estate to her heirs includes the after-tax value of the IRA. In computing the value of the IRA to the heirs, all taxes associated with the IRA are subtracted, and the value of all the deductions is added back.

No Gift to Charity, IRA to Children (Assuming death occurs in 2007)	
Non-IRD Assets	$6,000,000
IRA (IRD Asset)	$2,000,000
Total Estate	$8,000,000
Estate Tax	$2,700,000
Net Income Taxes	$385,000
Value of Estate to Heirs	$4,915,000
Net Value of the IRA	$715,000
Effective Tax Rate on the IRA	64.25%

Gift of the IRA to Charity (Assuming death occurs in 2007)	
Non-IRD Assets	$6,000,000
IRA (IRD Asset)	$2,000,000
Total Estate	$8,000,000
Estate Tax	$1,800,000
Bequest to Charity	$2,000,000
Net to Heirs	$4,200,000

In the first example, where the entire IRD asset is transferred to heirs and all the taxes are paid, the heirs receive $4,915,000. In the second example, where the IRD asset is transferred to charity, the heirs receive $4.2 million. The heirs receive only $715,000 less, yet the charitable organization receives a gift of $2 million.

This is a cost to the heirs of 36 cents for each dollar going to charity. The cost of using retirement plan benefits to fund a charitable bequest could be approximately 64 cents—the effective tax rate in our example.

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Charitable Remainder Trusts

If you choose instead to fund a charitable remainder trust at death with retirement plan assets, you receive an estate tax charitable deduction equal to the value of the remainder interest using an IRS calculation.

If the trust income is for your spouse, the income interest will not be subject to estate tax because of the marital deduction. If the income beneficiary is your child, the calculated income interest is subject to an estate tax. In this case, the estate tax must be paid out of other assets besides the CRT, and you need to make specific provisions in your estate for payment of those taxes. To be certain the retirement plan income is included in the charitable trust income and not the estate's income, with the consent of your spouse, designate the trust as the beneficiary of all or a portion of the retirement plan.

In this example, a donor who doesn't want to subject his or her IRA to a high tax rate, but who is not willing to give it all away either, uses it to fund a charitable remainder unitrust (CRUT). The trust pays the income beneficiary 7 percent of its annual value, for a term of 10 years.

Testamentary CRUT* Funded with the IRA (Assuming death occurs in 2007)	
Non-IRD Assets	$6,000,000
IRA (IRD Asset)	$2,000,000
Total Estate	$8,000,000
Estate Tax	$2,256,423
Net Estate to Heirs	$3,743,577
Present Value of CRUT Payments	$1,014,274
Net to Heirs	$4,757,851
Present Value of Remainder to Charity	$985,726

*Assumes quarterly payments and a 4 percent charitable midterm federal rate

Lifetime Transfers

During life, you generally cannot assign or transfer retirement plan assets to another beneficiary. As with retirement plan assets, if you give IRA assets during life, you must include all the income in your tax return as taxable income in the year of the gift.

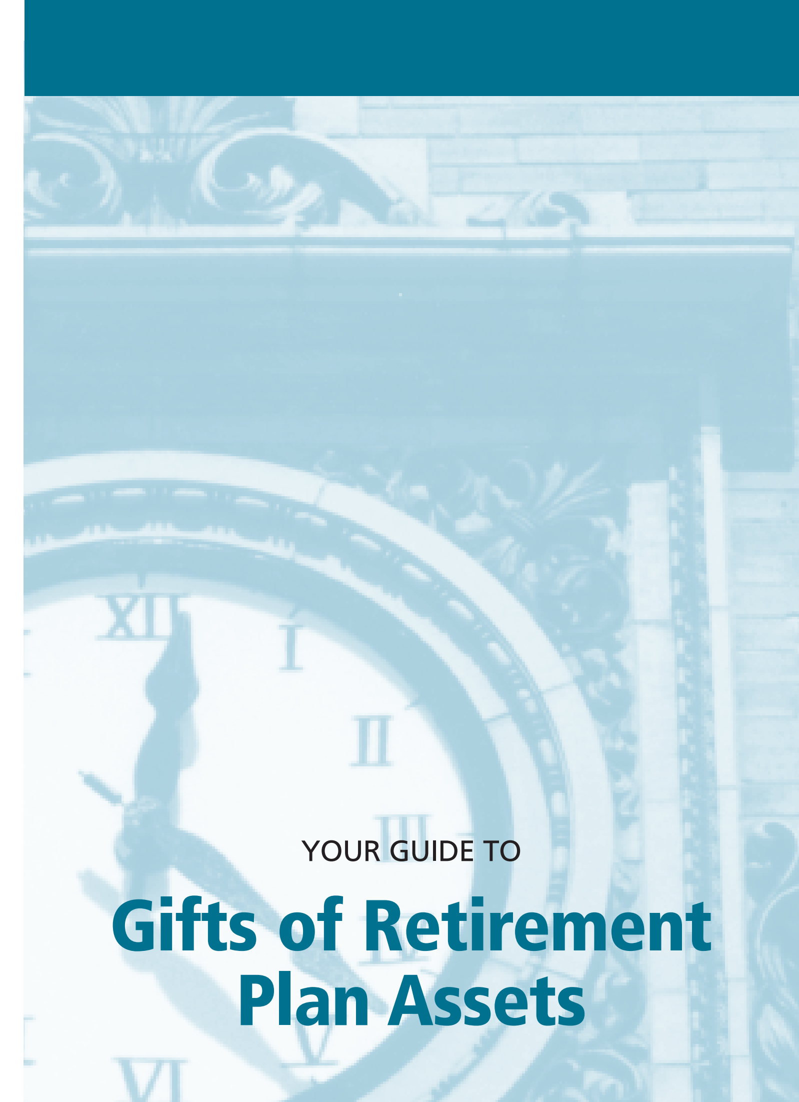
Although a charitable trust provides a partial income tax deduction (for the remainder interest), it's typically not enough to fully offset the tax owed on the gift. Two important points to consider in this scenario: A gift of these assets has the same result as cashing in the account, and you may also be subject to a 10 percent Internal Revenue Service early withdrawal penalty if the gift is accomplished prior to age 59½. Generally—at least under current law—a lifetime transfer of an IRA to a charitable remainder trust is not a good idea from a tax perspective.

Find Out More

Because they cost less, retirement plan assets are usually better to use as charitable bequests than non-IRD assets. When presented with an effective tax rate of 65 percent or more, the charitable alternative appears even more attractive.

If you'd like more information about the benefits of donating retirement plan assets, we can consult with you and your financial advisors and examine your particular situation.

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.



YOUR GUIDE TO

Gifts of Retirement Plan Assets

Profit is what we have left after we make a donation to a worthwhile cause.

—MARILYN VOS SAVANT

Economists and financial planners advise taking advantage of the tax-deferred growth of qualified retirement plans. Recent statistics reveal that many individuals are following such advice.

More and more people, with help from their employers, are putting more and more money into retirement accounts. The mutual fund industry alone manages trillions of dollars earmarked for millions of future retirees. As baby boomers near their retirement years, the unprecedented amounts accumulating in retirement funds are commanding attention.

Many people who update their estate plans are learning that their biggest assets reside in their retirement plans. Because of their tax efficiency and their relative abundance, retirement assets may prove more favorable than other assets as potential charitable gifts.

Retirement plan assets differ from most other assets you may own. Upon your death, your retirement plan assets are subject to not only an *estate tax*, but also an *income tax*. In legal terms, retirement plan assets fall into the category of income in respect of a decedent (IRD). In other words, they have earned income that is not included in a person's final income tax return.

In addition to retirement plan assets, you may have IRD property in the form of accounts receivable, commissions, stock options, installment notes, and untaxed contributions and earnings in Individual Retirement Accounts (IRAs). IRAs, however, usually make up the vast majority of IRD assets in your estate.

Types of Retirement Plans

Your estate may contain qualified retirement assets in one or more of several plans. These include:

Pension Plans. Pension plans are either defined *benefit* plans, based on a specific retirement benefit, or defined *contribution* plans, based on a scheduled annual contribution. Pension plans consist almost entirely of untaxed employer contributions. This means that any distributions from these plans are subject to income tax as well as estate tax.

Defined contribution plans are growing quickly in popularity and asset size. According to the Department of Commerce, the number of defined contribution accounts has grown by more than 100 percent in the last two decades. This compares with an increase in defined benefit plans of approximately 15 percent during the same time period.

The reason that defined contribution plans have grown so much in recent years is their ability to provide more income at retirement. For those who remembered the effects of the Great Depression, the defined benefit plan offered security; but for those of us who have more recently experienced (and have been more affected by) investment growth, the defined contribution plan offers greater opportunity.

Profit-Sharing Plans. For purposes of charitable giving, profit-sharing plans are no different than pension plans. Their distinction from pension plans is that your employer's contributions are not fixed, but are instead based on the firm's profits each year.

Stock Bonus Plans. Stock bonus plans are retirement plans your employer funds with securities. You usually are not taxed at the time of the contribution.

401(k) Plans. As an employee, you make untaxed contributions to these plans and, often, your employer matches a percentage of your contributions. Some plans allow you to make additional after-tax contributions. The after-tax contributions in a 401(k) plan are not IRD assets.

IRAs. These accounts may contain a mix of taxed and untaxed contributions. Regardless of whether the contribution is taxed, the earnings in most IRAs are not subject to tax until the assets are withdrawn. Because some of your contributions may have already been taxed, only a portion may be IRD assets.

The exception to this is the Roth IRA, which allows you to make nondeductible contributions to a special Roth IRA with eventual nontaxable withdrawals. The assets in a Roth IRA generally are not IRD assets.

Nonqualified Plans. These are usually deferred compensation agreements between employers and some of their senior executives and other key employees. The employer is not usually allowed to deduct the contribution until the employee withdraws the funds (often at retirement), at which time they are taxed to the employee.

Although nonqualified plans hold only a fraction of what qualified plans hold, giving nonqualified plan assets at your death is a viable option if you want to lower your taxable estate and support a worthy cause.

The Applicable Taxes

The value of your retirement plan assets will be included in your estate for estate tax purposes. Although legislation has passed to gradually reduce the maximum federal estate tax rate, it can still consume nearly half the asset's value.

As discussed earlier, most retirement plan assets, whether distributed during life or after death, are also subject to an income tax. This exposure to income taxes, in addition to estate taxes, makes your retirement plan assets more expensive to transfer than real estate, stocks and other assets you may have that are not subject to an additional income tax upon their transfer.

Anyone you have designated to receive all or a portion of your retirement plan assets must pay an income tax when he or she receives the income. There may be, however, an income tax deduction for the person who inherits the assets and pays the income and estate taxes. The income tax deduction equals the amount of any federal estate tax that was paid on the retirement plan assets your heir receives.

As with other assets transferred to grandchildren and those considered to be of a skip-generation, retirement plan assets are subject to an additional tax equal to the maximum estate tax rate—the *generation-skipping transfer tax*. Each person is allowed an exemption of $1.5 million (indexed for inflation) from this tax, but a transfer of anything more than that is subject to the maximum estate and gift tax rate.

Charitable Gifts of Retirement Plan Assets

Because of the extra income tax levied on most retirement plan assets when they are transferred, those assets are ideal to fund a charitable gift at death. As with the tax on the right to transfer other assets, the *estate tax* can be offset with a charitable estate tax deduction for a charitable bequest. Income tax on retirement plan or IRA assets transferred at death can be eliminated by designating a charitable organization as beneficiary of such assets. Charitable organizations are tax exempt and therefore pay no income taxes.

Your gifts should be in the form of a specific or residuary bequest (as opposed to a fixed sum of money) unless the fixed sum payable to the organization can be distributed by the end of the year following the death of the employee. As you review your IRA assets and non-IRA assets and determine which to transfer to whom, keep in mind that assets not subject to income tax, such as appreciated securities with a stepped-up basis at death, should be transferred to heirs before retirement assets that will be taxed as ordinary income.

Examples

The following examples show the impact of the taxes described above. The donor is a widow with an estate valued at $8 million, which includes a $2 million regular IRA. We'll assume she dies in the year 2007.

The net income taxes reflect a 35 percent federal tax bracket minus any deductions. The net value of the