Giving Qualified Retirement Assets to Charity

Many people who are at or near retirement age have accumulated large sums in their IRAs or other qualified plan accounts, yet they don't foresee ever personally needing most of this money for their own retirement needs. Other than the required minimum distribution amounts they will have to take out after age 70½, the assets in their qualified accounts will pass to their heirs as "income in respect of a decedent (IRD)"[1] and be taxable as ordinary income to them as the money is received.

In many cases, these same qualified plan assets will also be subject to federal estate taxes at the owner's death. While the beneficiary is allowed an income tax deduction for the portion of any estate taxes paid on the asset, the total tax cost can still be significant.

For example: Moses Basset, a 65 year-old widower, has a taxable estate of $10 million, which he intends to leave equally to his four grown children, Lemon, Gomer, Sherman and Dorothy. $2 million of the estate is in an IRA. If he were to die in 2007, federal estate tax attributable to the portion of the estate comprised of the IRA would be about $900,000, effectively reducing the IRA value to only $1.1 million. If the children are each in the 25% tax bracket, the children would collectively owe about $275,000 in income taxes on the balance. Assuming they all took lump sum distributions of their portions of the $1.1 million, they would be left with a total of $825,000 after payment of all federal income and estate taxes. Yet things could even be worse. Had Moses instead left the IRA to his four grandchildren, and assuming that he had already used his $2 million generation skipping transfer tax (GSTT) exemption, less than $575,000 might be left after all federal taxes were paid.

Charity as Beneficiary. Is there a way for your clients to avoid having their qualified plan assets carved up by taxes at their deaths? Absolutely – assuming that they are charitably inclined. Naming a charity as beneficiary of the IRA will prevent any federal estate or income taxes from being incurred on the IRA. Unfortunately, this approach also means that the client's heirs will lose that portion of their inheritance. The way to address this is for your clients to also establish, and fund, *a wealth replacement trust*. Here is an example of how that might work:

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Moses Basset was pretty sad to learn that his children might receive only about $825,000 after taxes from his $2 million IRA. So, after meeting with both his attorney and financial advisor, he came up with a different plan.

Instead of having his children receive his IRA, he changes the designation so that the American Humane Society, a charitable organization close to his heart, will receive it all. Leaving the IRA to charity avoids any post-death federal income or estate taxes on this money.[2]

At about the same time, his attorney establishes an irrevocable wealth replacement trust for the benefit of his four children. The trust buys a level death benefit (Option 1) $2 million Lifetime FlexPlus[SM] life insurance policy on Moses. Assuming Moses qualifies for Preferred No Nicotine Use rates, the annual level premium payment to age 100 required to ensure a lifetime guarantee[3] is $41,617.

Moses makes annual exclusion gifts[4] to the trust, which then uses that money to pay the life insurance premiums. Prior to age 70 ½, Moses takes voluntary annual distributions from his IRA, pays ordinary income taxes on those distributions, then uses the proceeds to fund the gifts to the wealth replacement trust. After turning 70½, Moses continues to take distributions from the IRA, except these are now based on his Required Minimum Distributions (RMD) schedule. The first RMD payment would be approximately $72,992, assuming an IRA account balance of $2 million at the time of valuation. If Moses is in the 35% federal income tax bracket, he would net about $47,445, more than enough to make his annual gifts to the trust.

When Moses dies, the charity receives the balance remaining in his IRA income tax free, and his estate is reduced by this amount for purposes of determining federal estate taxes. The wealth replacement trust receives $2 million from the life insurance policy, and distributes this amount income tax free to the beneficiaries. Since the wealth replacement trust is not part of Moses' estate, there is no estate tax charged against this amount

The results benefit all involved. Moses' estate avoids paying estate taxes on the IRA; his children receive an amount comparable to the full amount of the IRA, but not reduced by federal taxes; and the American Humane Society receives a substantial donation at Moses' death, not the IRS.

[1]"Income in respect of a decedent" (IRD) refers to those amounts to which a decedent was entitled as gross income, but which he did not take into income before he died, and which therefore were not includable in his taxable income for the year of his death. No step-up in basis is permitted for IRD. In addition, the tax liability on IRD goes with the asset –the beneficiary receiving the IRD must pay income taxes on it, not the decedent's estate.

[2]An estate tax deduction is allowed for the full amount of a bequest to charity. The deduction is not subject to the same percentage limitations as are applicable to charitable income tax deductions.

[3]A conditional guarantee that keeps the policy in force when policy values are too small to do so. Certain policy rights, if exercised by the owner, will end this guarantee. In addition, an unpaid policy loan may terminate coverage.

[4]The annual gift tax exclusion under Internal Revenue Code Section 2053 is $12,000 in 2007. There are four beneficiaries of the trust, therefore Moses can gift up to $48,000 per year to the trust without incurring gift taxes (assuming he hasn't made any other gifts to the beneficiaries during the year). The gift of cash for the premium must be a present interest gift in order to qualify for the annual gift tax exclusion. For this reason, many trusts provide the

trust beneficiaries a 30- to 60-day period during which they can exercise the power to take the cash given to the trust to pay the premium. This is called a Crummey power.

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