficiaries with the charity.

Under the new regulations, the account owner can take lifetime distributions using a uniform table even if the account owner has not named a designated beneficiary, or has named a beneficiary such as a charity that has no life expectancy. The table uses the age of the account owner and a fictional person 10 years younger than the owner to determine the lifetime distributions.

- III. Following the account owner's death, what is the impact on a non-charity beneficiary's required distribution schedule when a charity is named as one of several beneficiaries on the account?

Old Rules: Assuming the 5-year distribution rule did not apply, the old distribution rules penalized the non-charity beneficiaries by treating all of the beneficiaries as having the life expectancy of the charity, which of course is zero. This would result in larger minimum distributions for the non-charity beneficiaries than would have been required had a charity not been listed as a beneficiary on the account. This was because the old rules calculated post death distributions based on the identities of the account beneficiaries as of the owner's date of death.

New Rules: Under the new distribution rules, the deadline for determining the identity of the account beneficiary for purposes of determining required distributions is September 30 of the calendar year following the year of the account owner's death. While the identity of the beneficiaries listed as of the account owner's death cannot be changed, the new regulations provide some opportunities following the death of the account owner to prevent non-charity beneficiaries from getting stuck with the charity's zero life expectancy for

purposes of determining required distributions. In other words, the naming of a charity as one of multiple beneficiaries of a retirement account does not necessarily mean that the charity's zero life expectancy would apply to the non-charity beneficiaries. There are essentially two ways to prevent this from happening:

i) Establishment of Separate Accounts: Under the new rules, it is possible to establish separate accounts for the charity and non-charity beneficiaries following the death of the account owner, but no later than September 30th of the calendar year following the year of the account owner's death. This will allow a non-charity beneficiary to take distributions from his or her separate account using his or her own life expectancy.

ii) Paying out the Charity's Share: The new applicable date for determining the beneficiaries (September 30 of the year following the year of death) allows time for a lump sum payout of the charity's share before the September 30 deadline. Once the charity's share of the account has been paid out, the remaining beneficiaries will be allowed to take minimum distributions from the account over the life expectancy of the oldest remaining beneficiary, or over their individual life expectancies if the account is split into separate accounts for each remaining beneficiary.

IV. How does naming a charity as a beneficiary of a retirement account help minimize estate taxes?

As with other testamentary transfers to charity, leaving retirement assets to charity allows the estate to take a charitable deduction on the Federal estate tax return based upon the value of the charitable bequest. As demonstrated in Section V of this outline, leaving retirement assets to charity can achieve maximum tax benefits for the estate and estate beneficiaries since this technique will allow both a deduction for estate tax purposes and the continued tax deferral on income that has built up inside the retirement account as of the account owner's date of death.

IV. How can we quantify the tax benefits of using a retirement account to satisfy a client's charitable objectives?

Example: Mary's estate consists of the following assets:

- \$1,000,000 IRA
- \$1,300,000 farm
- \$300,000 cash
- \$250,000 life insurance

\$2,850,000 Gross Estate

Mary is interested in leaving the bulk of her estate to her 3 children, but also would like to make a \$300,000 charitable bequest to the Boys and Girls Clubs. Mary's Will currently provides for the \$300,000 bequest to the Boys and Girls Clubs. Her Will leaves the residue of her estate to her 3 children. Mary's children are named as equal beneficiaries of her IRA and her life insurance. Mary is in poor health and asks you if there is a more tax efficient way to accomplish her estate planning objectives.

Option 1: Make no changes.

Option 2: Change the beneficiary designation on Mary's IRA to leave \$300,000 to the Boys and Girls Clubs and the balance of the IRA to Mary's children. Change Mary's Will to leave everything to Mary's children since the charitable bequest will be satisfied from the IRA. Leave the children as the beneficiaries of the life insurance.

Mary dies a short time after coming to see you, and the federal estate tax exemption is \$1,500,000 at the time of her death.

What are the tax implications of these two options?

Option 1:

-Estate Tax: Approximately \$489,000 based on a net estate of \$2,550,000 after the \$300,000 charitable deduction, and assuming no other deductions.

Assuming the charitable deduction was satisfied from the cash passing under Mary's Will, the estate now has a cash shortage of \$239,000 (\$489,000 estate tax - \$250,000 of life insurance).

-Income Tax: Approximately \$160,000*
(Assuming Mary's children withdraw only the portion of the IRA needed to pay the estate tax)

Unless the farm can be sold within 9 months for a reasonable price, Mary's children will be forced to liquidate a portion of the

\$1,000,000 IRA to come up with the extra \$239,000 needed to pay the estate tax. Assuming the children are all in a 33% federal income tax bracket and 7% state income tax bracket, and further assuming that the entire distribution amount will be treated as ordinary income, the children will be forced to liquidate approximately \$400,000 of the IRA to produce \$240,000 of cash.

*IRC § 691(c) will allow the children to take an income tax deduction as a result of the inclusion of the IRA in Mary's gross estate for estate tax purposes. This deduction is not figured into the income tax calculation shown above. To be eligible for this deduction, the children must itemize deductions on their individual returns. This deduction is not subject to the 2% of AGI floor on miscellaneous itemized deductions.

- Amount Received by Beneficiaries:

-Boys and Girls Clubs=	\$ 300,000 Net to Charity
-Mary's Children=	\$1,300,000 farm
	<u>\$ 600,000</u> balance in IRA
	\$1,900,000 Net to Children

Option 2:

-Estate Tax: Approximately \$489,000 based on a net estate of \$2,550,000 after the \$300,000 charitable deduction, and assuming no other deductions.

Since the IRA was used to satisfy the \$300,000 charitable bequest, the estate can pay the estate tax from the cash and life insurance proceeds.

-Income Tax: \$0**

** This assumes the children do not take a distribution from the IRA at Mary's death since they are not required to do so to pay estate tax. They will pay income tax on the untaxed portion of the IRA at their individual rates at such time as they are required to take distributions.

-Amount Received by Beneficiaries:

-Boys and Girls Clubs=	\$ 300,000 Net to charity
-Mary's Children=	\$1,300,000 farm
	\$ 700,000 IRA
	<u>\$ 61,000</u> net cash after estate taxes
	\$2,061,000 Net to Children

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