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Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #755

Date: 06-Apr-21
From: Steve Leimberg's Employee Benefits and Retirement Planning Newsletter
Subject: Jim Lange - A Guide to Tax-Savvy Charitable Bequests

"In this newsletter, I want to focus on the smartest solution for donations or inheritances that you leave to a charity after you and your spouse pass. There are several critical ideas to cover, but the most fundamental is: what are the tax implications to each recipient if they inherit your money? By being very selective about who receives which type of money—whether Traditional or Roth IRAs, after-tax brokerage accounts, life insurance, etc.—you can dramatically cut the share that goes to the IRS and increase the amount going to your family."

James Lange provides members with commentary that examines the tax efficiency of charitable bequests. Jim is a CPA, an attorney and a registered investment advisor.[i] He has been quoted 36 times in The Wall Street Journal. He is the author of 8 best-selling books related to IRAs and retirement plans. Members who would like a copy of Jim Lange's newest book, *The IRA & Retirement Plan Owner's Guide to Beating the New Death Tax: 6 Proven Strategies to Protect Your Family from The SECURE Act*, should complete the online order form at https://paytaxeslater.com/getbook, and we will mail you a complimentary hard cover book.

Here is his commentary:

EXECUTIVE SUMMARY:

After reading this newsletter, you are likely to think—that is so obvious. How could I and my estate attorney both have missed this? Don't feel bad. We have reviewed thousands of wills and trusts and in our experience, hardly anyone gets this right. The mistake often costs families tens of thousands of dollars or more.

I'm referring to the decisions that you make when you are crafting your estate plan and are trying to figure out *who gets what*. In this newsletter, I want to focus on the smartest solution for donations or inheritances that you leave to a charity after you and your spouse pass. There are several critical ideas to cover, but the most fundamental is: what are the tax implications to each recipient if they inherit your money? By being very selective about who receives which type of money—whether Traditional or Roth IRAs, after-tax brokerage accounts, life insurance, etc.—you can dramatically cut the share that goes to the IRS and increase the amount going to your family.

COMMENT:

In most cases, Traditional IRAs subject to exception, are going to be fully taxable to your heirs. After the dreaded SECURE Act that effectively killed the stretch IRA, income taxes will be due on your IRA within a maximum of ten years after your death. Inherited Roth IRAs have the advantage of being able to continue to grow for ten more years after your death and then can be withdrawn tax-free. After-tax dollars and life insurance are generally not subject to income taxes. All of these different types of inheritances have different tax implications for your beneficiary…unless your beneficiary is a tax-exempt charity.

First and foremost, a charity that is recognized by the IRS as being tax-exempt does not care in what form they receive an inheritance. They never have to pay taxes on the money they receive. To them, a dollar is a dollar. So, a charity will look at bequests of Traditional IRAs, Roth IRAs, after-tax dollars, or life insurance in the same light. In sharp contrast, your heirs will face substantially different tax implications depending on the type of asset they receive after your death. Please note in this newsletter we are only addressing income taxes, not estate or transfer taxes.

Imagine this scenario. You want to leave $100,000 to charity after you and your spouse die. You have both Traditional IRAs and after-tax dollars. For the sake of simplicity, I am going to say that your child is in the 24% tax bracket. So, *Who Gets What?* In most of the estate documents that we review, we see instructions directing that the charitable bequest come from after-tax funds—usually found in the will or a revocable trust. The problem is that your will (or revocable trust) does not control the disposition of your IRAs or retirement plans. By naming that charity as a beneficiary in your will or trust, you will likely be donating after-tax money to charity. The charity gets $100,000 so the “cost” of the bequest to your heirs is $100,000. Restated, the amount that your children inherit is reduced by $100,000 because you made that bequest to charity.

But what if you decide to leave $100,000 to XYZ charity through your Traditional IRA and/or retirement plan beneficiary designation? It makes no difference for the charity because they get $100,000 tax free. If your heirs receive $100,000 from your IRA, they will have to pay taxes on the money. Assuming that they are in a 24% tax bracket, that would be $24,000—leaving them with $76,000 after the government takes their share. And the tax bite is even worse if your heirs are in a higher tax-bracket or live in a state that taxes Inherited IRAs. So, if you leave your Traditional IRA money to a charity that doesn't pay taxes, you are in effect leaving your beneficiaries an extra $24,000!

This is a simple tweak to your estate plan that can be very beneficial to your heirs. On a smaller bequest, smaller savings. On a bigger bequest, even larger savings. Consider the purchasing power, after taxes, available to your beneficiary if you have $100,000 in a Traditional IRA and $100,000 of after-tax dollars, and we switch who gets what.

Scenario 1

Leave $100,000 to charity through your will or revocable trust and $100,000 to your heirs as the beneficiary of your Traditional IRA.

Impact on the charity: They get $100,000 and pay no tax.

Impact on your heirs: $100,000 IRA money - 24% taxes = $76,000.

Scenario 2

Leave $100,000 to charity through your IRA beneficiary designations and $100,000 to your heirs in your will or revocable trust.

Impact on the charity: They get $100,000 and pay no tax.

Impact on your heirs: $100,000 and pay no federal tax.

This simple switch of *who gets what* saved this family $24,000. The savings would be even greater with a larger bequest or if your beneficiary's tax bracket was higher.

Scenario 3

Let's imagine another scenario. Suppose that your child is well off and, as a parent, you are totally comfortable with reducing his or her inheritance by $100,000. Does that mean you can leave even more money to charity? Yes!

You could leave $131,579 to charity through your IRA or retirement plan beneficiary designation. The same tax implications apply. A $131,579 IRA bequest will only "cost" your child $100,000. ($131,579 times 24% = $31,579). If you left that $131,579 IRA to your children instead of charity, your children would have to pay $31,579 in taxes leaving them $100,000.

By switching *who gets what*, you accomplish one of two things:

1. You save $24,000 in federal taxes for your child, or

2. If you increase your bequest to the charity to $131,579, you still only remove $100,000 from your heir's total inheritance, and you increase the charitable gift by $31,579.

If you are only leaving a minimal amount to charity, it probably isn't worth the time and aggravation to change your documents. If you are leaving a substantial amount to charity, it probably is worth it.

Finally, the application of the concept of *who gets what* can also save families a lot of money in taxes even without any charitable bequest involved. It is likely that not all your beneficiaries are in the same bracket. The different income tax brackets of your beneficiaries may create an opportunity for tax savings by changing *who gets what*. But you will have to wait for my next newsletter to read about that technique.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jim Lange

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CITATIONS:

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