




**HOW TO MAKE CHARITABLE GIFTS
FROM YOUR IRA**

DONOR'S GUIDE



HOW TO MAKE CHARITABLE GIFTS FROM YOUR IRA

*T*hanks to the success of tax-deferred investments within qualified retirement plans, many people have found that they have sufficient funds for retirement and that they will probably have funds left for distribution to heirs and charitable causes they wish to support. Recent changes in the distribution laws governing individual retirement accounts (IRAs) have made it possible to keep more of your tax-deferred dollars intact for heirs, and they have made it easier to give all or part of IRAs to charitable organizations you wish to help.

You can make a charitable gift from your IRA either during your lifetime or as a bequest at death. An IRA can be a very attractive source for making a charitable gift because distributions from most IRAs, not including the Roth IRA, are taxable. The income tax sting can be eliminated during your lifetime with an offsetting charitable income tax deduction. Upon a person's death, it is possible to structure a charitable bequest in such a way that the taxable IRA payments are made directly to a tax-exempt charitable organization so neither the




estate nor the heirs will have to report any taxable income from the IRA distributions.

Making a Charitable Gift During Life

You can make a charitable gift from an IRA during your lifetime, but the tax laws will require you to first report the distribution on your income tax return and then claim an offsetting charitable income tax deduction. Several bills have been proposed in Congress that may permit tax-free lifetime transfers from IRAs to charitable organizations in the future, but until such a law is enacted, every lifetime distribution from your IRA will have to be reported on your income tax return.

By way of background, any distribution from your IRA—even if it is paid directly to a friend or a charitable organization rather than to you—will trigger taxable income to you in the year of distribution. Under current law, a person cannot make a gift from an IRA during his or her lifetime without reporting the distribution as taxable income on his or her income tax return. The advantage of making a gift to a charitable organization, though, is that there will be an offsetting



charitable income tax deduction so that virtually no tax will be due from the distribution. In the year you make the gift, the charitable deduction is limited to 50 percent of your adjusted gross income. You can, however, carry it over for five additional years if necessary.

***Example:** Martha instructs her IRA administrator to write a check for \$15,000 to her sister and another check for \$20,000 to a charitable organization. Although the checks may have been issued directly from the plan to the sister and the charitable organization, at the end of the year Martha will receive a Form 1099-R from the plan, which states that she must report \$35,000 of income. She can, however, claim a \$20,000 charitable income tax deduction up to 50 percent of her adjusted gross income for the charitable contribution of \$20,000.*

A Better Strategy: Donate Stock and Keep Your IRA Distribution


Usually the best tax-saving strategy for lifetime charitable gifts is to contribute publicly traded stock or mutual funds instead of cash or an IRA distribution. Charitable gifts of appreciated stock and mutual



funds are a very effective way to offset the tax liability you would usually incur from receiving IRA distributions. The greatest tax savings occur with gifts of appreciated stock or mutual funds that you have held for more than one year (where the sale would have produced a long-term capital gain) because you can deduct the market value of the gift up to 30 percent of your adjusted gross income instead of just the cost basis.

***Example:** Joanne owns \$10,000 of XYZ stock she purchased years ago for \$2,000. She also receives a \$10,000 distribution from an IRA because she is over the age of 70½ and is required to receive distributions. If she gives the \$10,000 IRA distribution to a charitable organization, she will have an offsetting \$10,000 charitable income tax deduction up to 50 percent of her adjusted gross income. She will pay virtually no tax on the IRA distribution.*

Joanne would be better off, however, contributing the stock to the charitable organization rather than giving the \$10,000 IRA distribution. Either gift will produce a \$10,000 income tax charitable deduction, but by giving the stock she will forever avoid paying a long-term capital gains tax on the \$8,000 of appreciation.



If she wants, she can purchase new shares of the same XYZ stock for \$10,000, and then her basis in the new shares would be \$10,000 instead of the original \$2,000.


IRAs as Charitable Bequests

An IRA can be one of the best assets to use for a charitable bequest.

While normally an inheritance is exempt from income tax, distributions from an inherited IRA to the beneficiary are usually fully taxable. The payments are classified as “income in respect of a decedent” (IRD). IRD is the exception to the rule that most inheritances are exempt from the income tax.

Example: *Assume Frank would like to treat his two grandchildren, Patty and Michael, equally. Upon his death, he leaves Patty \$100,000 of stock that he had purchased for \$60,000. He leaves his \$100,000 IRA to Michael. When Patty receives her \$100,000 of stock, she will not have to pay any income tax. In fact, she obtains a “stepped-up” basis in the stock so that if she sells the stock for \$100,000 she will pay no income tax.*

By comparison, when Michael receives the \$100,000 from the

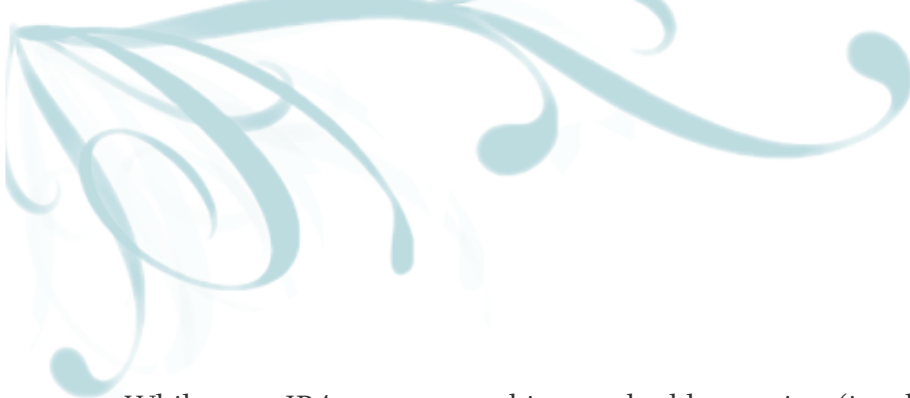


IRA, the entire amount will be subject to income tax because all IRA distributions are taxable, even after death. Consequently, Frank did not treat his two grandchildren equally. Michael will have less money than Patty after he pays the income tax liability.

If you are planning to make a charitable bequest, you should consider leaving the taxable IRA assets to your favorite charitable organization so your family and friends will receive more of the other income tax-free assets (e.g., cash, stock and real estate). The organization will not be worse off. It is tax-exempt and will be able to keep the full amount of every IRA distribution without paying any income taxes.

Estate Taxes and Your IRA

Whereas the highest current estate tax rate is 46 percent, inherited IRAs are subject to an even higher tax rate because each distribution will trigger an income tax liability. For most taxable estates over \$2 million, the combination of federal income and estate tax rates on IRA assets can reach 65 percent. If your state has an income tax, those assets could be facing a total tax rate of nearly 70 percent!



While your IRA assets are subject to double taxation (i.e., both federal estate and income taxes), the IRS allows the IRA beneficiary to take an income tax deduction for the estate taxes paid on the IRA. Without this deduction, your IRA could be taxed up to well over 80 percent or more.

To show the benefit of the tax deduction consider the following:

Example: *Assume that Kathryn's total taxable estate is \$3.2 million and that all of it will be transferred to her sole heir, her daughter. If \$100,000 in an IRA is distributed to the daughter and the daughter is in a 35 percent marginal income tax bracket, then the combined estate and income taxes after the deduction is factored in would be roughly 65 percent (\$64,900) on the \$100,000 IRA. Without the deduction, the daughter may have paid more than 80 percent of the IRA in federal and state taxes.*

A Charitable Solution

A bequest of your IRA assets to a charitable organization avoids all estate and income taxes. The organization will keep 100 percent of the IRA assets and will apply them to a charitable purpose you choose.



How does this work? First, your estate may claim a charitable estate tax deduction because the IRA will be transferred to a charitable organization.

Second, if you name the charitable organization as the beneficiary on the IRA forms and if the IRA is distributed directly to the organization after your death, then neither your estate nor your heirs will have to report any taxable income from the distribution! Instead, the charitable organization will have to report the income.

This leads to the third point: Because the organization is tax-exempt, it will not have to pay any income tax when it receives the distribution. Thus, instead of having the government decide how to spend nearly 70 percent of your IRA assets, you can apply 100 percent of those assets to a charitable purpose that is important to you.

How to Make a Charitable Bequest of An IRA

The best way to make a charitable bequest of your IRA assets is to name your favorite charitable organization(s) as the beneficiary on your IRA beneficiary designation forms. Please note: Your will does *not*



govern your IRA. An IRA is a separate trust or custodial account that usually passes outside of probate. The most important document, therefore, is the beneficiary designation form you receive from the IRA administrator.

If you would like to leave some of your assets to a charitable organization and the rest to other people, such as family members or friends, then extra steps may be advisable. There are explicit rules for mandatory distributions from your IRA after you reach age 70½ and after you die.

One alternative is to establish a separate IRA account for the charitable organization. You can take part of your existing IRA and move it into a new IRA naming the charitable organization as the beneficiary. The best way to accomplish this is through a “direct rollover” or a “trustee-to-trustee transfer,” which avoids the 20 percent withholding tax that normally applies to IRA rollover distributions.

It is not necessary, however, to establish multiple IRAs, some for charitable organizations and some for individuals, to avoid the problem of accelerating distributions over the individuals’ lifetimes.

During your lifetime, the minimum distributions of your IRA are the



same even when a charitable organization is named as beneficiary. After your lifetime, however, the administrator must “cash out” the charitable organization’s share of the IRA before Sept. 30 of the year that follows the year of your death. By doing so, it will leave only noncharitable beneficiaries and will give them greater flexibility to stretch out the receipt of their distributions than if the charitable organization were still a beneficiary. Overall, this cash-out strategy permits a charitable organization to be a beneficiary of part or all of any IRA or retirement plan account without causing accelerated distribution problems to other beneficiaries, such as children.

IRA Distributions

As noted earlier, once you attain age 70½, you are subject to the required distribution rules and must begin receiving amounts from all of your IRAs or face a 50 percent penalty tax. You can always take out more than the required amounts. They are merely the minimum to avoid the penalty.

While the Treasury has simplified the rules for determining your minimum distribution amounts, it has also aided the ability to enforce



the distribution rules. Every IRA administrator is required to report to you and the IRS the amount of the minimum required distribution for each calendar year.

The amount of your distribution is now determined by one uniform table, unless you are married to someone who is 10 years younger than you and you named your spouse as your sole beneficiary. The new table allows for the smallest minimum payout, letting more of your IRA accumulate tax-deferred.

For More Information

With the recent changes, and more tax changes on the horizon, you should see a competent tax advisor before you take any action. With good planning, you can make a major charitable gift of your IRA at a very small cost to your family and friends.

The information in this publication is not intended as legal advice. For legal advice, please consult an attorney. Figures cited in examples are based on current rates at the time of printing and are subject to change. References to estate and income tax include federal taxes only; individual state taxes may further impact results.

