

# **dc** DADE COMMUNITY FOUNDATION

## *Professional Notes*

July 2001

### **ABOUT DADE COMMUNITY FOUNDATION**

*For 34 years, Dade Community Foundation has been the community foundation for Miami-Dade County, an aggregate of funds created by individuals, families, and corporations to benefit the world around them -- especially the people of our community.*

*Grants made from these funds meet the changing needs of children, youth, and families; aid in community development; improve the environment; promote health; assist people with special needs; and support education, arts, and the humanities.*

*The Foundation also has taken the initiative in responding to urgent problems -- such as Hurricane Andrew, the AIDS epidemic, and the needs of recent immigrants.*

## **Planning for Retirement Plan Assets and Other Income in Respect of a Decedent**

The new administration has put tax reform at the top of its agenda. Under the new tax law in which tax rates have been reduced, estate tax (not gift tax) is scheduled to be repealed in 2010. Whether it will be repealed will not doubt be debated until 2010. For the present, income tax plan issues involving charitable gifts have not changed. This series of columns will focus on those issues.

### **Introduction**

To encourage savings for retirement, the tax laws permit deferral of income tax on compensation set aside for retirement until the funds are withdrawn. As a result of this incentive, especially when coupled with the strong stock market the last several years, retirement assets may constitute a substantial portion of a client's estate. This issue of Professional Notes discusses the uses of retirement plan assets for clients with charitable interests, as well as for those who may not have considered charity as part of the estate plan. Because of its flexibility-in the assets it accepts and the services it offers - Dade Community Foundation is an ideal recipient for both kinds of clients.

### **Taxes on Retirement Plan Assets and Other IRD**

Under current law, the beneficiary of an estate generally does not pay taxes on his or her inheritance (although the estate pays a tax) and also receives the bequeathed property with a step-up in basis to the property's date-of-death valuation. But a taxpayer who inherits what is called "income in respect of a decedent" (IRD) - items of income that would have been taxable to the decedent had he lived - must pay income tax on the gift, even though the value of the asset was taxable in the estate. This income tax liability will not be affected by any of the proposals for reform or repeal of estate taxes.

Retirement plan assets are one example of IRD, and are particularly important because they may constitute such a significant portion of a client's estate. Non-statu-

tory stock options and deferred compensation also may give rise to IRD. Other examples of IRD are installment sale payments, and interest on certain savings bonds.

### **Use of Retirement Plan Assets for Charity**

IRD can be used by the charitably inclined client to vastly improve tax planning. Clients can earmark IRD assets for a charity such as Dade Community Foundation, eliminating any income tax.

In other words, substantial taxes can be saved by simply changing the allocation of assets among charitable beneficiaries and other heirs. As the chart on the next page shows, providing for retirement plan assets (as opposed to other assets) to go to charity results in a larger bequest to family and other non-charitable beneficiaries. Even taking the estate tax out of the equation, more is available for non-charitable beneficiaries if the bequest to charity uses IRD.

Only "account" type retirement plans-which include IRA's 401(K)s, 403(b)s, and defined contribution plans can be used for charitable gifts. "Account" type plans are not unlike savings accounts; upon the death of the participant or surviving spouse, the account balance becomes an asset of the estate. IRAs are the retirement plans most frequently used for charitable gifts because of their popularity and because the IRA owner is free to name any beneficiary. "Annuity" plans, such as defined benefit plans, generally cannot be used because payments terminate on the participant's or surviving spouse's death, leaving nothing for charity.

This tax reduction strategy is available for other types of IRD property left to charity. The Internal Revenue Service recently ruled that deferred compensation payable to charity upon the taxpayer's death, and "non statutory stock options" (so called because they do not meet the requirements for special income tax treatment under Code Section 421\*\*) bequeathed by will to charity, will give rise to IRD in the hands of the charity, and not to the estate.

\*\* All "Code" references are to the Internal Revenue Code of 1986, as amended.

**ABOUT DADE  
COMMUNITY  
FOUNDATION**

*The Foundation is governed by a 21-member Board of Governors composed of community leaders.*

*Its staff is recognized for experience in grant making, financial administration, and donor services.*

*In 2000, Dade Community Foundation made grants of over \$6 million and administered \$70 million in assets.*

*For more information about the Foundation call Joe Pena, Director of Development at 305-371-2711.*

Because the charity is exempt from tax, no income tax will be payable on the IRD. Consequently, a person who holds nonstatutory stock options may choose not to exercise the options (which would give rise to taxable income), so that the options can pass to charity at his or her death.

**Charitable Remainder Trusts**

Another way to sidestep taxes on retirement plan assets is to create a charitable remainder trust (CRT) with those assets. The CRT provides for a charity, such as Dade Community Foundation, as the remainderman, with non-charitable heirs as income beneficiaries. As with an outright distribution to charity, no income tax should be payable when the plan assets are distributed to the charitable remainder trust, which is tax exempt.

It is critical that a charitable remainder trust be structured and invested to avoid unrelated business income because it is only tax exempt in a year in which the CRT does not have unrelated business income. Even one dollar of unrelated business income could make all income and gain of the CRT taxable.

**Estate Tax Considerations**

It may be premature to write off the estate tax, and

estate tax considerations also encourage leaving IRD assets to charity. The federal estate tax currently has a maximum rate of 55 percent. Leaving pension assets to charity not only eliminates the income tax that otherwise would be due, but generates a corresponding charitable deduction that reduces the taxable estate.

Where pension or other IRD assets are transferred to a testamentary CRT, under current law, the estate will receive a charitable deduction equal to the actuarial value of the charitable remainder. This value will depend on the term, payout percentage, and type (unitrust or annuity trust) of CRT.

A married client may want to transfer retirement plan assets to the surviving spouse first, and then to charity. The marital deduction assures that no estate tax applies to the transfer to a spouse. (A spouse may have a legal interest in the retirement assets and so may be required to consent to a transfer to a CRT or to charity.) Since neither unmarried clients nor surviving spouses can take advantage of the marital deduction for estate tax purposes, they ought to consider allocating retirement plan assets or other IRD to a CRT or directly to charity.

**Example:**

Donor dies leaving an estate of \$6 million, including \$1 million in her IRA. **Box 1** assumes donor Foundation, having named her children as beneficiaries of her IRA. **Box 3** assumes donor provid

Estate to Children Nothing to Charity	Estate to Children Nothing to Charity (no estate tax)
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**Box 1**

1. Taxable Estate	\$6,000,000	
2. Federal Tax (Line 1 x 50% Assumed Rate)	3,000,000	
3. IRD Subject to Tax	1,000,000	
4. Deduction for Federal Estate Tax attributable to the IRA	430,800 *	
5. Net income subject to tax (Line 3 minus line 4)	569,200	1,000,000
6. Federal Tax (Line 5 x 40% Assumed Rate)	227,680	400,000
<b>Summary</b>		
7. Estate Taxes (Line 2)	3,000,000	0
8. Income Taxes (Line 6)	227,680	400,000
9. Total Taxes (Line 7 + line 8)	3,227,680	400,000
10. Assets to Charity	0	0
11. Assets to Children ((\$6 Million Estate minus Line 9 minus Line 10)	2,772,320	6,600,000

\*Under Section 691(c), the deduction equals the Federal estate tax on the taxable estate, includi

**Planning Tips**

\* Under current law, if pension assets are assigned during one's lifetime, the assignment will trigger recognition of the income to the donor. If an IRA owner makes a withdrawal from an IRA and transfers that amount to charity, he or she must include the amount in income and claim a charitable deduction.\*\*\*Because of rules that reduce itemized deductions for taxpayers with income over a certain level(\$128,950 in 2000), the charitable deduction frequently does not offset the income.

\*Even if an estate distributes retirement plan assets to pay a charitable bequest, it can still end up with taxable income. To avoid this result, the will or beneficiary designation must provide that the retirement assets or other IRD go to charity. Where desired, a fixed dollar cap may be used to limit the amount of such a bequest ("I bequeath \$100,000 of my IRA to ABC Charity").

\* It generally is recommended that pension assets be allocated to charity through the account's beneficiary designation, rather than through the will. However, it is important to keep track of such designations because the designation in a retirement plan takes precedence over the

terms of a will. In a recent case, the District Court for the Eastern District of New York held that a beneficiary of an IRA account was entitled to the account proceeds despite the fact that the beneficiary was separated from the decedent and had begun divorce proceedings, and the decedent's new will eliminated all bequests to the beneficiary.

\* In the past, the minimum lifetime distribution rules permitted the retirement plan participant to take into consideration a successor beneficiary's life expectancy in calculating the length of time over which distributions must be made, sometimes resulting in smaller annual distributions. Reduced distributions might be desirable if the retiree were in a high income bracket or otherwise did not need the income. Under proposed regulations issued in January of this year, the payout to the plan participant would *not* reflect the life expectancy of a successor beneficiary (except in the case of a spouse more than 10 years younger). However, the period over which the remaining retirement assets will be distributed to the successor beneficiary upon the death of the account owner will be affected by that beneficiary's life expectancy.

*Upcoming Series*

*Gifts of Partial Interest*

*Timing of Charitable Contributions*

her whole estate to her children. **Box 2** assumes donor leaves \$1 million to Dade Community charity by designating the Foundation as the beneficiary of her IRA.

\$1 million to Charity  
Balance of Estate  
(incl. IRA) to Children

\$1 million to Charity  
Balance of Estate  
(incl. IRA) to Children  
(no estate tax)

\$1 million IRA  
to Charity  
Balance to Children

\$1 million IRA  
to Charity  
Balance to Children  
(no estate tax)

**Box 2**

**Box 3**

\$5,000,000	
2,500,000	
1,000,000	
438,800 *	
561,200	1,000,000
227,680	400,000
2,500,000	0
227,680	400,000
2,752,680	400,000
1,000,000	1,000,000
2,272,320	4,600,000

\$5,000,000		
2,500,000		
0		
N/A		
0	0	0
0	0	0
2,500,000	0	0
0	0	0
2,500,000	0	0
1,000,000	1,000,000	1,000,000
2,500,000	5,000,000	

\*\*\*Under one tax proposal, this would be changed so that an IRA owner who is 59-1/2 years old (or 70-1/2 in another proposal) could disregard the amount withdrawn and contributed to charity in calculating income.

IRA, less the Federal estate tax on the estate, excluding the IRA.

(Continued from page 3)

\* If there are two beneficiaries, the distributions generally will be measured by the shorter life expectancy. Where charity is one of the beneficiaries, distributions will use the decedent's remaining actuarial life expectancy, because charity is not considered to have a life expectancy. If the second beneficiary otherwise would have (and wants to take advantage of) a longer life expectancy, charity's entire interest should be distributed before the end of the calendar year following the year of death.

## Conclusion

Many people automatically name individuals as beneficiaries of their retirement plans. When they do, they are transferring to heirs assets that are subject to income (as well as estate) taxes. They would be better served by leaving assets not subject to income tax to their heirs and retirement plan assets to charity.

Confronted with the choice of "giving" more than 45 percent of retirement plan assets to the Internal Revenue Service and local taxing authorities at death (or as much as 80 percent if the estate tax is not repealed) or leaving 100 percent to charity, even clients who have not thought about providing for charity may want to rethink the allocation of assets in their estates.

Dade Community Foundation is the ideal recipient of retirement plan assets. A fund can be established with the family name, or any other name the donor selects. For a donor who wants to help his community, and ensure that time will not make his gift obsolete, an unrestricted fund offers maximum flexibility. A donor with a particular area of concern, such as children or the arts, may select a field-of-interest fund. Designated funds allow the donor to specify the institution(s) to benefit. An advised fund enables children or grandchildren to participate in selecting charitable organizations to receive grants after the donor's death.

*This material was originally developed for the use of professionals by The New York Community Trust, one of the nation's largest community foundations. It was published as of March 2001 with the understanding that neither the publisher nor the authors are engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.*

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*The information herein has been adapted for Florida purposes.*

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