Beneficiary Designations of Retirement Plans and IRAs

Retirement accounts, which include pension plans, profit sharing plans, stock bonus plans, Keogh Plans, 401(k) plans and Individual Retirement Accounts (IRAs), generate a number of tax consequences at the time of death of the owner. These tax consequences make qualified retirement assets and IRAs appropriate as charitable giving vehicles.

Contributions to qualified retirement plans allow a deferral of the income tax on those assets. This incentive is provided to encourage taxpayers to save for retirement. However, this tax is only deferred. The assets and income generated by those assets inside the retirement plan is taxed on distribution.

When an individual dies with assets remaining in a retirement plan, several taxes may be due:

> **Income Taxes** are owed on assets on which the decedent would have paid income tax if alive. This tax is assessed in the form of Income in Respect of a Decedent (IRD). The taxis incurred as distributions of untaxed contributions and earnings are made from the plan. This tax may run up to 39.6% at the federal tax rate, in addition to state taxes.
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> **Estate Tax** will apply for the full market value of the asset in the decedent's estate. The marginal rate for this tax is 55%.
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> Finally, **Generation Skipping Tax** may apply if the owner directs that the plan assets be distributed to a beneficiary two or more generations below the owner. For example, the tax applies when property passes from a grandparent to a grandchild, since the grandchild is two generations younger than the donor-grandparent. This tax is assessed at a flat rate equal to the maximum estate tax rate (55% in 1998).

Prior to the Taxpayer Relief Act of 1997, a fourth tax was due. This tax, the excess accumulation tax, was assessed at the rate of 15% on retirement plan assets with a value in excess of certain limits, and distributions in excess of $150,000 in a calendar year. Congress first suspended this tax for three years, and then repealed the tax altogether in TRA 1997. It is mentioned here because the tax figured prominently in many commentator's remarks on retirement planning and the gift planner that is new to the field may have a hard time understanding those remarks without notice of the change in the law.

The impact of these taxes on the retirement plan assets depends upon the beneficiary designations made by the taxpayer. For example, he or she may name a spouse and defer both income and estate taxes until the spouse's death. Or, a child may be named as a beneficiary, which may trigger the estate tax on the assets but defer the income tax until distribution over the child's lifetime. When the donor names the estate as beneficiary of a retirement plan, the transfer may trigger tax on IRD (income in respect of a decedent) in the retirement plan. In addition, estate tax will be due. Obviously the decision about how the beneficiary designation is structured is important and donors should be encouraged to discuss these options with a financial advisor.

Talking with donors: Few donors are aware of the taxes due on retirement plan assets. Retirement plans were originally designed to be used during life for support and maintenance. The huge growth of the securities markets in the 1990's created enormous wealth inside these plans. Many taxpayers found that their retirement plan assets grew, even when they took the required annual distribution. As these plans began to represent a significant portion of total wealth, people began to consider retirement assets as part of the overall estate that would be passed to the next generation.

Education is the best way to raise awareness about this issue. Include articles in your newsletter, raise the issue in board meetings, and focus on the topic in seminars. One of the simplest ways to plan a deferred gift is to name the nonprofit as the beneficiary of the retirement plan and use estate assets for distributions to family.

Transfer requirements. Retirement plans can not be transferred to charity during life without triggering income tax on the transferred proceeds. The only way to transfer an IRA or retirement plan benefit without triggering tax is through a beneficiary designation.

The donor has several options in structuring a retirement plan or IRA gift to charity:

1. The donor can make an outright gift of the IRA to a qualified charitable beneficiary by naming the charity (or several charities) as the beneficiary of the plan. When the donor wants to transfer only a portion of the IRA to charity, he or she should either split the IRA into pieces so that the charity is the sole beneficiary of a designated IRA, or name the charity as the beneficiary of a fractional (not pecuniary) interest.

2. A second option is to name a charitable remainder trust as the beneficiary of the retirement plan. Transfers of retirement plan assets to a charitable remainder trust should avoid tax assets to a charitable remainder trust should avoid tax on IRD since the charitable remainder trust is a non-taxable trust. It should also generate a charitable estate tax deduction for the charitable portion of the transfer. If the transfer to the charitable remainder trust pays income to the spouse only, the portion of the transfer that does not qualify for the charitable estate tax deduction will qualify for the marital estate tax deduction, thus avoiding all estate tax. The bottom line is the transfer to a charitable remainder trust may accomplish the dual goals of making distributions to family members as well as implementing a gift to charity. This method preserves an income stream to the decedent's dependents, and may in some instances pass a greater amount of property to family members.

3. Finally, the donor may name the estate as the beneficiary of the proceeds, but specifically6 direct that the assets of the IRA or retirement plan be used to satisfy the bequest. A specific bequest of the retirement plan assets should avoid tax on IRD assets passing to the charity. In the absence of a specific bequest, IRD will be triggered.

The best way to examine the impact of taxes on the value of an IRA or retirement plan asset is to look at a few examples. The first example assumes that Dad Donor has a $250,000 IRA and a total estate of $2,000,000. The example compares the results of an outright gift of the IRA to family versus a gift of the IRA to a 6% charitable remainder trust.

The second example assumes that Dad Donor has a $1,000,000 IRA and a total estate of $10,000,000. Again the example compares the difference between a gift to family and a gift of the IRA to a 6% charitable remainder trust. These calculations were made in February 2000. The chart below provides a quick review of the results of these examples.

Pay particular attention to:

- the differences in the effective tax rates of the IRA,
- the value of the property passing to the family under will, and
- the income stream from the charitable remainder trust for the family in each scenario.

Comparison of Results of Gifts of Retirement Assets to Charity

	$250,000 IRA $2,000,000 Estate No Gift to Charity	$250,000 IRA $2,000,000 Estate Gift of IRA to 6% CRAT	$1,000,000 IRA $10,000,000 Estate No Gift to Charity	$1,000,000 IRA $10,000,000 Estate Gift of IRA to 6% CRAT
Total Tax on IRA	$166,950	$78,199	$728,200	$382,305
Effective Tax Rate	66.78%	27.29%	72.82%	33.36%
Property passing to family under will	$1,302,250	$1,234,022	$4,620,750	$4,703,809
Amount of after-tax income from CRAT to family	n/a	$300,000	n/a	$1,200,000
Amount of property passing to CRAT at end of term	n/a	$822,750	n/a	$3,291,000