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Way



United Way
of Santa Barbara County

an income, estate and gift
tax service for attorneys and
other financial advisors

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TECHNIQUES

The Pension Protection Act and the IRA Charitable Rollover: Key Considerations for Your Clients

The Pension Protection Act of 2006, passed by Congress and signed into law on August 17, 2006, contains both charitable incentives for donors and reforms for the charitable sector itself. One incentive, the most widely discussed charitable provision in the new law, is the so-called "IRA Charitable Rollover." For 2006 and 2007, an owner of an individual retirement account ("IRA") can direct a transfer of funds from an account directly to qualified charitable organizations. Both traditional and Roth IRAs are eligible for the charitable rollover. This provides, for a very limited time, a valuable and unique opportunity for legal and financial planners, their clients, and charities.

For years, charities had asked Congress to enact the so-called "IRA charitable rollover" as an easy way for IRA owners to make lifetime gifts from their individual retirement accounts. Because IRAs can pose some difficult tax issues for charitable gift planning, a direct rollover of the funds from an IRA to charity provides a simple alternative. We think you will find this overview helpful in counseling your clients on how to take advantage of this temporary incentive.

INDIVIDUAL RETIREMENT ACCOUNT BASICS

Prior to the Pension Protection Act, amounts withdrawn from a traditional IRA were automatically subject to ordinary income tax, even if an amount were directly donated to charity. A donor could claim a deduction for those amounts gifted to a qualified charity, but only if deductions were itemized. For charitable gifts of cash, the deduction available in the year of the contribution is limited to 50% of the donor's Adjusted Gross Income ("AGI").

For example, if an individual had \$50,000 of AGI and made a taxable withdrawal of \$100,000 from an IRA to make a charitable contribution, the AGI would then be \$150,000. Of course, the individual would be subject to ordinary income tax on the \$100,000 withdrawal.

However, the individual would only be entitled to an offsetting charitable deduction of \$75,000 – the net impact of the IRA withdrawal and charitable contribution is an increase of \$25,000 of AGI.

Itemized deductions are further reduced when a taxpayer has adjusted gross income in excess of certain threshold amounts. The AGI threshold amount for 2006 is \$150,500 (\$75,250 for married individuals filing separate returns) adjusted annually for inflation. The total amount of itemized deductions is reduced by three percent of the amount over the AGI threshold, but not more than two-thirds of total itemized deductions. These overall itemized deduction reductions are to be phased out by 2010.

While distributions from Roth IRAs are ordinarily not subject to income tax, they must meet certain alternative qualifications to receive this favorable treatment.

IRA Basics

The New Law

*Conditions of the IRA
Charitable Rollover*

*Required Minimum
Distribution Rules*

New Tax Developments

Withdrawals from a Roth IRA must be:

- Made either five years after the Roth IRA was established or after the individual attains 59 1/2 (whichever is later); or
- Made to a beneficiary or the estate of the owner following the owner's death; or
- Attributable to the owner being disabled; or
- Used for first time homebuyers' expenses up to a total lifetime amount of \$10,000.

THE NEW LAW

The Pension Protection Act permits distributions by individuals from their Individual Retirement Accounts to qualified charities without including those amounts in their income. Although the owner of an IRA does not receive a charitable tax deduction, the distributions are excluded from income for federal tax purposes. There are several advantages to this:

- Since the distribution is not included as part of AGI, deductions based on a percentage of AGI (such as medical expenses and miscellaneous deductions) will not have to be calculated on a higher threshold of income for those expenses to qualify as deductions.
- For those who are in the higher income brackets, the issue of reduced deductions, once the AGI exceeds a certain level, is not affected by the distribution.
- In those instances when a donor claims the maximum deduction for charitable contributions of cash (50% limitation of AGI), further charitable contributions can be made from an IRA without having those amounts subject to taxation.
- Those who do not itemize deductions will benefit because the tax benefit of not including a distribution from an IRA as part of income is similar to receiving a full charitable tax deduction for that distribution.

SOCIAL SECURITY RECIPIENTS

Social Security recipients may also benefit. Income from Social Security can be tax-free or partly tax-free depending on a taxpayer's AGI. Since the IRA charitable rollover strategy does not increase AGI, it does not affect the percentage of Social Security subject to income tax.

CONDITIONS OF THE IRA CHARITABLE ROLLOVER

There are several conditions to keep in mind regarding the IRA charitable rollover:

- 1) **Amount:** The aggregate amount of qualified charitable distributions from an IRA cannot be more than \$100,000 per year for each individual.

- 2) **Eligible Organizations:** The distributions must be made to a qualified public charity described in IRC Section 170(b)(1)(A) – a 50% organization, so called because a charitable contribution of up to 50% of AGI may be deducted. These organizations include churches, educational organizations, hospitals, medical research organizations, organizations that support government schools, etc. Note that while donor advised funds and Section 509(a)(3) supporting organizations are 50% organizations, they are not eligible beneficiaries for the charitable IRA rollover.
- 3) **Direct distributions:** Distributions must be made directly to the charity by the IRA trustee or custodian.
- 4) **Age:** The donor must have attained 70 1/2 years of age as of the date of the distribution. Unlike the required minimum distribution rules, this does not mean that the donor has attained 70 1/2 in the year of the distribution – it means the date the charity receives the gift. To be on the safe side, be sure your client is at least a few days past age 70 1/2. Note that getting the contribution done near year-end will require some advance planning if the client turns 70 1/2 in December.
- 5) **Time Limitation:** There is only a two-year window of opportunity. These provisions apply only to distributions made in 2006 and 2007.
- 6) **Transfer of Funds:** For the distribution to the charity to qualify, the custodian of the IRA account must transfer the funds to a qualified charity. Thus, to be eligible for the favorable treatment this year, the donor must notify the custodian in sufficient time for the transfer to be made before December 31st of 2006 or 2007.
- 7) **Distributions:** The distribution must be from an IRA or Roth IRA (though there may be less incentive to use a Roth IRA since distributions are generally tax-free). Distributions from other qualified retirement plans, such as 401(k)s, 403(b) annuities, defined benefit plans, defined contribution plans, profit sharing plans, Keoghs, sponsored Simplified Employee Pensions and Simple Plans do not qualify. However, the prospective donor may consider rolling over qualified retirement plan assets into a new or existing IRA and then implement an IRA charitable rollover.
- 8) **State Income Tax:** The IRA charitable rollover concerns how an IRA distribution is excluded for federal income tax purposes. Whether the IRA distribution is excluded for state income tax purposes depends on state tax law. Many states do take either federal adjusted gross income or federal

taxable income as a starting point for determining income tax so that the IRA Charitable Rollover is effective on the state level as well as the federal, but other states do not. It is advisable to check individual state tax laws.

BENEFICIAL TREATMENT OF NONDEDUCTIBLE CONTRIBUTIONS

The Joint Committee on Taxation published a technical explanation of the Pension Protection Act that highlights another benefit for owners of traditional IRAs that contain non-deductible contributions.

Prior to the Pension Protection Act, if an individual owning a \$100,000 IRA – comprised of \$80,000 of deductible contributions and earnings, and \$20,000 of non-deductible contributions – took an \$80,000 distribution, part of the distribution would have been deductible and part non-deductible. Although there was no tax on \$16,000 of the distribution, \$64,000 would be treated as ordinary income. The amount of ordinary income was determined by a ratio of non-deductible contributions to total IRA assets, or 20% (\$20,000/\$100,000).

However, under the Pension Protection Act, the rules for the qualified charitable distribution do not depend on this ratio of deductible and nondeductible contributions. Instead, an individual who wants to directly transfer funds to a qualified charity enjoys this advantage. Only the deductible contributions (which would have otherwise been taxable as income) are attributed to the distribution.

Thus, in this example, the \$80,000 distributed from the IRA is entirely deductible. What remains in the IRA is \$20,000 of nondeductible contributions that will not be taxed when funds are distributed.

REQUIRED MINIMUM DISTRIBUTION RULES

Because the IRA Charitable Rollover applies to individuals who have attained age 70 1/2, one concern is the impact the direct distributions from the IRA to the charity would have on the required minimum distribution rules. If the direct distribution were not treated as meeting the minimum distribution rules, the donor would be required to make additional distributions from the plan to meet those requirements. Fortunately, the Pension Protection Act permits a charitable rollover distribution to count toward the individual's required minimum distribution, which is a real advantage for those individuals who prefer not to take taxable distributions from the IRA. This strategy allows the individual to preserve more of his retirement

savings while both taking the opportunity to make a gift and meet the required minimum distribution requirements.

SPLIT INTEREST GIFTS AND SUBSTANTIATION ISSUES

In its Technical Explanation of the Pension Protection Act, the Joint Committee on Taxation explains:

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.)

From "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) p. 267.

Because the distribution would have to otherwise qualify for a full deduction, the qualified charitable distribution cannot be used for a gift to a charitable remainder trust, charitable gift annuity, or charitable lead trust. If the amount gifted to the charity is reduced in any way due to any benefit received, it will not qualify for the exempt treatment. This applies to any benefit, even a free dinner at a donor recognition event.

One needs to make sure there is sufficient substantiation for the gift or the exclusion will not be available with respect to any part of the gift. Thus, it is crucial that appropriate documentation is obtained to qualify the gift as a charitable contribution. For gifts less than \$250, a canceled check or receipt showing the name of the donee, date of the gift and amount of the gift should be sufficient. For gifts of \$250 or more, the receipt should show the nature, date and amount of payment, and the value of goods or services received. If none were received, such should be stated.

CONCLUSION

The Pension Protection Act and its IRA Charitable Rollover provision is one of the most important legislative developments to affect the non-profit sector in several years. There is a distinct benefit for qualifying donors as well as for qualified charities – a win-win arrangement for both parties. Please feel free to contact our office if we can provide you with more information or help answer your questions. Undoubtedly, you will be receiving questions from many of your clients, and we stand ready and willing to assist you in any way we can.

NEW TAX DEVELOPMENTS

As noted, the Pension Protection Act of 2006 contains many new provisions affecting charitable giving. Here is a selective summary of provisions affecting individuals:

Qualified Conservation Contributions

The charitable deduction limit of 30 percent of AGI is raised to 50 percent for qualified conservation contributions, provided that such contribution does not prevent the use of the donated land for farming or ranching purposes. Also, the charitable deduction limit is raised to 100 percent of AGI for eligible farmers and ranchers. The provision allows a taxpayer to carryover the deduction for 15 years, provided the taxpayer is a farmer or rancher in the year of the carryover (though the provision is effective for two years through 2007).

Charitable Contributions of Facade Easements

A charitable deduction is allowed with respect to easements concerning buildings located in a registered historic district. The easement must provide that no portion of the exterior of the building may be changed or altered in a manner inconsistent with the historical character of the exterior. The provision also clarifies that the charitable deduction is reduced if a rehabilitation tax credit has been claimed with respect to the donated property.

Taxidermy Property and Valuation Limits

A limit to the basis for donated taxidermy property to the cost of preparing, stuffing and mounting the animal. The value of the deduction would be equal to the lesser of basis or fair market value.

Clothing and Household Items

There is no deduction allowed for charitable contributions of clothing and household items if such items are not in good used condition or better. In addition, the IRS may deny a deduction for any item with minimal monetary value.

Recapture of Tax Benefit for Charitable Contributions of Property Not Used for an Exempt Purpose

The tax benefit derived from the contribution of property with respect to which a fair market value deduction was claimed could be recovered if the property is not used for an exempt purpose of the donee organization.

Update of Recordkeeping Requirements for Cash

For a charitable contribution of money, regardless of the amount, the donor must maintain a cancelled check, bank record or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

Partial Interest in Tangible Personal Property

Charities receiving a fractional interest in an item of tangible personal property must take complete ownership of the item within 10 years or the death of the donor, whichever is first. In addition, the donee must have (i) taken possession of the item at least once during the 10-year period as long as the donor remains alive, and (ii) used the item for the organization's exempt purpose. Failure to comply with these requirements results in the recapture of all tax benefits plus interest and the imposition of a 10 percent penalty.

Appraisal Reform

The threshold is lowered for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required. The provision also applies for purposes of estate tax appraisals and provides definitions of a qualified appraiser and qualified appraisals.

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