SMA Foundation, Inc.

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MEMO CONCERNING ADVANTAGE OF CHARITABLE GIVING FROM AN IRA, 401-K, OR SIMILAR DEFERRED COMPENSATION PLAN AT DEATH

NOTE: 1) As set forth on the attached list of Definitions, the current Federal exemption for Estate taxes is large enough to exclude most decedents' estates from Federal taxation and this memo assumes a gross estate valuation which is not subject to Federal Estate taxes; 2) This document deals **only with Federal Estate Tax provisions at death**; tax rules in each state are different and must be consulted; 3) This is a general memo written to assist persons in planning the designation of their IRAs, Simple IRAs, and 401-Ks [hereafter, generally: "**IRA/K**"] assets at the time of their death.

It is assumed a "charitable organization" is properly IRS qualified for tax exempt purposes. The Staunton Military Academy Foundation is a qualified 501(C)(3) charitable organization.

The examples contained herein show why it is "tax advantageous" to use an IRA/K as a vehicle to make charitable donations at death, rather than making the donations through a Will or Trust.

Certain tax rules apply to IRA/Ks distributed at a decedent's death. This type of asset contains a beneficiary designation, with the Beneficiary specified by the decedent. The distribution of an IRA/K – with the exception of a rollover to a surviving spouse – results in taxable income to the specified Beneficiary. Under the IRS rules, and depending on the documents governing the IRA/K, the income distribution to the Beneficiary may be spread over an extended period of years; however, a distribution to the Beneficiary must occur annually and will be taxed at the beneficiary's marginal income tax rate.

As noted in the attached Definitions, all assets are "stepped up in basis" at death. If a beneficiary is left 100 shares of stock which decedent paid $10.00/share for during decedent's lifetime and the stock is selling at $100.00/share on the date of decedent's death, because there is a step up in basis to $100.00/share at decedent's death, the beneficiary can sell the stock at $100.00/ share – total $10,000.00 – free of any Federal taxes as the cost is the same as the sale price.

If the stock is sold to make a $10,000.00 charitable donation, there would also be no gain on the sale; the Estate would have a charitable deduction which would have no Estate tax consequence as the Estate is below the exemption amount.

If the stock is in Decedent's IRA/K, and an individual, non-spouse, Beneficiary is named to receive the IRA/K, the named Beneficiary must pay income taxes on all annual withdrawals at the Beneficiary's marginal rate. If the Beneficiary receives $10,000.00 as a distribution in a single tax year, and the Beneficiary's marginal tax rate is 20%, the Beneficiary will receive a net amount of $8,000.00 after paying the $2,000.00 Federal tax.

However, if the IRA/K is left to a charitable organization, **there is no tax paid** as the organization is exempt from paying income taxes.

The following charts show examples of the above.

Assume an Estate with all personal assets of $1,000,000.00. Additionally, decedent has a separate IRA/K valued at $100,000.00. There is no surviving spouse. One grandson, over 21 years of age and with a marginal income tax rate of 20%, is the designated Beneficiary of all assets and the IRA/K. Decedent wants to leave $100,000.00 to a charitable organization. [There will be no Federal Estate taxes as the Estate is worth less than the exemption amount.]

Example 1, Charitable donation paid from personal assets of the Estate

Personal assets passing through Estate [stocks, bonds, real estate, etc.]. Stepped up to fair market value at death.	$1,000,000.00
Charitable gift by Estate to the "Staunton Military Academy Foundation"	($100,000.00)
Federal taxes paid by Estate	$0.00
Net Estate amount received by Grandson	$900,000.00
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Grandson sells assets received and holds $900,000.00 cash	$900,000.00
Grandson deducts cost basis when computing taxes	($900,000.00)
Grandson's taxable income	$0.00

IRA/K distributed to Grandson	$100,000.00
IRS income taxes at 20% marginal rate [amount taken over several years to not "kick up" to a higher marginal rate]	($20,000.00)
Net received by Grandson	$80,000.00

In Example 1, the Grandson gets a total of $900,000.00 + $80,000.00 = $980,000.00 and the charitable organization gets $100,000.00.

Example 2, Charitable donation paid from IRA/K

Personal assets passing through Estate [stocks, bonds, real estate, etc.]. Stepped up to fair market value at death.	$1,000,000.00
Federal taxes paid by Estate	$0.00
Net Estate amount received by Grandson	$1,000,000.00
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Grandson sells assets received and holds $1,000,000.00 cash	$1,000,000.00
Grandson deducts cost basis when computing taxes	($1,000,000.00)
Grandson's taxable income	$0.00

IRA/K charitable donation to the "Staunton Military Academy Foundation"	$100,000.00
IRS income taxes due when donated to charitable organization	$0.00
Net received by charitable organization:	$100,000.00

In Example 2, the Grandson gets a total of $1,000,000.00 and the charitable organization gets $100,000.00. Grandson's total gift is $20,000.00 more than in Example 1.

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If you wish to make such a donation of your IRA/K, **remember to discuss with the Fund Raising Committee how you wish to designate your gift**. The SMA Foundation, Inc., has three choices:

1. "SMA Foundation - Heritage Fund"; this supports the Alumni Association, the Museum, and similar activities.

2. "SMA Foundation - Truth, Duty, and Honor Fund - Scholarships"; this supports scholarships for VWILL.

3. "SMA Foundation - Truth, Duty, and Honor Fund - Program Support"; this supports programs such as VWIL marching in out-of-town parades, training outside of the Mary Baldwin Campus, and similar items.

TERM DEFINITIONS

1. **Cost Basis**: The total amount you pay for an asset. If you buy 100 shares of DuPont stock at $10.00 a share (for $1,000.00 plus a commission of $100.00), your total cost basis is $1,100.00 or $11.00 a share. If the stock splits 2 for 1 (you are given 100 shares and you now have a total of 200 shares), your total cost basis remains $1,100.00 but your cost basis per share becomes $5.50 ($1,100.00 ÷ 200 shares = $5.50 per share). If you buy a house for $100,000.00 and pay additional settlement charges of $3,000.00, i.e. attorney's fees, transfer taxes, document preparation, etc., your total cost basis is $103,000.00. If you add additions or make other substantial capital improvements, i.e. rebuild a chimney, rebuild a wall or add a new porch, the cost of that is added to your cost basis. If a porch is added for a construction cost of $10,000.00, your cost basis is now $113,000.00.

2. **Step-up in Basis at death**: At the time of your death, all of your assets are valued as of their current fair market value at that time. That then becomes the "basis" for that asset in the beneficiaries' hands. For example, if you paid $100,000.00 for your house during your lifetime and it is worth $250,000.00 at the time of your death, your beneficiaries would inherit the house with a cost basis of $250,000.00. If your beneficiaries then sold it for $250,000.00, they would not have a taxable gain or loss. If they sold it for $270,000.00, they would have a $20,000.00 gain; if they sold it for $230,000.00, they would have a $20,000.00 loss.

3. **Gifts during your lifetime (an *inter vivos* gift)**: Any individual may give away to any other individual up to $14,000.00 in any calendar year after 2013, i.e.: **the amount for 2014 is $14,000.00** – without any gift tax consequences. [There are exceptions which allow greater amounts so long as the payments are for medical care, tuition and similar expenses. NOTE: there is an unlimited exemption for gifts between spouses unless the spouse is not a US citizen.] If you gift an asset such as land, stock or a similar item, the value of the gift is computed based on the fair market value as of the date of the gift. HOWEVER, the recipient of the gift -- the "donee" -- takes the gift with the same cost basis that it had in your hands. The step-up in basis occurs only at death. For example, if you give to one of your grandchildren a share of DuPont stock which you own valued at $70.00 and it has a cost basis of $10.00 in your hands, it will have a cost basis of $10.00 in your grandchild's hands. Therefore, if it was sold by the grandchild for $70.00 per share, there would be a $60.00 gain, the same as in your hands, on which taxes would have to be paid. ($70.00 sale price - $10.00 cost basis = $60.00 gain.) The same is true for any capital asset, including land. **A $5,340,000.00 lifetime exemption provision is available for the making of gifts beginning January 1, 2014 so long as a Gift Tax Return is filed**. **Use of this exemption means there will be no exemption at the time of death unless the exemption amount has been adjusted upward. SEE # 5 BELOW.** [NB: a spouse's unused gift tax exemption may also be available if applicable.]

4. **<u>Federal Estate Tax Exclusion</u>:** The Federal Estate Tax "exclusion" based on the Federal credit is as follows: (the following applies only to citizens of the USA.)

Year	Tax rate	Unified Credit Equivalent ("exclusion")
2010	-0-%	N/A
2011	35%	$5,000,000.00
2012	35%	$5,000,000.00
2013	40%	$5,250,000.00
2014	40%	$5,340,000.00

NB: There was a very limited "step up in basis" in 2010 unless an election was made to file under the 2011 and 2012 provisions. There are special election rules for the 2010 tax year and you <u>must</u> consult with your tax advisor about those rules, if applicable.

NB: There is now "portability" between the Decedent's exclusion and the surviving spouse's exclusion, allowing for a total exclusion in 2014 of $10,680,000.00 for a married couple.

5. **<u>Federal Gift Tax Exclusion</u>**: The Federal Gift Tax Exclusion is based on a lifetime credit. For 2013 the amount was $5,250,000.00. **For 2014 the amount is $5,340,000.00.** Excluded from the provisions of gift taxes are the following:

A. Spouses may give unlimited amounts of property to each other without limitation, so long as the spouse is a U.S. citizen. [Special rules apply to non-U.S. citizen spouses.]

B. Beginning in 2013 and extending into 2014, an individual may gift property up to $14,000.00 in value to any individual in any year. The gift must be absolute and not remain within the control of the donor. Note, for husbands and wives who wish to give to their children, the total amount would be $28,000.00 of joint gifts per child in any one year.

C. A donor may make payments of unlimited amounts of "tuition" or "medical care" (including health insurance premiums) for any donee during the year. The payments must be made directly to the educational institution, doctor, hospital, or insurance company in the particular instance. The payments may **not** be made directly to the individual for purposes of reimbursing them for these expenses.

D. Gifts to lawfully approved charities.

E. You are not required to file a gift tax return, IRS Form 709, for any of the foregoing gifts [A, B, C, & D]; however, on an annual basis, you may wish to fill one out for your own records to document your gifts and the cost basis of the

gifts, or, should you so desire, file the return with the IRS even though no taxes are due.

F. You may make gifts of up to $5,340,000.00 during your lifetime beginning in 2014 if you use your $5,340,000.00 lifetime exemption. You **must** file a Federal Gift Tax Return, IRS Form 709, to document these gifts. [**NB**: These amounts are **not** in addition to prior years amounts. If you gifted $5,250,000.00 before January 1, 2014 you only have an additional $90,000.00 you may take as an exclusion.]

6. **<u>"Normal income tax" due from beneficiaries on distributions from IRAs, 401(k)s, and similar tax deferred plans:</u>** The receipt of any of the foregoing by a non-spouse beneficiary is a taxable event at the marginal income tax rate of the beneficiary and is reported on schedule 1040 in the year in which it is received by the beneficiary. **The only exception is a post death transfer to a spouse; no tax is due on such transfer as long as the asset is "rolled over" to the spouse's own "roll over account."** There are specific rules which allow a non-spouse beneficiary to accept distribution over a number of years. Careful attention must be given to the designation of beneficiaries for these accounts. Roth IRAs are subject to separate treatment; consult with your accountant. Roll overs must be direct, Trustee to Trustee; if the Beneficiary receives the funds, even if later deposited to an "Inherited IRA" account within 60 days, the funds are considered as "received" and are taxable. [Beech, TC Summ. Op. 2012-74]

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