



To: Sharpe Group Clients

From: The Sharpe Group

Re: **Charitable IRA Rollover**

Date: August 9, 2006

On August 3rd the Senate passed the Pension Protection Act of 2006 (PPA). The President has stated that he is looking forward to signing this bill soon. The bill is considered the most comprehensive reform of pension funding legislation since 1974.

This legislation primarily focuses on pension matters. Congress decided, however, to also use this bill to enact various charitable giving incentives and reform measures. Of particular interest is the portion of the bill that relates to tax-free withdrawals from certain retirement accounts to fund charitable gifts.

In this memorandum we will provide a basic explanation of the legislation and offer a roadmap of how it applies to various donor segments.

Portions of CARE Act enacted

For a number of years the charitable community has lobbied Congress for enactment of the CARE Act. From the beginning the CARE Act has consistently included incentives to increase charitable giving by allowing gifts from Individual Retirement Accounts (IRAs).

Numerous versions of the CARE Act have been passed by either the House or the Senate over the years. Some of the bills would have allowed outright gifts from IRAs, and others included both outright gifts and gifts to planned giving vehicles such as gift annuities, charitable remainder trusts, and pooled income funds. Various age limits were proposed for outright and planned gifts from retirement accounts.

In the PPA, both houses have finally enacted a version of the IRA giving component of the CARE Act. One section of the legislation allows tax-free distributions from traditional or Roth Individual Retirement Account (IRA) assets directly to organizations that qualify for charitable deductions under IRC Section 170(b)(1)(a). The act excludes qualified contributions from a donor's adjusted gross income (AGI). The result is effectively a tax-free rollover of funds for charitable use.

Up to \$100,000 per donor per year may be given. The provision applies to gifts completed by December 31, 2007. The legislation will expire at that time unless it is extended or made permanent. To qualify, the owner of the IRA account must be age 70 ½ or older and the gift must be made in a way that it would otherwise be fully deductible. In the words of the Joint Committee on Taxation Technical Explanation:

“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.”

This language precludes funding of gift annuities or similar life income plans such as charitable remainder trusts or pooled income funds. This provision of the PPA applies only to outright gifts.

Other language in the Joint Committee explanation indicates that charitable distributions will count toward satisfying mandatory withdrawal amounts. For the full text of the Joint Committee explanation, text of the bill, and other relevant documents, see www.sharpenet.com/irarollover.

To qualify, the distribution must be made directly from the Trustee of an IRA to the charitable recipient. Donors will need to check with their IRA Trustees, or their advisors if they self-direct their funds, for details on how to distribute the gifts. Donors should not take the distribution themselves and subsequently write a check to charity.

Note that donor advised funds (as defined in IRC Section 4966(d)(2) and “supporting organizations” described in IRC Section 509(a)(3) are explicitly excluded. Nor does the provision apply to distributions from employer-sponsored plans such as 401(k) or 403(b) plans, or SIMPLE IRAs and simplified employment pensions (“SEPs”).

Who can benefit from this legislation?

The next logical question would be “who would make gifts in this manner?” Millions of IRA owners over the age of 70 ½ can benefit by effectively utilizing the charitable giving incentive provisions of the PPA.

Donors will be affected differently depending on their ages, wealth, and how much they wish to give. Some can give the same amount at lower cost and others can give more at the same after-tax cost. Recall the gift planning matrix™ employed as a teaching tool in The Sharpe Group training programs:

	YOUNGER -50	MIDDLE-AGED 50-70	OLDER 70+
WEALTHY	A1	B1	C1
MODERATE MEANS	A2	B2	C2
LIMITED MEANS	A3	B3	C3

©The Sharpe Group

The process of gift planning, matching the donor with the appropriate gift vehicle, depends to a large extent on the age and wealth of a particular individual. The provisions of the PPA will apply primarily to those in the C1, C2, and C3 boxes of the matrix. Additionally, the PPA will also call attention to gift planning opportunities applicable to some in the B1 box as well.

Starting with the basics

First, a donor must have an IRA. Recall that distributions from 401(k) and other non-IRA retirement plans do not qualify. In many instances, however, retirees “roll” their company-sponsored retirement accounts into what is sometimes referred to as a “rollover IRA.” Data indicates that many of the larger IRA accounts have, in fact, been “rolled over” from company plans post retirement, or are held by surviving spouses in “spousal rollover” IRAs. Others may have inherited an IRA from a parent or other relative.

Second, a person must have donative intent. A donor can always pay the tax on the withdrawal and devote the balance to personal use. For example, a 72-year-old could take a \$100,000 withdrawal, pay up to \$35,000 in federal income tax, (plus applicable state income taxes) and spend or reinvest the balance of approximately \$65,000 remaining after tax.

The good news: No tax is paid on money distributed directly to one or more qualified charities. The bad news: The donor does not enjoy any after-tax income. Therefore, a PPA gift requires donative intent.

Incentives for large and small gifts

Prospective donors of IRA gifts fall into several different categories with incentives to make gifts of various amounts depending on their wealth, level of donative intent, and other factors. The following simplified scenarios present a basic overview of IRA giving opportunities:

Category 1

Some individuals may have wanted to withdraw funds from an IRA in the past and devote the funds to charitable use but decided not to after learning they would be unable to completely deduct the gift for federal income tax purposes due to the 50% of AGI limit.

For example, John Donor, age 75, has an AGI of \$85,000. Under pre-PPA law, if John withdrew \$100,000 from his IRA his new AGI would be \$185,000. If he then gave the entire \$100,000 to charity, his deduction would be limited to 50% of his new AGI, or \$92,500.

Tax would have then been due on \$7,250 worth of income he had given to charity. The PPA removes this disincentive when the \$100,000 is transferred directly to charity, as it is not reported as part of his adjusted gross income, and thus does not have to be deducted on his tax return. The transaction is a pure “wash” for tax purposes.

No additional deduction is allowed for his gift, but one is not necessary because the withdrawal is not reported as income in the first place. Not receiving income is essentially the same as receiving and fully deducting it.

Similarly, if a donor has already given all he can this year under the 50% of AGI limit, he can give an additional \$100,000 this year and next year from his IRA without paying tax on the additional contributions.

Matrix Note:

The John Donors of the world will be found primarily in the C1 box of the matrix. They are a subset of older major donors and/or their surviving spouses. In many cases they will be retired executives, professionals, or business owners who have retirement funds in excess of their anticipated needs.

Special attention may be paid to current and former board members and their spouses. The strategy here will be to try to receive as much as possible of the \$100,000 that can be donated this year and in 2007. Capital campaign commitments, reunion gifts, and other specialized programs designed to encourage large gifts from older donors will be impacted.

Category 2

Another group of higher income donors would have been able to give \$100,000 or more from their IRAs and fully deduct the gift under pre-PPA law, but not without experiencing other potentially adverse tax consequences. For example, assume Jane Donor, age 71, has an AGI of \$250,000. She has total assets of \$5 million, including an IRA with a balance of \$200,000.

She could have withdrawn the entire \$200,000 under pre-PPA law, bringing her AGI to \$450,000. The provisions of the new law would have been unnecessary for her to deduct the full \$200,000 because it would have been less than 50% of her new AGI.

However, reporting the withdrawal would have caused her AGI to increase, potentially resulting in additional taxes on *other* income because a number of federal income tax deductions and credits are phased out as the amount of one's AGI increases. This is the reason some advisors recommended that donors not take withdrawals under KETRA legislation last year. Even though the withdrawals would not have been taxed because of KETRA's removal of AGI limits, a donor's AGI would nevertheless be "swelled" and possibly result in increased taxes.

Under the PPA, however, Jane can direct \$100,000 to charity this year and again next year and completely avoid tax on the \$200,000 because the funds are not reported as part of her AGI. A distribution to charity in this way thus does not cause increased taxes on other income.

Consequently, some wealthier donors with substantial other assets may now opt to “clean out” their smaller IRAs to fund larger gift commitments.

Keep in mind that IRA funds can be subject to both income and estate tax if left to heirs. Even if the estate tax is eliminated, income tax will still be due on IRA funds left to heirs. Therefore, these assets may be a wise choice when considering how to fund charitable gifts at death. The PPA thus represents a reason in addition to estate tax planning to make gifts using IRA funds during one’s lifetime this year and next.

Note that a donor in this situation might decide to spread the \$100,000 per year out among several charities. An IRA gift under the PPA is not necessarily a “winner take all” situation.

Matrix Note:

This opportunity applies to those over the age of 70 ½ who have both significant income and assets. As in the case of Category 1, they will be found almost exclusively in the C1 box of the matrix.

Category 3

Yet another group over age 70 ½ is not as wealthy, and not necessarily concerned with planning around the 50% of AGI limit, but is concerned that withdrawals from their IRAs will increase their AGI, causing more of their Social Security income to be taxed. This group also worries they could lose part of the benefit of other credits and deductions that are phased out for upper middle income seniors.

For example, George Donor, 75, enjoys a comfortable income from non-IRA sources including his Social Security. His net worth is less than \$1 million. He is forced to take a mandatory withdrawal of \$15,000 from his IRA this year and is concerned that the IRA withdrawal will push his AGI to a level where a portion of his Social Security income will be taxed. George would like to make charitable gifts totaling \$5,000 this year and next.

George could be well-advised under the PPA to direct that his charitable gifts this year and next be made from his IRA. This would result in \$5,000 less in adjusted gross income and could help reduce the amount of tax he pays on his Social Security income.

Matrix Note:

Those who could benefit from planning their gifts in this manner may include some in the C1 box but are more likely to be found among those with less income in the C2 and perhaps C3 boxes of the matrix.

Category 4

Another group who may benefit from the PPA are those who give to charity each year but receive no tax benefit from doing so because they do not itemize their deductions. Persons in this category are actually paying income taxes on money they have donated to charity.

For example, Mary Donor, age 73, has an income of \$50,000 and is in the 25% marginal tax bracket. Her home is paid for and she has few medical or other deductions. She will take a withdrawal of \$5,000 this year from her IRA. She also gives \$5,000 to charity each year. Because she does not itemize her deductions, she enjoys no tax savings as a result of her charitable gifts.

In fact, she pays income tax of 25%, or \$1,250 on the \$5,000 she donates. In effect it costs her \$6,250 to give \$5,000 to charity. Unfortunately Congress did not choose to partially or fully alleviate this problem by enacting a non-itemizer deduction as was proposed in some versions of the CARE Act.

However, if Mary directs that her charitable gifts be made directly from her IRA this year and in 2007, she will not have to report the \$5,000 distribution, saving her \$1,250 in taxes in her 25% bracket. The cost of her \$5,000 in gifts is thus only \$5,000, a cost reduction of 20%.

Alternatively, she could give \$6,250 from her IRA to charity at the same cost as her \$5,000 in gifts before. She could therefore be advised to increase her giving by 25% at no additional cost.

One way to look at this is that Congress has effectively allowed the equivalent of a non-itemizer deduction provision for persons over the age of 70 ½ who complete their gifts by directing distributions from their IRAs.

Matrix Note:

In many cases donors who are non-itemizers make a number of relatively small contributions to more than one charitable interest. These donors will be found among the broader ranks of annual fund donors, direct mail respondents, members and others. Many will be found in the C2 box of the matrix, with a number also coming from those in the C3 box who are currently making non-tax-favored charitable gifts from relatively small incomes.

Common denominators

One benefit shared by all affected donors is that funds given from IRAs are excluded from gross income while they are nevertheless taken into account when determining a person's mandatory withdrawal. **At a minimum, those over 70 ½ who are taking a required withdrawal from an IRA and are also contributing funds to charity should strongly consider taking advantage of tax-free gifts from their IRAs this year and next.**

Others who have funds in IRAs in excess of their anticipated needs might consider making larger than usual gifts in order to "drain" at least \$100,000 per year from their estates on a tax-free basis.

Potential Pitfalls

When considering making gifts under the terms of the Pension Protection Act of 2006, donors should be aware of the following mistakes that could jeopardize their tax benefits:

1. Making a distribution to a non-qualified recipient such as a donor advised fund or a supporting organization.
2. Making a distribution from a plan other than a traditional or Roth IRA.
3. Making a distribution in an incorrect manner, such as the donor taking the distribution into his or her funds and then writing a check to charity.
4. Receiving any benefit in return for the IRA distribution. This could include attendance at an event or any other benefit that would require a reduction in the amount of the deduction were the gift to be funded with other assets. The law requires that the entire distribution would otherwise have to be deductible.
5. Not receiving sufficient substantiation for a gift. If a donor does not receive the substantiation documents required under current tax law to adequately support a full deduction, the entire withdrawal will not qualify for favorable tax treatment if audited.
6. If the donor has already taken a mandatory withdrawal, any gifts to charity made from the amount withdrawn will not qualify as a distribution under the PPA. The donor could still make additional, tax-free distributions of up to \$100,000 to charity, but it would be above and beyond the previous mandatory withdrawal that would have to be reported as income.

Don't forget younger donors

What if a donor is under the age of 70 ½? It may be wise to use discussions of the PPA as an opportunity to point out to those over the age of 59 ½ but under age 70 ½ that attractive gift planning opportunities using retirement fund assets exist for them apart from the incentives offered under the PPA.

Under certain circumstances, persons over the age of 59 ½ may still want to make gifts using assets withdrawn from their IRAs or other plans such as a 401(k), 403(b), SIMPLE IRA, or simplified employment pensions (SEP). If properly planned, such gifts can result in a near total “wash” for tax purposes.

Review Category 2 on page 5 describing one of the groups who could benefit from the PPA. The same principles apply to some over the age of 59 ½ (who can make withdrawals without an early withdrawal penalty). For those in certain tax brackets, the negative impact of swelling their AGI may actually be relatively insignificant in comparison to the size of the gift they are able to make from funds that would eventually be subject to confiscatory levels of tax if left to non-charitable heirs.

Matrix Note:

Those in this category will be found primarily in the B1 box of the matrix. They will be relatively high income, high net worth individuals over the age of 59 ½ but under the age of 70 ½.

What to do now

The Sharpe Group recommends a carefully segmented approach to communicate the benefits of the Pension Protection Act of 2006 to donors. As indicated above, we believe communication efforts should be “tiered” according to the age and wealth of donors and prospective donors. **Because the Act affects different categories of donors differently, programs organized around the size, timing, and methodology of gifts and/or the age of donors may wish to consider a team approach to sharing the benefits of this law with their donors.**

The ramifications for older major donors are many. In some cases they might use this provision to help complete larger pledge commitments or make additional special gifts in the context of a campaign or other highly focused fund-raising efforts.

For the broader group of older direct mail donors, members, annual fund donors and others an opportunity exists to make all or a portion of their gifts in a more tax-efficient manner using the incentives provided under the PPA.

Careful thought should be given to informing various groups with strategically prepared messages. What may be appropriate for a multimillionaire considering an extra gift of \$100,000 this year may not be appropriate for the average retiree considering the best way to make a \$500 gift from relatively limited resources.

The Sharpe Group is committed to creating the most effective communications tools for use with various constituencies. Our attorneys, editors, and marketing experts are now at work putting the final touches on new and existing materials designed to encourage gifts from retirement plans in an understandable and cost-effective manner.

We believe this bill represents the beginning of a new approach to charitable giving by a new generation of seniors who hold a significant portion of their discretionary capital in the form of retirement plans. The charities that approach this subject most effectively will raise more funds in coming years.

Additional information and materials will be posted shortly on our Web site at www.sharpenet.com/irarollover.