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Lessons Learned From Charitable IRA Rollover

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I. Introduction

The Pension Protection Act of 2006 permits a person over age 70 ½ to make up to \$100,000 of charitable gifts directly from an Individual Retirement Account ("IRA") in 2006 and 2007. The donor will benefit by not having to report the IRA distribution as taxable income, although the donor will not be able to claim a charitable income tax deduction for the gift. Many retirees have been particularly motivated to apply their charitable IRA gifts to satisfy their mandatory minimum distributions. For example, a 76 year old who would normally be required to receive a taxable distribution of just over 4% from an IRA could satisfy the requirement by contributing 3% to a charity and receive a taxable distribution of just 1%.¹

The new law makes no change to the rules that govern charitable bequests of IRA assets, either outright to charities or to deferred giving arrangements. Such transactions qualified for favorable income tax consequences in the past and will continue to be an attractive planning strategy in the future. The new law only changes the rules for lifetime charitable gifts from IRAs.

How popular were these IRA gifts in the last four months of 2006 when the law became effective? In a survey of 1,468 such gifts totaling \$30 million made from IRAs administered by over 230 financial institutions, The National Committee on Planned Giving (*NCPG*) found the median gift was \$5,000. Approximately 52% of the gifts were \$5,000 or less and 9% of the gifts were the legal maximum of \$100,000, resulting in a higher average gift size of \$20,365.² Only 4.4% of the gifts were made by the donors who received the greatest income tax benefits: donors who did not itemize their tax deductions and donors who were subject to the 50% annual charitable deduction limitation.³ Nearly 20% of the donors indicated that the charitable gift satisfied all or part of their minimum required IRA distribution for the year and many others cited their desire to accelerate a promised future gift or to satisfy a pledge. The University of Kansas received approximately 100 gifts totaling \$1.6 million. Harvard University received 150 such IRA gifts totaling \$2.5 million in 2006, with 11 (7.3%) at the maximum \$100,000 level and some gifts as small as \$100.⁴

¹“Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision.” *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 266. See also IRS Notice 2007-7; 2007-5 IRB 1, Q&A 42.

²[http://www.ncpg.org/gov_relations/NCPG IRA survey--general results \(1-18-07\).pdf](http://www.ncpg.org/gov_relations/NCPG_IRA_survey--general_results_(1-18-07).pdf)

³*Id.* Only 2.6% of donors mentioned that they did not itemize their deductions and 1.8% reported that they were subject to the annual charitable deduction limitation.

⁴Dale, Arden, “Charities Love IRA Rollovers”, *The Wall Street Journal*, Jan. 27, 2007, p. B2, Col. 3.

II Who Wins With Charitable IRA Rollover?

A. Donors who don't itemize their deductions

Probably the biggest winners under this new law are IRA owners over age 70 ½ who do not itemize income tax deductions (i.e., they take the standard deduction). Since the charitable deduction is an itemized deduction, they normally have the worst tax consequences from the gifts they make from their IRA distributions: they had to report the entire distribution as taxable income but received no offsetting income tax deduction. In theory, they should take advantage of the charitable IRA exclusion and make all of their charitable gifts from their IRAs. The primary obstacle is the practical impediment of making numerous small gifts -- e.g., \$10 or \$20 -- from an IRA. The "IRA checkbooks" offered at many brokerage houses may offer the most practical solution to this problem.

Nearly two thirds of American taxpayers claim the standard deduction and the percentage is even higher for taxpayers over age 70 ½. By comparison, the new charitable IRA exclusion law gives eligible IRA donors the equivalent of an unlimited charitable income tax deduction for up to \$100,000 of the charitable gifts that they make from their IRAs.

TAXPAYERS WHO USE THE STANDARD DEDUCTION AND RECEIVE NO FEDERAL TAX BENEFIT FROM CHARITABLE GIFTS 2001 Federal Income Tax Returns

	<u>All</u> <u>Taxpayers</u>	<u>AGI Over</u> <u>\$100,000</u>	<u>AGI Over</u> <u>\$200,000</u>
Nationwide	65%	9%	7%
Detail on Selected States			
-- States With A State Income Tax			
California	61%	4%	2%
New York	61%	1%	1%
Ohio	65%	5%	2%
-- States With No State Income Tax			
Florida	71%	20%	19%
Texas	77%	21%	21%

Although non-itemizers are typically middle and lower income taxpayers, many are wealthy. The IRS estimates that there are 5.2 million *higher-income taxpayers* who claim the standard deduction and cannot get any tax benefit from their charitable gifts.⁵ They tend to live in the nine

⁵ Parisi, Michael and Hollenbeck, Scott, "Individual Income Tax Returns, 2003," *Statistics of Income Bulletin*, Internal Revenue Service, Fall, 2005, at. p. 13.

states that do not have a state income tax: **Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming.** Donors (and, consequently, charities) who reside in these states will generally benefit more from the new charitable IRA exclusion law than donors who live in other states.

B. Donors Who Lose Tax Deductions As AGI (adjusted gross income) Increases.

1. The 2% (formerly 3%) phaseout of itemized deductions. The most common lost deduction is the phaseout of itemized deductions as income increases over \$156,400 (\$78,200 if married filing separately). The phaseout was 3% in 2005 but is only 2% in 2006 and 2007. By keeping AGI low, donors can deduct more of their itemized deductions.

2. Phaseout of \$3,400 Dependent & Personal Exemption Deductions. Wealthy taxpayers cannot claim personal exemptions for themselves or their dependents. By avoiding the recognition of IRA distributions, taxpayers in the affected thresholds may be able to deduct personal exemptions and dependent deductions. The thresholds for phaseout in 2007 begin at the following AGI levels and are phased out at the rate of 2 percent for every AGI increase of \$2,500: Married Filing Jointly (\$234,600), Head of Household (\$195,500), Single (\$156,400) and Married Filing Separately (\$117,300).

3. Reduced Income Tax on Social Security Payments. If a social security recipient's modified AGI is over either \$44,000 (married-joint) or \$34,000 (single or head-of-household), 85% of the social security payments are taxable and 15% are tax-exempt. However, if modified AGI is under either \$32,000 or \$25,000, then all of the social security payments are tax-exempt. By avoiding the recognition of taxable IRA distributions an eligible social security recipient may be able to pay less tax on social security distributions. The thresholds might not apply to married individuals who live together and file separately.

4. Other Deductions That Are Phased out as AGI Increases. Other deductions that are subject to income phase-outs, and the rates of phase-out, are:

- * 2% for "miscellaneous itemized deductions" (employee expense and investment expense deductions)
- * 7 ½% for medical expense deductions
- * 10% for nonbusiness casualty losses (e.g., damage to a vacation home)

5. Alternative Minimum Tax – An adjustment to exemption amount as income increases.

C. Donors who live in states with a state income tax that provides no tax breaks for charitable gifts: Connecticut, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia state income tax computations do not permit itemized deductions. Consequently, Connecticut, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia residents get no state income tax breaks from charitable gifts. Eligible donors in these states will save taxes at their highest marginal state income tax rate (e.g., 4% or 6%) for every charitable gift that they make from their IRAs instead of from their checking accounts. Although **Illinois** residents also cannot claim charitable income tax deductions, all distributions from retirement plans are exempt from the income tax so they would not see any benefit on their state returns from this new law. **Michigan and New Jersey** residents also might not see benefits since they may receive threshold amounts of

retirement income exempt from state income tax and only excess amounts are subject to state taxes. The thresholds are \$10,000 (\$20,000 married) in New Jersey and about \$40,000 (\$80,000 married) in Michigan.

D. Donors who are subject to the 50% annual charitable deduction limitation. Charitable deductions cannot exceed 50% of a taxpayer's adjusted gross income ("AGI") in any year.⁶ A donor who is subject to the annual deduction limitation and who uses a taxable distribution from a retirement plan account to make an additional charitable gift would generally be able to deduct only 50% of the amount in the year of the gift. The other 50% of the distribution would be subject to income tax that year. If, instead, the charitable gift is made directly from an IRA to the charity, a donor over age 70 ½ would not pay any extra income tax.

E. Wealthy Individuals Who Want to Reduce the Size of Retirement Assets in Their Estates. Whereas most inherited stock, real estate and other assets receive a step-up in tax basis, inherited retirement distributions are generally taxed as income in respect of a decedent. The combination of estate taxes and income taxes – particularly in states that have both a state estate tax and a state income tax – can produce an effective tax rate on such inherited distributions of over 80%. Some senior citizens draw down their retirement accounts to reduce the proportion of their wealth in these assets. The charitable IRA exclusion offers an opportunity to withdraw up to \$100,000 for charitable gifts without triggering some of the problems that large distributions might normally cause (e.g., the phaseout of itemized deductions and the 50% charitable deduction limitation).

III. Who Doesn't Win With Charitable IRA Rollover?

A. Donors Who Are About To Sell Appreciated Stock and Appreciated Real Estate. The sale of such property will trigger a 15% federal long-term capital gains tax. This tax could be avoided by instead donating the property to a charity before the sales negotiations are finalized. The issue, then, is whether the tax savings from the charitable IRA exclusion can exceed the pending 15% tax.

Charitable gifts of appreciated stock, mutual funds and real estate have traditionally provided donors with greater income tax benefits than gifts of most other types of assets. *In most cases, gifts of these assets will continue to provide greater tax benefits than gifts from an IRA.* On the other hand, if the donor is subject to some of the tax challenges described above – such as the 50% annual charitable income tax deduction limitation -- the donor could be better off making a gift from an IRA.

⁶ Secs. 170(b)(1)(A) and (C) and Reg. Sec. 1.170A-9(e)(11)(ii). There is a 5 year carryforward for the charitable contributions that exceed 50% of AGI. Sec. 170(b)(1)(C)(ii) and last sentence of Section 170(b)(1)(B).

Example: Ms. Donor has a \$10,000 IRA and has stock worth \$10,000 that she bought years ago for \$2,000. She is 75 years old and has AGI of \$200,000. If she makes a charitable gift from her IRA that qualifies for the charitable IRA exclusion, she will save a little bit of money compared to receiving a taxable IRA distribution (roughly \$140, or 1.4% of the distribution, due to the phaseout of her personal exemption and the 2% loss of itemized deductions). However, she will still own her stock. If she sells the stock, she will have an \$8,000 taxable gain subject to a federal 15% capital gains tax (\$1,200). Consequently, even with the opportunity to make a tax-free charitable gift from her IRA, she should probably receive a taxable \$10,000 distribution from her IRA and contribute her stock to produce an offsetting \$10,000 charitable income tax deduction. She can use the cash from the distribution for any purpose that she chooses, including the purchase of new stock that will give her a new tax basis of \$10,000.

Compare – wealthy donors in poor health have an incentive to keep appreciated stock and to instead make charitable gifts from their IRAs: “stepped-up basis.” Whereas appreciated stock will receive a step-up in basis in the hands of the beneficiaries -- generally the value at the time of death -- retirement accounts receive no step-up in basis and distributions to beneficiaries are generally taxed as ordinary income. Many individuals –especially those who are so wealthy that their estates will be subject to estate tax – consciously strive to reduce the amount of retirement assets in their estates. If they plan to hold appreciated stock until death, they may prefer to make their charitable gifts from their IRAs rather than use appreciated stock.

Example: Ms. Donor has a \$10,000 IRA and has stock worth \$10,000 that she bought years ago for \$2,000. She loves the stock and does not think it wise to sell it. She is 75 years old, in poor health and has AGI of \$200,000 and would like to make a charitable gift of \$10,000. She should use the IRA for her charitable gift. Upon her death the stock will receive a new tax basis – i.e., about \$10,000 – and the potential capital gains tax on the \$8,000 of appreciation would be eliminated. By comparison, had she donated the stock to charity and died with \$10,000 in an IRA, the distribution to her beneficiaries would produce \$10,000 of taxable income.

B. Donors Who Reside In States Where the State Income Tax Laws Pose Problems

For example, the **Kentucky** state income tax laws exempt the first \$41,000 of retirement income and also allow a charitable income tax deduction to reduce state income taxes. Consequently, a retiree who withdraws \$1,000 from an IRA and then donates \$1,000 to a charity usually has a tax advantage that the withdrawal was tax-free but the gift produced tax savings. Suppose that the \$1,000 charitable gift was made directly from the IRA. On the state income tax return the donor would not report any taxable income but would lose the state income tax deduction and, consequently, would pay more state income tax.

C. Donors Who Would Not Receive Any Tax Savings from the Charitable IRA Exclusion and Who Encounter Administrative Hassles Trying to Make a Charitable Gift Directly from an IRA. Millions of donors won't save any income taxes with the charitable IRA exclusion. Who are they? They are donors who itemize tax deductions (and can therefore deduct charitable gifts) with incomes under \$150,000 (so they are not subject to the 2% phase-out of itemized deductions)

who can't realistically make social security benefits tax-exempt and who live in states that allow charitable income tax deductions. Most of these donors have not incurred a tax cost from their charitable gifts since the charitable income tax deduction has offset the taxable income from an IRA distribution. If the IRA administrator balks at making charitable grants from an IRA or has fees for the transaction, it will be much easier to simply receive a taxable distribution from an IRA and then write a check to make a charitable gift.

III. LEGAL REQUIREMENTS

A. Overview

A person over age 70 ½ who makes an outright charitable gift from her or his IRA:

- (1) will not report the distribution as taxable income,⁷ and
- (2) will not be entitled to claim a charitable income tax deduction for the gift.⁸

B. Seven Basic Requirements

In order to make a lifetime charitable gift from an IRA without having to report the payment as a taxable distribution, the distribution must meet the definition of a "**qualified charitable distribution**" (hereafter "**QCD**").⁹ Unless a distribution qualifies as a QCD, any lifetime charitable gift from any sort of retirement plan account (IRA, 403(b), 401(k), profit sharing, etc.) must be reported as a taxable distribution. The donor can then claim an offsetting charitable income tax deduction.¹⁰

There are seven requirements for an IRA distribution to qualify as a QCD:

1. Donor must be at least age 70 ½. The distribution must be made on or after the date that the IRA owner attained age 70 ½.¹¹ In most cases such donors will be retirees. Donors under age 70 ½ will have to report charitable gifts from their IRAs as taxable distributions and can claim offsetting charitable income tax deductions if they itemize their deductions.

Tax Trap in The Year a Person Attains Age 70 ½: There can be a lot of confusion in the year that a person attains age 70 ½. All distributions that are made at any time during that year can be applied toward satisfying the minimum distribution requirement to avoid the 50% penalty tax for

⁷ Sec. 408(d)(8)(A).

⁸ Sec. 408(d)(8)(E).

⁹ Sec. 408(d)(8)(B).

¹⁰ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 43.

¹¹ Sec. 408(d)(8)(B)(ii).

insufficient distributions. However, only the distributions that are made after attaining the age of 70 ½ qualify for the charitable exclusion. This can be a problem for someone who attains age 70 ½ late in the year, say on December 28. The law should be changed by a technical corrections act to conform the charitable IRA exclusion rules with the minimum distribution requirements. That is, all distributions should qualify for the charitable exclusion if made "within or after the calendar year that the individual for whose benefit the plan is maintained has attained age 70 ½". Tax administration would be simplified and innocent parties would not be caught in a tax trap.

2. IRAs only. The distribution must be made from an individual retirement plan.¹² That means only an IRA -- not a qualified retirement plan or a Section 403(b) annuity. Distributions to charities from other types of retirement accounts -- such as 403(b) plans, 401(k) plans, profit sharing plans and pension plans -- will still be treated as taxable distributions to the account owners eligible for an offsetting charitable income tax deduction.

In most cases, the restriction of such favorable tax treatment to IRAs should not pose a significant problem. Many retirees have large IRA balances because they rolled over distributions from their company retirement accounts into IRAs when they retired. Donors without IRAs who would like to take advantage of the charitable IRA exclusion can establish a new IRA and then rollover some assets from their other qualified retirement plans into the new IRA.¹³

Whereas distributions from IRAs that were once part of an SEP or a SIMPLE plan qualify for the charitable exclusion, grants made from either an *ongoing* SEP IRA or an *ongoing* SIMPLE IRA do not. Small employers often establish an SEP IRA plan or a SIMPLE IRA plan as the company's only retirement plan. The employer makes contributions to each employee's IRA rather than to the usual arrangement of a single retirement trust maintained by the employer. An SEP IRA or a SIMPLE IRA is an *ongoing* arrangement if a contribution was made to it during the year. Thus, a retired individual who has an SEP IRA or a SIMPLE IRA that received employer contributions during her or his working career can make charitable distributions from that IRA if no employer contributions were deposited in the same year as the charitable gift.¹⁴

3. Directly from the IRA to the charity.¹⁵ The check from the IRA must be issued payable to the charity. If a check is issued from the IRA payable to the IRA owner who then endorses the check to the charity, it must be reported as a taxable distribution to the IRA owner.

¹² Sec. 408(d)(8)(B).

¹³ Sec. 408(d)(3). Employees who receive distributions from any type of qualified retirement account can rollover the distribution to an IRA.

¹⁴ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 36.

¹⁵ Sec. 408(d)(8)(B)(ii).

Does the IRA Administrator have to mail the check to the charity? Can the check be issued payable to a charity and then mailed to the IRA account owner who then forwards the check to the charity? Yes. The IRS concluded that this arrangement would be a “direct payment” to the charity.¹⁶ This is a very good result. The NCPG survey reported that charities received about 15% of IRA gifts from donors and 83% from IRA administrators, and that when they received checks from IRA administrators, they had difficulty identifying the correct donor 10% of the time (e.g., “\$1,000 from the IRA of John Smith. Which John Smith? We have several donors with that name”).¹⁷

4. The recipient organization must be a public charity or a private operating foundation, or possibly a conduit private foundation. The recipient organization must be described in Sec. 170(b)(1)(A).¹⁸ This statute includes most public charities as well as private *operating* foundations. **Two exceptions: donor advised funds and supporting organizations:** Although contributions to donor advised funds and Sec. 509(a)(3) supporting organizations qualify for public charity tax deductions, they are not eligible beneficiaries for the charitable IRA exclusion. In that case, the donor must report the IRA distribution as taxable income and then claim an offsetting charitable income tax deduction.¹⁹

Grant-making private foundations are generally excluded, except the legislation appears to permit grants from IRAs to two types of grant-making private foundations: conduit private foundations and donor-directed funds.²⁰ A conduit private foundation is typically a grant-making foundation that in any given year makes an election to distribute by March 15 (oversimplified) 100% of the contributions that it received that year. A donor-directed fund allows a donor to control, not just advise, the recipient of the fund’s income. Private operating foundations, such as libraries and museums that are endowed by one family, are also eligible recipients.²¹ However, payments to organizations that qualify for charitable income tax deductions but which are not eligible public charities – notably veterans organizations, certain

¹⁶ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 41.

¹⁷ NCPG survey, at *supra* n. 2.

¹⁸ Sec. 408(d)(8)(B)(i).

¹⁹ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 43.

²⁰ Conduit private foundations are described in Sec. 170(b)(1)(A) and so therefore be eligible. Specifically, they are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(ii). Donor directed funds are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(iii).

²¹ Private operating foundations are described in Sec. 170(b)(1)(A)(vii) via Sec. 170(b)(1)(E)(i).

fraternal organizations and cemetery companies – are not eligible for the charitable exclusion for IRA distributions.²²

OBSERVATION: It is unfortunate that donor advised funds and grant-making private foundations were excluded as eligible recipients. There have been a few publicized scandals in recent years, but the overwhelming majority are well administered. They specialize in making charitable grants and could prove helpful to implement the charitable IRA exclusion in a manner that furthers Congressional policies and objectives. For example, at well-managed community foundations, Jewish federations and commercial-affiliated gift funds, it is standard practice that when a check is issued from a donor advised fund to a charity, the transmittal letter (and sometimes even the back of the check) contains instructions that the charity should not cash the check, and should notify the sponsoring organization, if the donor would obtain a personal financial benefit from the payment. Policies such as this one would be helpful to implement the charitable IRA exclusion.

5. The payment would otherwise fully qualify for a full charitable income tax deduction.²³ A distribution will qualify as a QCD only if a person would normally be able to claim a charitable income tax deduction for the entire payment. This eliminates favorable tax treatment for IRA distributions that are used for auctions, raffle tickets, fund-raising dinners or any other type of *quid-pro-quo* transaction. If there is any financial benefit, then the entire distribution is taxable income and the donor must hope to get a partially offsetting charitable income tax deduction. This eliminates the possibility that an IRA distribution will qualify as a QCD if it is used to obtain a *charitable gift annuity*.

6. Distribution would otherwise be a taxable distribution, with a maximum amount of \$100,000 per year.²⁴ By way of background, most IRA distributions are fully taxable. However, if an IRA owner made any nondeductible contributions to the IRA, then those distributions to the IRA owner are normally tax-free. A QCD only applies to the taxable portion.

The new law provides very favorable tax treatment for outright charitable gifts from IRAs that hold non-deductible contributions. Charitable distributions are deemed to come first from the taxable portion, thereby leaving the maximum amount of tax-free dollars in the IRA.²⁵ An

²² Charities are one of five categories of organization that are eligible to receive contributions that qualify for charitable income tax deductions: (1) governments, (2) U.S. charities, (3) veterans organizations, (4) certain fraternal organizations and (5) cemetery companies. Sec. 170(c). By comparison, only organizations described in Sec. 170(b)(1)(A) – generally public charities – are eligible for the charitable IRA exclusion.

²³ Sec. 408(d)(8)(C).

²⁴ Sec. 408(d)(8)(B) (last sentence).

²⁵ Sec. 408(d)(8)(D).

example is in the footnote.²⁶ If any tax-free amounts are distributed to a charity, that portion does not qualify as a QCD. Instead, the donor is deemed to have received that amount free from income tax and can claim a charitable income tax deduction for a charitable gift of that part of the payment.

7. Donor must have documentation from the charity that would qualify the gift for a full charitable income tax deduction under normal circumstances.²⁷

Part of the challenge of this new law is that the donor will have to obtain the required documentation from the charity necessary to qualify the payment for the customary charitable income tax deduction.²⁸ That is, the charity must issue a “contemporary written acknowledgment” that describes the amount of cash contributed and that certifies that the donor did not receive any financial benefits in exchange for the gift. Failure to obtain such an acknowledgment will cause the IRA distribution to be a taxable distribution to the IRA account owner and, in the absence of the documentation necessary to justify a charitable income tax deduction, presumably might cause the person to lose an offsetting charitable income tax deduction.

Many charities are “tweaking” their letters to refer to the IRA distribution, so there is less chance of confusion with other tax-deductible charitable gifts that the donor might make. For example, a letter might state “thank you for your charitable gift from your IRA of”

²⁶ Example: An IRA owner has a traditional IRA with a balance of \$100,000, consisting of \$20,000 of nondeductible contributions and \$80,000 of deductible contributions and accumulated earnings. Normally, 80% of a distribution to the IRA owner would be taxable and 20% would be a tax-free return of non-deductible contributions. If however, there is a distribution to a charity that qualifies as a QCD, all of the distribution is deemed to come first from the taxable portion. Thus, if the IRA trustee makes an \$80,000 distribution to a charity, the entire \$80,000 is deemed to come from the taxable portion of the IRA and is a QCD. No amount is included in the IRA owner's taxable income. The \$20,000 that remains in the IRA is treated as entirely nondeductible contributions.

Modified from from Example 2 of *Technical Explanation Of H.R. 4, The Pension Protection Act of 2006*, Prepared by the Staff of the Joint Committee On Taxation August 3, 2006 (JCX-38-06) on page 268.

²⁷ The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, *or if a deduction is not allowable because the donor did not obtain sufficient substantiation*, the exclusion is not available with respect to any part of the IRA distribution.” (Emphasis added). *Technical Explanation of H.r. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 267.“

²⁸ For any gift of \$250 or more, the donor must produce a “contemporary written acknowledgment” from the charity that describes the gift and that states the value, if any, of a financial benefit that the charity provided the donor. Sec. 170(f)(8). For a contribution from an IRA, there cannot be any such benefit.

C. Projections for 2008

1. The Public Good IRA Rollover Act of 2007 -- H.R. 1419 and S. 819. The proposed legislation would make charitable IRA rollover permanent. It would also permit distributions from IRAs that would qualify as deferred gifts to charitable remainder trusts and charitable gift annuities after an IRA owner attains age 59 ½.

2. The House Ways and Means Oversight Subcommittee held hearings on July 24, 2007 concerning the impact of the Pension Protection Act of 2006 on charities. Various charitable representatives testified and all urged extension of Charitable IRA Rollover. Several members of Congress specifically asked about the law during the question and answer period. The tenor of their comments suggested:

(a) the members of Congress were willing to extend the charitable IRA rollover legislation beyond 2007, the year that the current legislation expires, and

(b) the members of Congress seem willing to consider expanding the legislation to include donor advised funds and supporting organizations. By comparison, there was not any testimony, questions or comments concerning possibly expanding the legislation to include deferred gifts, like charitable gift annuities.

3. The American Bar Association's Section of Real Property, Probate and Trust submitted comments to The House Ways and Means Oversight Subcommittee and urged permanent extension of Charitable IRA Rollover and expansion to include distributions to donor advised funds and supporting organizations. There was no recommendation concerning deferred gifts. The comments submitted by The American Bar Association's Section of Taxation made no mention of Charitable IRA Rollover.

IV. Technical Issues

1. How does the IRA administrator report charitable distributions to the IRS and to the IRA owner on the Form 1099-R?

For 2006 distributions, there is no special reporting responsibility for IRA administrators. Both the charitable distributions and the distributions received by the IRA owner are reported as presumably taxable distributions to the IRA owner.

2. How does the IRA owner report the charitable IRA exclusion on his or her income tax return (Form 1040)?

Since the IRA administrator does not make any distinction between charitable and non-charitable IRA distributions, the burden falls on the IRA owner to make the adjustments on his or her personal return. From a policy perspective this is a good practice since the IRA owner is in the best position to know whether a charitable distribution in fact qualifies for the charitable IRA exclusion or not.

The IRA owner should report all of the IRA distributions on the front page on the income tax return (Form 1040 - *total distributions* on Line 15A) but should then report only the *taxable distributions* on line 15B. Source: Form 1040 instructions, page 25. Thus, the charitable IRA exclusion will be reported similarly to a traditional rollover, where a person may have received a taxable distribution from an IRA but is able to avoid taxation by rolling over the amount within 60 days to another IRA. These charitable IRA gifts will not be disclosed in any way on Schedule A, where a person claims an itemized income tax deduction for conventional charitable gifts.

Example: Mr. Smith, age 76, is required to withdraw \$4,000 from his IRA in 2007 to avoid the 50% penalty for failure to take minimum required distributions after age 70 1/2. He had the IRA trustee send a \$1,000 check to his favorite charity. Mr. Smith received an acknowledgment from the charity that stated that he received no personal benefit and that the entire gift qualified for a charitable income tax deduction under the normal rules (such an acknowledgment is necessary for the charitable IRA exclusion). Mr. Smith personally withdrew an additional \$3,000 from the IRA.

The IRA custodian will issue Form 1099-R and will report \$4,000 of total distributions. Mr. Smith will report the \$4,000 of total distributions on Line 15A of Form 1040 but will report only \$3,000 of taxable distributions on Line 15B.²⁹ The \$1,000 gift will not be disclosed or reported on Schedule A where Mr. Smith deducts the other charitable gifts that he made.

3. A person over age 70 ½ who is the beneficiary of an *inherited* IRA can take advantage of the charitable IRA exclusion.³⁰

4. Can a charitable IRA distribution be used to satisfy a pledge? Yes. This is a very important development. The payment of a pledge from an IRA was a recurring reason donors cited for made a charitable gift from an IRA.³¹

a. No violation of IRA self dealing rules. Charitable IRA distributions can satisfy pledges without violating the IRA self-dealing prohibited transaction rules. “The Department of Labor, which has interpretive jurisdiction with respect to section 4975(d), has advised Treasury and the IRS that a distribution made by an IRA trustee directly to a section 170(b)(1)(A) organization (as permitted by section 408(d)(8)(B)(i)) will be treated as a receipt by the IRA owner under section 4975(d)(9), and thus would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization.”³²

²⁹ See the instructions to Form 1040 at <http://www.irs.gov/pub/irs-pdf/f1040.pdf>

³⁰ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 37.

³¹ NCPG survey, at *supra* n. 2.

³² IRS Notice 2007-7; 2007-5 IRB 1, Q&A 44.

b. No income to the donor, even though normally there can be income when a third party pays off a person's personal liability. For a legally binding pledge (as opposed to a non-binding pledge), some people raise the argument that a donor might have taxable income if a legal liability is discharged by a third party, thereby making the donor richer. However, Section 108(e)(2) provides that a taxpayer does not have taxable income if there is a discharge of indebtedness and the payment would have been deductible. Since the payment of a pledge provides a charitable deduction, a donor should not have taxable income if a third party satisfies it.

5. Each spouse over age 70 ½ is eligible to contribute up to \$100,000 from that spouse's IRA to eligible charities, with the maximum charitable IRA exclusion on a joint return of \$200,000. The distribution must come from each spouse's respective IRA. For example, a married couple would not be able to exclude \$140,000 of charitable gifts from one IRA and \$60,000 of charitable gifts from another since the \$140,000 would exceed the annual \$100,000 limit.³³ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 34.

6. A charitable IRA distribution is not subject to withholding taxes. The IRA administrator may rely upon reasonable representations made by the IRA owner. A qualified charitable distribution is not subject to withholding under section 3405 because an IRA owner that requests such a distribution is deemed to have elected out of withholding under section 3405(a)(2). IRS Notice 2007-7; 2007-5 IRB 1, Q&A 40.

7. The exclusion applies to any such charitable distribution made during 2006, even those made before the law was enacted on August 17, 2006. IRS Notice 2007-7; 2007-5 IRB 1, Q&A 38. This may be advantageous to people who have "IRA checkbooks" (typically at brokerage houses) where they can write checks directly from an IRA. A person over age 70 ½ who wrote such a check to a qualifying charity early in 2006 can take advantage of the exclusion.

8. What happens to checks issued before the end of the year but not physically delivered to the charity until the following year? There is no official guidance yet. At the very least the "mailbox" rule should apply to mailed checks (checks mailed in December are deemed delivered even though the charity doesn't receive the check until January).

V. MAKING IRA GIFTS WORK: SUGGESTED BEST PRACTICES FOR DONORS, ADMINISTRATORS AND CHARITY

A. Clear, Early Communication is Key.

Troublesome issues can be avoided when donors (or their advisors) clearly communicate their intentions to the IRA administrator and to the charity(ies) they wish to benefit. IRA administrators should inform their account-holders of any internal procedures that must be followed, as well as any limits the financial institution might have placed on IRA charitable distributions. Charities, for their part, should provide donors with accurate name, address and account information and should acknowledge QCDs appropriately in writing. As we approach the end of 2007 (and the sunset of

³³ IRS Notice 2007-7; 2007-5 IRB 1, Q&A 34.

IRA charitable rollover legislation), it is increasingly important that donors contact their administrators soon to begin the QCD process. Early communication helps the parties identify potential issues, gather necessary information and process distributions accurately, without the extra pressures of a statutory deadline.

1. Donor should request transfer paperwork early. Ideally, the donor should request transfer paperwork from the IRA administrator two weeks before the gift is to be sent. (NOTE: The administrator may have its own QCD request form that will simplify the paperwork and speed the process. See, for example: <http://www.tiaa-cref.org/pdf/forms/F11185.pdf>)

2. Donor should provide correct transfer instructions. The donor should be able to provide the IRA administrator with the correct name and address of each charity to receive a QCD. If the transfer is to be made electronically, the donor can facilitate the gift by providing the routing number, account number and name of the charity's bank, along with contact information at the bank for verification.

3. Donor should alert the charity to the intended IRA gift. Anecdotal evidence abounds of charities that have received IRA transfers with no indication of the donor's identity. (Not all IRA administrators provide this information to the charity.) By alerting the charity ahead of time to expect a qualified distribution from his/her IRA account at "XYZ Bank," a donor can help avoid this confusion, and assist the charity in providing donor with the necessary gift acknowledgement.

4. Administrator should be prepared to accommodate QCD requests. By this point in time, most IRA custodians are aware of the PPA's provision for IRA charitable rollover. While the PPA places no obligation on IRA custodians to facilitate QCDs, not to do so is poor customer service and invites the account-holder to move his/her account to another provider. Administrative personnel should understand QCDs and be prepared to gather necessary information to make timely transfers and treat the distribution properly for withholding and tax-reporting purposes.

5. Administrator should advise account-holders of any restrictions. IRA custodians have created varying internal policies regarding the number and size of QCDs they will process for an account-holder without charging extra fees. Custodians may also restrict the form of distributions (for example, checks or wire transfers, only). Certainly, administrators must be aware of their own institution's policies in this regard and be able to inform account-holders accurately.

6. Administrator can help facilitate gift acknowledgement. As noted above, a donor must receive appropriate written acknowledgement of his/her QCD from the recipient charity. The IRA custodian can facilitate acknowledgement to the donor by providing the charity with the name and address of the account-holder along with the distribution. In addition, some custodians provide charitable recipients with a form "acknowledgement letter" (see Exhibit).

7. Charity should make the transfer as easy as possible. Charities play an important role in marketing IRA rollover and educating their donors about this opportunity under the PPA. A crucial element in effective marketing is to provide donors with the logistical information needed to

make the distribution. Correct name and address, along with wire transfer instructions will help facilitate the gift.

8. Charity must acknowledge the gift. As discussed above, QCD donors depend on recipient charities to provide written acknowledgment of their gifts. Charities should have a form acknowledgement letter tailored to the requirements of the PPA. (See Example, below).

B. Reminders for Professional Advisors.

Professional advisors play a central role in helping clients to understand not only the opportunities for tax-leveraged donations inherent in the PPA, but also the division of responsibilities among the parties to a QCD gift. Some education in advance from the professional advisor can alleviate donor concerns, especially with regard to tax reporting.

1. Donors must verify the charitable status of QCD beneficiaries. Unlike sponsors of donor-advised funds, whose duty it is to verify the good standing of other charities receiving grants, IRA custodians are not in a position to perform due diligence concerning eligibility of QCD beneficiaries under the PPA. IRA administrators will follow account-holders' direction in making distributions, but are not prepared (nor required by the law) to determine whether a distribution to a given organization qualifies as a QCD.

2. QCDs are reported on the donor's Form 1040; not on the 1099. Tax-reporting duties are consistent with the donor's duty to verify the eligibility of QCD recipients. As noted above, the donor's 1099 will not distinguish between taxable IRA distributions and non-taxable QCDs. Rather, the donor will report QCDs separately on his/her Form 1040.

VI. ROLLOVERS FROM NON-IRA ACCOUNTS TO IRAs

A. Many potential donors have funds in 401(k), 403(b) or other non-IRAs.

As discussed above, a QCD may only be made from a donor's IRA. Distributions from 401(k), 403(b) or other non-IRA accounts, (even if subsequently donated to charity), represent taxable income to the account-holder. A common inquiry from potential donors is whether funds may be "rolled over" from a 403(b) or other plan account to an IRA in order to fund a QCD. While the answer is often "yes," there are limitations for such a donor to keep in mind.

1. Limits on ability to roll these non-IRA funds to IRA. The donor's ability to roll funds from a 403(b) plan (for example) to an IRA depends upon: the donor's status with respect to the employer and the terms of the plan document. Typically, a donor may make such a direct rollover only upon "separation from service." Even then, not all plans allow the donor to transfer funds to another plan type or another provider. For example, some 403(b) plans allow annuitized distributions only (during the participant's life), and do not permit the account-holder to roll funds directly to an IRA or otherwise transfer assets to another plan.

2. Timing of rollover to IRA. Assuming an account-holder is eligible to make a direct rollover from his/her retirement plan to an IRA, the length of time it takes to complete this process

and to request a QCD from the IRA may become an issue (especially for end-of-year giving). The donor is faced with a multi-step process: separate forms must be submitted to direct a distribution from the retirement plan to the IRA; to open the IRA itself; and to request a charitable distribution from the new IRA. Each of these steps could take from several days to two weeks to accomplish, depending on the company(ies) involved and the press of other business. Donors are advised to start early, especially as we approach the end of calendar year 2007.

3. A QCD cannot be used to satisfy the donor's required distribution from a non-IRA plan. A question that often arises is whether a donor's required minimum distribution from a 401(k), 403(b) or other plan can be satisfied by making a direct rollover from the plan to an IRA, then making a QCD from the IRA. The answer is "no." Under IRS Regulations §1.402(c)-2, A-7, distributions from the plan during a given year must be applied first toward the owner's required minimum distribution until that amount is satisfied and, until then, are not eligible for IRA rollover treatment. A donor who wishes to transfer funds from a non-IRA plan to an IRA in order to fund a QCD must therefore first take his/her required minimum distribution from the plan. Distributions beyond the required minimum may then be eligible for direct rollover to an IRA.

VII. EXAMPLE -- QCD ACKNOWLEDGEMENT

Charitable Acknowledgement

As an authorized representative of [Charity], I acknowledge receipt of a check/wire in the amount of \$_____ from [IRA Custodian], as custodian of the [Donor's IRA title and account number]. I further acknowledge that our organization is an organization described in Sec. 408(d)(8)(B)(i) of the Internal Revenue Code of 1986, as amended by Section 1201 of the Pension Protection Act of 2006, and that no goods or services were transferred by our organization to the "donor" in consideration for this gift, and that the donor's gift will not be placed in a donor advised fund or supporting organization.

Signature of Authorized Person

Date

Name (Printed)

Title

Address

City/State/Zip