Kristin A. Hermann, J.D., CFRE
Cranbrook Educational Community
Office of Advancement
P.O. Box 801
Bloomfield Hills, MI 48303-0801
cranbrook.giftplans.org
cranbrook.edu

Your Questions Answered: Charitable Tax Planning with Retirement Funds

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Here are some common questions we are asked regarding tax planning with retirement funds:

- How can I avoid sacrificing much of my retirement funds to taxes?
- How could my spouse receive income from a charitable gift of retirement funds?
- How could 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, but it first examines the tax issues that occur with accumulation of retirement funds.

Most of us are putting something away to make sure our retirement is enjoyable and comfortable. Total assets in all types of retirement plans are more than $35 trillion, and IRAs make up more than $12 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 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 that large:

Retirement funds not subject to estate tax (i.e., do not exceed $12.06 million in 2022)

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 $12.06 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

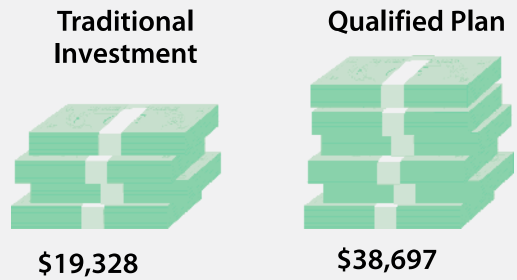
*The income-tax bracket of beneficiaries is presumed to be 37%. If it is lower, the net amount to beneficiaries would be somewhat larger.
**An income-tax deduction is allowed for federal estate tax paid. If you live in a state with a state estate tax, total tax could be larger.

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 loved ones keep more of your money while fulfilling your philanthropic objectives.

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.

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

Here are some ideas you might consider:

Delay receiving 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 72, 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 72; or (2) leave the account in your name and start payments no later than when you would have reached 72. 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. Previously, if you were survived by a nonspousal beneficiary—an adult child, for instance—the payments could have been stretched over the child's remaining life expectancy, and the income-tax rate on distributions would likely have been lower than if they were taken in a lump sum or over a short period. However, the SECURE Act, enacted in December of 2019, requires that retirement funds given to a nonspousal beneficiary must be fully distributed within ten years, unless that beneficiary is a minor child, disabled, chronically ill, or ten years or less younger than the account owner.

You can still arrange to have those payments made to a nonspousal beneficiary for life, or for a period up to 20 years, if you name a charitable remainder trust the beneficiary of the retirement funds and have trust payments made to the individual. (See below for more details.)

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 loved ones, you are likely to save more in taxes if you give retirement-fund assets to charity and give securities, real estate, or cash to loved ones. 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 unitrust. Marjorie will receive $30,000 the first full year of the trust. Each year thereafter, she will receive 6% of the value of trust assets as of the beginning of the year. When the IRA funds are distributed to the unitrust, they are subject neither to 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.

When the beneficiary of an IRA is the surviving spouse, it is not necessary to create a charitable remainder trust in order to stretch payments over life—as it now is for a nonspousal beneficiary. However, a person may choose to provide for the surviving spouse through such a trust in order to ensure a charitable gift and provide income to the spouse without management responsibility.

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

As noted above, one way is to establish a charitable remainder trust naming your children as beneficiaries. Depending on their ages, you could choose to have trust payments made to them for life or for a period of up to 20 years.

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 levels, which in 2022 are $12.06 million for a single person and $24.12 million for married persons who combine their exemptions. Even if you have a high net worth and your estate size exceeds the exemption amount, 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 the after-tax results of (1) leaving an additional $1 million 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	$ 255,108
Income tax	$ 222,000*	-0-
Total tax	$ 622,000*	$ 255,108
Net to children	$ 378,000	Payments for 20 years less income tax on those payments**

*Assumes children in a 37% tax bracket.
**Unitrust with a 5% annual payout with payments for 20 years factoring in the charitable deduction.

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** for yourself. The trust would be designed to pay you only net income while you are working and then a percentage of trust assets once you retire. That net income during your working years would be modest—basically just large enough to cover trust expenses—because the investment objective would be growth. That growth results in more income when you retire because at that point you start receiving a percentage of trust assets.

Unlike retirement plans, such as a 401(k) or IRA, there is no limit to how much you can contribute to the charitable remainder unitrust. Also unlike those plans, you can contribute appreciated securities and you will not be taxed on the gain when you transfer them. A significant portion of your distributions from the trust upon retirement may be taxed at the lower capital-gain tax rate rather than at the ordinary-income rate applicable to retirement-plan distributions (other than a Roth IRA).

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 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 initially will pay him only net income. He contributes $100,000 to establish the trust, and each year until he quits working he makes an additional contribution to the trust of whatever surplus he has available. Often it is in the $25,000-$50,000 range. Suppose that the trust has grown to $700,000 by the time of his retirement. He would then start receiving 5% of trust assets, which in the first year of retirement would be $35,000. This will be a nice supplement to his retirement income from other sources.

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. (Note that under the SECURE Act, the age when mandatory distributions must begin was raised from 70½ to 72.)

Because another law, the Tax Cuts and Jobs Act, enacted in 2017, essentially doubled the standard deduction, fewer people now itemize their deductions. If you are one of them and you are subject to mandatory distributions, it could be advantageous to make an intended gift through a qualified charitable distribution from your IRA. Even if you don't itemize deductions in general, you effectively get a deduction from an IRA gift because it is not included in your income as it would be if you simply withdrew the required amount.

Let Us Help

These are but a few ideas to help you plan for your retirement and for the future of your loved ones—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.