LEGACY PLANNING:

The Pros and Cons of Choosing a Charity as Your Beneficiary.

Making a charity your beneficiary is a generous act, but it comes with complexities. This article outlines the pros and cons of this philanthropic decision.

What is it?

Naming a beneficiary for your traditional IRA or employer-sponsored retirement plan may be one of the most important financial decisions you ever make. The beneficiary (or beneficiaries) you name will receive the funds remaining in your IRA or plan after you die, so you should certainly consider your loved ones' future needs. However, choosing the right beneficiary is often more complicated than that.

Your choice could have an impact in one or more of the following areas:

- The size of the annual required minimum distributions (RMDs) that you must take from the IRA or plan during your lifetime.
- The rate at which the funds must be distributed from the IRA or plan after your death.
- The combined federal estate tax liability of you and your spouse (assuming you are married and expect estate tax to be an issue for one or both of you).

Your first thought may be to designate your spouse, child, grandchild, or other loved one as beneficiary of your IRA or retirement plan. Naming one or more of these individuals is common, and often makes sense for a number of reasons. However, your beneficiary choices are not limited to individual people. Another option may be to designate one or more charities as beneficiary of your IRA or retirement plan. Naming a charity can allow you to provide for an organization you believe in, and it can also result in significant income tax and estate planning benefits.

KEEP IN MIND:

This discussion applies only to traditional IRAs and employer-sponsored retirement plans. Choosing a beneficiary for a Roth IRA involves different considerations.

Naming a charity as beneficiary will not affect required minimum distributions during your life.

Under federal law, you must begin taking annual required minimum distributions (RMDs) from your traditional IRA and most employer-sponsored retirement plans (including 401(k)s, 403(b)s, 457(b)s, SEPs, and SIMPLE plans) by April 1 of the calendar year following the calendar year in which you reach age 73 (75 if you reach age 73 after 2032), known as your "required beginning date." With employer-sponsored retirement plans, you can delay your first distribution from your current employer's plan until April 1 of the calendar year following the calendar year in which you retire if (1) you retire after age 73 (75 if you reach age 73 after 2032), (2) you are still participating in the employer's plan, and (3) you own 5% or less of the employer. If you reached age 72 in 2022, your general RMD age is 72.

Your choice of beneficiary generally will not affect the calculation of your RMDs during your lifetime. An important exception exists, though, if your spouse is your sole designated beneficiary for the entire distribution year, and he or she is more than 10 years younger than you.

Under the final regulations, having a charity as beneficiary will generally result in limited options (and the fastest possible payout) for required post-death distributions. However, a charity generally pays no income tax on distributions. See below for more information on these issues.

CAUTION: The calculation of RMDs is complex, as are the related tax and estate planning issues. For more information, consult a tax professional.

TIP:

The Pension Protection Act of 2006 first allowed taxpayers age 70½ or older to make tax-free charitable donations directly from their IRAs. Technically, these taxpayers were allowed to exclude from gross income otherwise taxable distributions from their IRA ("qualified charitable distributions," or QCDs), up to $100,000, that were paid directly to a qualified charity. These gifts are also known as "Charitable IRA rollovers." The law was originally scheduled to expire in 2007, but was extended periodically through 2014 by subsequent legislation, and finally made permanent by the Protect Americans from Tax Hikes (PATH) Act of 2015. The SECURE 2.0 Act of 2022 expanded QCDs to allow a one-time election to be made for a QCD of up to $50,000 to a charitable remainder unitrust, a charitable remainder annuity trust, or a charitable gift annuity. QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to receive from your IRA, just as if you had received an actual distribution from the plan. However, distributions that you actually receive from your IRA (including RMDs) that you subsequently transfer to a charity cannot qualify as QCDs.

Advantages

of naming a charity as beneficiary

1 A CHARITY WILL NOT PAY INCOME TAX ON POST-DEATH DISTRIBUTIONS.

Like distributions taken during your lifetime, required post-death distributions from a traditional IRA or retirement plan are taxable (to the extent that a distribution represents pre-tax or tax-deductible contributions, and investment earnings). Consequently, your beneficiary will generally be subject to federal income tax on any distribution that he or she receives from the inherited IRA or plan. (State income tax may also apply.) The post-death distributions will be taxable according to the beneficiary's federal income tax bracket. By contrast, if you name a charity as beneficiary, that charity will not have to pay any income tax on the IRA or plan funds the charity receives after your death (provided that the charity qualifies as a tax-exempt charitable organization under federal law).

EXAMPLE:

Assume you have an IRA valued at $10,000, and a bank savings account also valued at $10,000. You want to leave $10,000 to your favorite charity. Whether you leave the charity the IRA or the bank savings account makes no difference to the charity. The charity is able to keep the full $10,000 either way, since no income tax applies to the receipt of an IRA or a savings account by a charity. If you leave the $10,000 savings account to an individual beneficiary such as your child, your child will receive the full $10,000 without a reduction for income tax. However, if you instead leave the $10,000 savings account to the charity and leave your $10,000 IRA to an individual beneficiary such as your child, your child will end up with less than $10,000, since income tax must be paid on IRA distributions received by an individual beneficiary. The portion of the funds that your child loses to taxes could be substantial, depending on his or her income tax bracket and how quickly the funds are distributed from the IRA or plan.

The fact that a qualified charity can receive your IRA or plan funds tax free after your death can be a compelling reason to consider naming a charity as beneficiary. However, be certain that you really want to provide for that particular charity so that you're not naming a charity solely for tax reasons.

2 NAMING A CHARITY CAN REDUCE ESTATE TAXES.

After your death, distributions of your assets to a charity generally qualify for an estate tax deduction known as the charitable deduction. In other words, the full value of your IRA or retirement plan funds (determined as of the date of your death) will be excluded from your taxable estate for purposes of determining the amount of federal estate tax (if any) that is due. This can be a significant advantage if you expect the value of your taxable estate to be at or above the federal applicable exclusion amount.

Consult an estate planning attorney for further guidance regarding federal estate tax. (State death taxes may also be an issue, depending on the laws of your state.)

3 PROVIDING FOR A CHARITY CAN BE PERSONALLY GRATIFYING.

Charities need funds to operate and reach their goals. You can do your part and gain a sense of personal satisfaction by naming one or more charities as beneficiary of your IRA or retirement plan. If you truly believe in the mission of the charitable organization that you are providing for, your retirement savings will be well spent.

Disadvantages

of naming a charity as beneficiary

1 NAMING A CHARITY MAY ACCELERATE POST-DEATH DISTRIBUTIONS.

If you named a spouse, child, other individual, or qualifying trust as beneficiary of your IRA or retirement plan instead of a charity, a different method would apply for taking required post-death distributions from the account. For decedents dying before 2020, these beneficiaries would generally have the option of taking required post-death distributions over a longer period by using their own remaining life expectancy. For decedents dying after 2019, the life expectancy method can only be used if the designated beneficiary is an eligible designated beneficiary. An eligible designated beneficiary is a designated beneficiary who is the spouse or a minor child of the IRA owner or plan participant, a disabled or chronically ill individual, or other individual who is not more than ten years younger than the IRA owner or plan participant (such as a close-in-age sibling). (Spouses have additional options, such as the ability to roll over the inherited funds into the spouse's own IRA or plan.) The post-death payout period will therefore be long in many cases, helping to spread out the income tax bill on the money and further prolong tax-deferred growth.

KEEP IN MIND:

In the case of a trust as beneficiary of an IRA or plan, if the election is made to base post-death distributions on the beneficiary's life expectancy, the oldest beneficiary of the trust (i.e., the one with the shortest life expectancy) generally must be used for this calculation.

In the case of a charity as beneficiary, this life expectancy payout method is not available. This is because a charity is not an individual, and therefore has no life expectancy to calculate annual distributions. The charity will have to take required post-death distributions from the IRA or plan at the fastest possible rate, generally either in a lump sum or according to one of the following methods:

- If you die prior to your required beginning date for RMDs, the charity must receive the IRA or plan funds within five years after your death (the "five-year rule").
- If you die after your required beginning date for RMDs with a charity as beneficiary, the IRA or plan funds must be distributed over your remaining single life expectancy, calculated in the year of death (maximum 17 years).

For any other type of beneficiary, these post-death distribution options would be considered unfavorable from a tax standpoint, because they generally accelerate distributions. As discussed, however, a qualified charity named as beneficiary does not have to pay any income tax on post-death distributions from the IRA or plan. Therefore, in terms of taxes, it does not matter how quickly or slowly the IRA or plan funds are distributed to the charity—the result will be the same.

What happens if you have named both a charity and an individual as beneficiaries of your IRA or plan? Is the individual beneficiary allowed to use the life expectancy method to distribute his or her share? The answer is maybe. It depends on whether certain rules are followed. If you have left your IRA or plan to a charity and one or more individuals in fractional amounts (as opposed to dollar amounts), the account may be divided into separate accounts up until the December 31 following the year of your death. Then, the individual beneficiary can use his or her own life expectancy for his or her separate account. Or, the benefits due to the charity can simply be paid out to the charity before September 30 following the year of your death. If the charity has been fully paid off by the date indicated above, it is no longer considered a beneficiary for distribution purposes. (This approach can be used whether the charity's share is expressed as a fractional amount or a dollar amount, but the separate accounts rules generally won't apply to pecuniary (specific dollar amount) bequests).

CAUTION: The rules regarding separate accounts are complex. Consult a tax professional.

2 YOUR LOVED ONES WILL NOT RECEIVE YOUR RETIREMENT FUNDS.

If you name a charity as sole beneficiary of your IRA or retirement plan, when you die, your family members and other loved ones will not receive any benefit from those retirement assets. This is potentially the biggest drawback of naming a charity rather than a spouse, children, or other loved ones. So, if your main goal is to provide for your loved ones after your death, naming a charity as sole beneficiary of your IRA or plan may not be the best choice. However, if you want to benefit a charity and provide for your loved ones, there may be strategies involving your retirement funds that can help you achieve both goals.

If you would like to leave some of your assets to your loved ones and some assets to charity, consider leaving your retirement funds to charity and other assets to your loved ones. This may offer the most tax-efficient solution, since the charity will not have to pay any tax on the retirement funds. If the retirement funds are a major portion of your assets, you might consider leaving those funds to a charitable remainder trust. Under this type of trust, the trust receives the funds free from income tax at your death, then pays a lifetime income to individuals of your choice. When those individuals die, the remaining trust assets pass to the charity.

Finally, as discussed above, another option is to name the charity and one or more individuals as co-beneficiaries.

CAUTION: The estate planning strategies discussed here are sophisticated, and may involve drawbacks as well as advantages. Consult an estate planning attorney for further guidance.