Tax Wise Gifts to Charity Using Retirement Accounts

Making charitable gifts from retirement accounts can save income, estate and inheritance taxes, and increase funds available for family beneficiaries.

Retirement accounts, such as IRAs, 401Ks and SEPs, are great tools for saving for retirement. When you make contributions to these accounts, you generally get a tax deduction which reduces your current income tax burden. Then as the funds in the retirement account are invested and grow in value, you do not pay current income taxes on the earnings in these accounts. Over the years, this tax free rate of return contributes significantly to the growth of the account. The sooner you start saving in this type of tax advantaged account, they more this tax free growth will work to your advantage in building your retirement nest egg.

The cost for this tax benefit is that when you withdraw funds from the retirement account, all of the funds you take out are subject to ordinary income tax rates in the year of the distribution. This is true even if some of the funds being withdrawn represent long term capital gains earned in the retirement account over the years.

In addition to the income taxes that apply to the distributions, amounts remaining in the retirement accounts at death are subject to both federal estate tax and Pennsylvania inheritance tax. And your children still pay income tax when they take the money out of the account. If you live in Pennsylvania and your estate is subject to federal estate tax, the combination of the federal estate tax, Pennsylvania inheritance tax and federal income tax could be in the range of 75% of the amount in the account. In other words, your children would only receive 25% of the amount that was in the account at the time of your death.

When faced with this onerous tax burden, many people look for ways to mitigate those taxes. One way to eliminate the taxes is to name a charity as the beneficiary of the retirement account. Charities do not pay income taxes, and there is an unlimited charitable deduction for federal estate and Pennsylvania inheritance tax purposes. Therefore the charity would receive the full value of the account, without any reduction for taxes.

For example, suppose you have $100,000 in your retirement account. If you name your children as beneficiaries, they might only receive $25,000 from the account, assuming your estate is subject to federal estate tax. The government will get the other $75,000. If on the other hand, you were to name a charity such as the Heritage Conservancy as the beneficiary, it would receive the full $100,000, free of all taxes. Another way to look at this is that it would only cost your children $25,000 to make a $100,000 gift to Heritage Conservancy.

This technique works especially well for people who are already thinking of giving a portion of their estate to charity. In this situation, it is just a matter of deciding which asset to give to charity and which asset to give to your children. With a little planning, you can increase your children's inheritance by using the retirement assets to fund the gift to charity.

To illustrate, suppose you have $100,000 in your retirement account and $100,000 in your bank account. If your plan is to give $40,000 to Heritage Conservancy, and the balance of your estate to your children, most people would make a bequest of $40,000 to Heritage Conservancy in their

Will and leave the balance of their estate, including the retirement account to the children. By doing this, the children will bear the tax burden on the retirement account assets. Instead, you could name Heritage Conservancy as the beneficiary for $40,000 of the retirement account, and name the children as beneficiaries of the balance of the assets. This would eliminate the tax on $40,000 of the retirement account assets, increasing the children's share of the estate by as much as $30,000. In other words, instead of that $30,000 going to pay taxes, it will go to the children, and Heritage Conservancy still receives the $40,000 gift.

This is just one of many ways that a little estate planning can have a significant impact on your family, regardless of the size of your estate. It is a lot easier (and a lot more fun) to be charitable when you get to use the government's money to make the gift.

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