Charitable IRA Rollovers Are (Sort Of) Here!!!

by Robert J. Kolasa

INTRODUCTION

When the Federal estate tax was purportedly gradually repealed by tax legislation in 2001[1], the charitable institutions in this country collectively shuddered at the thought of anticipated decreased charitable revenues. Although supporters of the estate tax repeal would offer fanciful studies contending otherwise, many in the charitable sector did not need an economist to state the obvious—that the existence of the estate tax motivated affluent donors to make significant charitable gifts. However, to openly oppose estate tax repeal was anathema for most charities, as such legislation was overwhelmingly supported by wealthy charitable patrons.

The political "marker" loosely promised to the charitable sector in 2001 involved a trade—don't oppose estate tax repeal and Congress would support legislation to stimulate charitable giving. While some may naively, or dishonestly, deny the existence of this deal, in reality a flurry of charitable "relief" bills were introduced in Congress after 2001, some narrowly missing passage. The culmination of this political intrigue was, at least temporarily, settled on August 17, 2006, when President Bush signed the Pension Protection Act of 2006[2] (the "Act") which for the first time in U.S. tax history, contained provisions authorizing charitable IRA rollovers (roughly translating into charitable IRA gifts by age 70½ donors of up to $100,000, without adverse income tax consequences).

The purpose of this article is to briefly explain the rules relating to the advent of charitable IRA rollovers. While such legislation in its present form was, to the chagrin of the charitable sector, narrowly drafted (it will expire in 2008 and excludes some heavily lobbied provisions discussed herein), it still represents a tremendous political payback and revenue opportunity for charities. It is optimistically hoped that the provisions of the Act will dramatically increase charitable giving, and in time such continued giving will merit the permanency of charitable tax relief and the expansion of its scope.

THE PROBLEM OF USING IRAs TO MAKE CHARITABLE GIFTS UNDER PRIOR LAW

Under prior law, a withdrawal from a traditional IRA was generally fully taxable. Using IRA proceeds to then make a charitable gift would generate an offsetting charitable deduction. The problem was that the charitable deduction would in many cases be less than the income generated by the IRA withdrawal due to two limitations. First, under the "reduction of itemized deductions rule" of Section 68 of the Internal Revenue Code ("Code"), itemized deductions, including charitable deductions, are generally reduced by 3% of adjusted gross income in excess of a certain limit ($145,950 for most filers in 2005).[3] Second, under the "50% of AGI rule," charitable deductions under Code Section 170(b) are generally limited to 50% of the taxpayer's adjusted gross income (30% for charitable contributions made to private

[1] The Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law No. 107-16, which in 2010 completely repeals the Federal estate and generation-skipping transfer taxes, only to see such repeal "sunset" (i.e., expire) in 2011 by a reversion back to prior law.

[2] H.R. 4. For reference, refer to the text of the charitable provisions of H.R. 4 (http://www.pgdc.com/pdf/HR4_Text_Charitable_Provisions.pdf) and the Joint Committee on Taxation's Explanation (http://www.pgdc.com/pdf/JCX-38-06.pdf).

[3] The Economic Growth and Tax Relief Reconciliation Act of 2001 gradually phases out (beginning in 2006) the reduction of itemized deductions rule over a four-year period to complete elimination in 2010; however the phase out sunsets (i.e., expires) in 2011, unless Congress extends or makes permanent such elimination.

foundations), with limited carryover of the disallowed amount to future years.

As a result, a taxpayer making an IRA withdrawal and subsequent charitable contribution of the proceeds thereto would typically recognize taxable income in the year of contribution (if the IRA included nondeductible contributions, a portion would be treated as a nontaxable return of contribution). Worse yet, if the taxpayer was a standard deduction filer (perhaps because of living in a state with no state income taxes and without enough other deductions to become an itemized deduction filer), he would recognize 100% of the IRA income without any offsetting deduction. Furthermore, some states (not Illinois) do not currently provide for charitable income tax deductions at all, resulting in state income taxation of charitable contributions.

It goes without saying that recognizing taxable income for IRA proceeds contributed to charity discouraged charitable contributions from these accounts.

Example. John Smith has reached age 70½ and has a traditional IRA with a balance of $100,000 consisting solely of deductible contributions and earnings (possibly through a rollover of his qualified retirement plan balance into a traditional IRA). In December 2006, the entire IRA balance is distributed in a distribution to an organization described in Code Section 170(b)(1)(A) (other than a donor advised fund or supporting organization described in Section 509(a)(3)).

Under present law, the entire distribution of $100,000 would be includible in John's income. Correspondingly, if his adjusted gross income was $180,000, the charitable deduction would generally be reduced to $90,000 under the 50% of AGI rule, resulting in $10,000 of extra taxable income. This is before application of the reduction of itemized deduction rule, which would even further increase taxable income by reducing the amount of the charitable deduction.

Under the new law, the entire distribution of $100,000 constitutes a "qualified charitable distribution." Accordingly, no amount is included in John Smith's income as a result of the distribution, and the distribution is not taken into account in determining the amount of John's charitable deductions (which would have otherwise been reduced) for the year.

SUMMARY OF MAJOR RULES RELATING TO CHARITABLE IRA ROLLOVERS

In general, the major rules relating to IRA Charitable Rollovers can be summarized as follows:

1. When do the Charitable IRA Rollover Rules Become Effective? The new rules apply to IRA distributions made in 2006 and 2007 and are not available for 2008 and later years.

   Making tax legislation effective for only a few years is a gimmick currently favored in the political process to drive down the overall costs of tax cuts for budgetary purposes. What usually happens is that on the eve of statutory expiration, legislation is hastily crafted to either make the tax cut permanent, or start another cycle of temporary existence. Why not just make tax changes permanent in the first place, instead of having a multitude of transitory rules skewing the real economic costs of tax proposals? In any event, you can bet the farm that the charitable sector will use all of its political clout in order to make these rules permanent, as well as expand the scope (discussed below) of such rules.

2. What Taxpayers Benefit? Only individuals who have reached age 70½ by the date of contribution are entitled to the income exclusion.
3. How Much can be Excluded from Income? The limit on income exclusion is $100,000 applied on a per taxpayer per year basis. Accordingly, a married couple may donate up to $200,000, provided each spouse owns an IRA worth $100,000.
4. What Accounts can Qualified Charitable Distributions be Made From? Only traditional IRAs and Roth IRAs are covered by the provisions. Other retirement plans such as defined benefit plans, defined contribution plans, profit-sharing plans, Keoghs, SEPS, 401(k) and SIMPLE plans are not eligible.
   However, ineligible plans may magically become eligible if the account owner rolls over such plan balances to a traditional IRA or Roth IRA to take advantage of the new law. While at first, Roth IRA eligibility under the new rules seems rather ludicrous (aren't distributions from Roth IRAs exempt anyway?), the answer is that there are circumstances when distributions from Roth IRAs are taxable—such as within five years of initial contribution, or before age 59½.
5. What Charities can Receive Qualified Charitable Distributions? "Qualified charitable distributions" are distributions from a traditional or Roth IRA to public charities described in Code Section 170 (b)(1)(A). In addition, while distributions to private foundations (other than "conduit" foundations), donor advised funds or supporting organizations are prohibited, designated funds, field of interest funds, scholarships and restricted or general endowments (for which donors or their designees have no advisory rights) are permitted.
6. Can IRA Distributions be made to the Account Owner who then Endorses the Check to a Qualified Charity? No. The check must be payable directly to the charity, although the donor may want to personally deliver the check to the charity (if so, make sure the check is actually delivered to the charity by year-end). In most cases, it is anticipated that the IRA administrator will make the charitable gift directly to the charity.
7. Does the Donor need to "Substantiate" the Charitable Contribution? Yes. Just like any other charitable contributions the charity should provide the donor with a contemporaneous written acknowledgment of the gift (Regulation Section 1.170A-13(f)).
8. Can the Donor Receive any Benefits in Exchange for the Gift? No. If the donor receives a "quid pro quo" benefit (i.e., such as the contribu-

tion is used partly for a charitable auction; or to purchase tickets for an event; or obtain preferential seating at an athletic event), the entire distribution is disqualified.

9. Do IRA Rollover Distributions constitute "Required Minimum Distributions?" YES!
   A. Background. Under the minimum distribution rules of Code Section 401 (a)(9), owners of traditional IRAs, age 70½ and older, must take a required minimum distribution each year. Distributions are based on approximately 3.8% of the IRA account balance and gradually increase each year based on the life expectancy of the IRA owner.
   B. Significance. It is anticipated that IRA custodians will add the IRA charitable rollover to their list of permissible IRA distribution categories. IRA donors should thereby be able to rather easily select the charity by legal name and enter the amount of the rollover. Many retirees do not really need their required minimum distributions for financial solvency, yet the distributions are mandatory and generate taxable income. Accordingly, charitable IRA rollover of required minimum distributions becomes a tremendous opportunity to give away "forced" taxable dollars on a tax-free basis.
10. What Donors will Benefit by the New Rules? It has been noted by Charles Schultz of Crescendo (a leading developer of charitable giving software) that charitable IRA rollovers will be favored by at least five types of IRA owners:
    A. Convenience Donor. A donor who enjoys the new rules as an easy, simple way to make charitable gifts.
    B. Standard Deduction Donor. A standard deduction filer who avoids taking the IRA distribution into income, resulting in lower taxable income.

C. Social Security IRA Donor. A donor who may be taking IRA required minimum distributions which increase income to a level where 85% of his Social Security is taxable. By using the IRA charitable rollover, his income may be lower and only 50% of Social Security payments may be taxable.

D. Generous Donor. A donor who gives more than 50% of income by using an IRA to make charitable gifts over the usual deduction limits (50% of AGI rule and reduction of itemized deductions rule).

E. Major Donor. A donor who gives the full $100,000 per year. While there is no added deduction, avoiding an additional $100,000 of taxable income may save substantial income taxes not otherwise available due to the charitable deduction limitations (50% of AGI rule and reduction of itemized deductions rule). The IRA rollover may be favored by many major donors and their tax advisor to simplify taxes and keep income levels lower.

ANTICIPATED EXPANSION OF IRA CHARITABLE ROLLOVER RULES

The real story relating to the Act's new charitable giving rules was what these provisions did not provide, rather than the actual rules themselves. Most significantly, the new charitable IRA rollover rules only apply to outright charitable gifts. Previous legislative bills would have allowed (at various specified ages, some as early as age 59½) tax-free distributions from IRAs for various life-income charitable gifts, such as charitable remainder trusts, gift annuities and pooled income funds. While explanations of these advanced charitable techniques are well beyond the scope of this article, such gifts generally pay taxable income to the IRA donor and/or spouse during their lifetimes, with the remainder to charity upon their deaths.

Without any dollar caps relating to the size of IRA life-income charitable gifts, the charitable sector and many estate planning attorneys were duly ecstatic at the thought of million-dollar IRAs transmuting to charitable gifts. The presumed reason for why this legislation was not adopted probably related to its revenue costs. However, this is perplexing. Typically, IRA owners wait until age 70½ to start drawing down their IRAs, and then (with proper planning) try to s-t-r-e-t-c-h payment out as long as possible over the lives of their children or grandchildren. In the short-term at least (which politically is all that apparently matters for budgetary purposes), by allowing charitable IRA rollovers for charitable life-income plans at age 59½, the Treasury should start collecting taxes earlier (a revenue gainer!), resulting in increased tax collections. Even if this reasoning is somehow economically flawed, in the future you can expect charities to push hard to permit life-income charitable IRA gifts starting at age 59½.

Other major items on the charitable industry's wish list which may soon see enactment are (i) a charitable deduction for standard deduction taxpayers (such as $400 for single individuals, and $800 for married couples); (ii) a rollback to age 59½ (instead of 70½) and an elimination of the $100,000 cap under the charitable IRA rollovers rules; (iii) an expansion of the charitable IRA rollover rules to other retirement plans, in addition to traditional IRAs and Roth IRAs, and (iv) a multitude of other charitable giving tax incentives. It should be interesting to watch Congressional action in this area for the next few years.

CONCLUSION

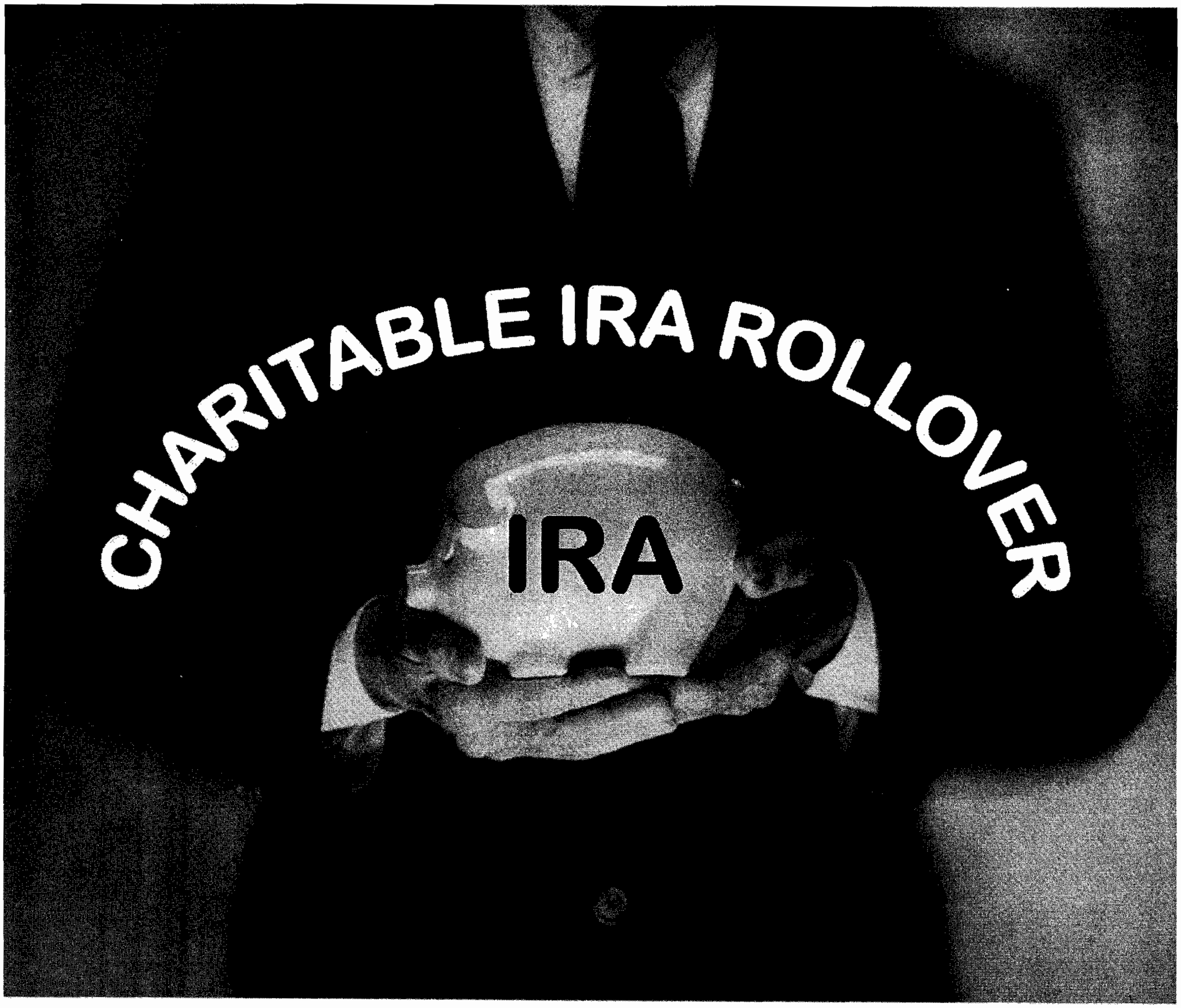
The recently enacted Pension Protection Act of 2006 provides new rules allowing charitable IRA rollovers. Such legislation generally enables donors in 2006 and 2007, who have attained age 70½, to make $100,000 charitable gifts of traditional IRAs and Roth IRAs without adverse income tax consequences. While the new law does contain major limitations (such as its dollar limitation, 2008 expiration date and nonapplication to life-income charitable gifts), it is anticipated that future legislation will expand these rules and offer numerous other tax incentives for charitable giving.

Robert J. Kolasa is an attorney practicing estate planning, probate and asset protection in Lake Forest, Illinois. He is also a C.P.A., holds a Master of Laws in Taxation degree from Georgetown University Law Center and once was an attorney for the IRS National Office, Office of Chief Counsel, in Washington, D.C.

THE DOCKET

The Official Publication of the Lake County Bar Association October 2006 • Vol. XIII, No. 10

In This Issue:



Also

- FOURTH AMENDMENT: TERRY ISSUES
- SECURITIES REGULATORS ISSUE NEW ROUND OF WARNINGS REGARDING HEDGE FUNDS
- INFLATION-ADJUSTED AWARD LIMITS UNDER THE DRAMSHOP ACT