Some donations are better than others for philanthropic clients

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For charitably inclined clients, some donations may be better than others. Tactics that excel during a client's lifetime might not be ideal at death. "Changing plans for charitable bequests, as opposed to lifetime contribution choices, can be a smart strategy," says Cheryl Holland, founder of Abacus Planning Group in Columbia, South Carolina.

During life, one established ploy is to contribute appreciated assets rather than cash. "By donating appreciated securities that have been held for more than one year, clients can get a charitable deduction for the market value of the security," says Benjamin Sullivan, a CFP and an Austin, Texas-based portfolio manager with the Palisades Hudson Financial Group. "These clients also avoid paying the capital gains tax they would incur if they were to sell the assets." The charitable recipient can sell the securities and owe no tax while the built-in gain is never taxed.

Advisers often encourage clients to hold onto tax-deferred retirement accounts such as IRAs. Tax-deferred compounding builds wealth, and there's a possibility that in retirement, future withdrawals will be more lightly taxed.

FLIPPING THE SWITCH

Philanthropy needn't stop with a client's heartbeat. The Giving USA Foundation reports charitable bequests reached $31.76 billion in 2015, up more than 28% since 2013. When clients want to leave assets to a favorite cause, the lifetime donate-appreciated-securities-and-retain-IRA parlay can be turned on its head in estate planning.

Charitable Bequests

Inflation adjusted donations, in $billions.

Year	Amount
2006	$25.75
2007	$27.19
2008	$34.39
2009	$21.12
2010	$25.43
2011	$26.53
2012	$25.44
2013	$24.77
2014	$31.16
2015	$31.76

Source: Giving USA 2016: The Annual Report on Philanthropy for the Year 2015.

"Because the cost basis of assets is adjusted to their fair market value at death, there's no benefit to donating appreciated securities at death," says Sullivan. The purpose of a lifetime donation of appreciated assets—avoiding tax on capital gains—ceases to matter, as the heirs can sell inherited assets without paying tax on pre-death appreciation.

"From a tax perspective, it's better to have the children inherit appreciated assets held in taxable accounts, at the parent's death," says Mike Piershale, president of Piershale Financial Group in Crystal Lake, Illinois. "The kids will then receive a step-up in cost basis, which will wipe out all capital gains on the inherited assets up to the date of the parent's death. This can be a huge tax savings for the heirs, on a future sale of those assets."

If charitable bequests aren't fulfilled by appreciated assets, tax-deferred retirement plan dollars might be take their place. Those plans don't get a basis step-up at death: human IRA beneficiaries must take distributions and pay tax on pre-tax dollars. If an 80-something IRA owner leaves the account to a 50-something son or daughter, the IRA beneficiary may be at a career peak, in a high bracket, so those IRA distributions could be heavily taxed. A $1 million IRA bequest might have a present value of $600,000 or even less.

It's easy to underestimate how important philanthropy is to clients.
"Assets left to beneficiaries in a pre-tax retirement account such as an IRA will be taxed as ordinary income when they take distributions," says Piershale. "In most cases it should be a goal of advisers to help clients minimize assets left in such accounts, whenever possible, as long as that doesn't reduce the amount that the heirs would otherwise receive." Piershale adds bequeathing money to a qualified charity also reduces the size of a client's taxable estate, which can save taxes in some cases.

DECIDING ON THE DESIGNATION

Once explained, the idea of bequeathing untaxed assets to charity while leaving appreciated assets to heirs, with a basis step-up, is easily grasped by clients. "It's pretty intuitive," says Holland. "However, many people are not aware of this strategy. We often review estate plans that call for a certain percentage of net worth to go to charity, but without the extra step of specifying that those dollars come from retirement plans. When appropriate, we'll sit down with the client's attorney, work together to amend the estate plan, and follow up with the beneficiary designations."

Quote

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As Holland's comments indicate, bequeathing IRA money to charity generally is done through beneficiary designations. "There are two ways this can be done," she says. "One is to state that a percentage of the IRA is to go to a certain charity or charities. Many IRA custodians won't permit a dollar amount to be stated, probably for fear that the account won't be large enough at the IRA owner's death, but most will allow a percentage to go to charity." No matter how long the IRA owner lives, taking distributions, if there is some money in the account at death it will be possible to pay, say, 25% of the balance to charitable recipients named on the form.

The alternate approach is to calve off a new IRA, which will have one or more charities as designated beneficiaries. "We prefer retirement money left for charities to be in a separate account, one that has no human co-beneficiaries," says Marilyn Dimitroff, CFP, principal and director of wealth management at Planning Alternatives in Bloomfield Hills, Michigan. "We have clients who have moved some retirement funds to an IRA with charities as beneficiaries. The paperwork is relatively straightforward. On the other hand, if someone decides that a charity will get, say 25% of their existing IRA, adding the charity to their listed beneficiaries, then the human beneficiaries may have to use a shortened withdrawal plan."

Depending on the IRA owner's age at death, the entire balance of the account might have to be distributed by the end of the fifth year following the year of death. However, well-advised human beneficiaries can see that any charitable beneficiary has received its entire benefit before September 30 of the year after the year of death; then the remaining beneficiaries may be able to take required minimum distributions (RMDs) over their life expectancy, "stretching out" valuable tax deferral.

"We've seen it done both ways," says Holland. "Our preference is to keep the IRA money in one pot. That approach requires regular monitoring of the IRA, to see that the percentage left to charity is consistent with the client's desires." In addition, advisers and human beneficiaries should know the rule on paying out the charity before September 30 of the following year, if a possible stretch IRA is desired.

FINE POINTS

Advisers also should be aware that not all IRAs will fit into this strategy. "Roth IRA distributions can be tax-free," says Dimitroff, "so they are not appropriate assets to leave to charity." When a human inherits a Roth IRA, an RMD schedule applies but the amount previously contributed may be withdrawn, untaxed; withdrawn

earnings also will avoid income tax, once five years have passed since the Roth IRA was established. If a Roth IRA is left to charity, heirs could miss decades of tax-free cash flow.

Leaving tax-deferred retirement assets to charity makes more sense, and that principle goes beyond IRAs. “I have clients who are still working, at an age when many people are retired,” says Holland, “and they’ve kept their retirement money in the company plan. Charitable bequests are possible — one client has left his entire 401(k) to charity.” Federal law entitles a surviving spouse to inherit money in a qualified retirement plan, but a spouse can sign off, permitting those assets to pass to another beneficiary. Such a waiver in favor of a charity may be obtained after an adviser has shown the couple that they can do well by doing good.

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