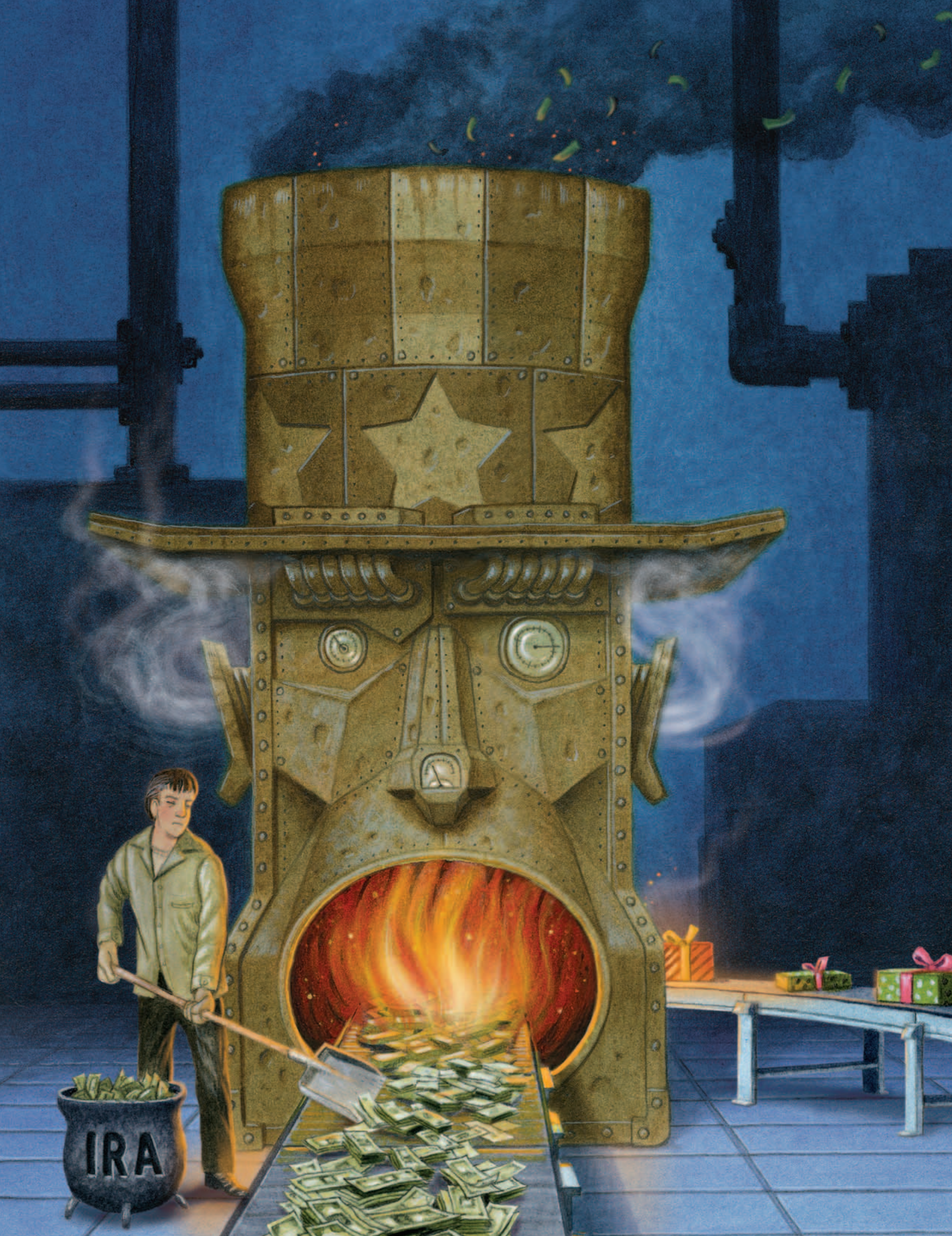
IRA

Max Licht

What Estate Planners Should Know About the IRA Charitable Rollover

By Kate M. H. Kilberg

As of the writing of this article, four bills are pending in the Senate and two bills are pending in the House of Representatives that include a provision to allow taxpayers to make charitable contributions directly from their individual retirement accounts (IRAs) federal income-tax free, rather than withdrawing funds, including the withdrawn funds in gross income, and then transferring the funds to charity, which may still result in additional income tax for the donor despite the possible charitable deduction. These bills, discussed in more detail below, are the most recent incarnations of proposed legislation to enact the IRA charitable rollover. Since 2001, Congress has considered a number of bills containing an IRA charitable rollover provision:

- In 2001, both S. 1924 (the Charity, Aid, Recovery and Empowerment Act or "CARE Act") and H.R. 7 included IRA charitable rollover provisions. Ultimately, however, the 107th Congress did not enact any IRA charitable rollover legislation.
- In 2003, the Senate passed S. 476, a new version of the CARE Act, by a vote of 95–5, while the House passed H.R. 7, which included a provision that would allow donors age $70^{1}/_{2}$ and older to make a direct rollover from an IRA account to charity in the form of either an outright gift or a deferred giving arrangement. S. 476 and H.R. 7 differed, however, and no conference was held to resolve those differences during the 108th Congress.

Support for an IRA charitable rollover provision has again gained momentum, and, as noted above, the current Congress (that is, the 109th) is considering six bills that include a charitable rollover provision. In addition, at the White House Leadership Conference on Faith-Based and Community Initiatives on March 1, 2005, President Bush stated that the IRA charitable rollover is one of his top four charitable initiatives and that his priorities include ridding the federal tax code of provisions that can discourage charitable giving. Indeed, Mr. Bush has included the IRA charitable rollover in each of his FY2005 and FY2006 budgets. Thus, even if the 109th Congress does not enact an IRA charitable rollover provision, it is likely that some such provision will be enacted in the coming years. If so, estate planners and clients will gain a tax-advantaged way to make charitable gifts.

Prevalence of IRAs

Fueled in part by the boom in the economy and the bullish stock market of the 1990s, the last few years have seen retirement assets become a significant portion of the wealth of many Americans. For example, of the gross estates of male decedents that filed estate tax returns, retirement assets were, on average, 5.8% in 1992,

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7.8% in 1995, and 11.2% in 2001. Similarly, of the gross estates of female decedents that filed estate tax returns, retirement assets were, on average, 2.3% in 1992, 3.2% in 1995, and 5.5% in 2001. Barry W. Johnson & Jacob M. Mikow, *Federal Estate Tax Returns, 1995–1997*, Stat. Inc. Bull. (Summer 1999), at 77; Martha Britton Eller, *Which Estates Are Affected by the Federal Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001*, Stat. Inc. Bull. (Summer 2005), at 191. For all Americans, retirement assets grew from 43.7% of financial assets in 1992 to 49.9% of financial assets in 2001. Craig Copeland, *Individual Account Retirement Plans: An Analysis of the 2001 Survey of Consumer Finances*, EBRI Issue Brief No. 259 (July 2003), at 13.

This trend will continue as younger generations have concentrated more of their wealth in retirement assets than their predecessors. A breakdown by age group for years 1992 and 2001 is instructive. In 1992, 44.5% of American households in which the head of the household was between ages 55 and 64 (birth years 1928–37) owned an IRA or Keogh plan account, 33.7% of American households in which the head of the household was between ages 65 and 74 (birth years 1918–27) owned an IRA or Keogh plan account, but only 6.8% of American households in which the head of the household was age 75 or older (birth years 1917 and before) owned an IRA or Keogh plan account. By 2001, 41.5% of American households in which the head of the household was between ages 55 and 64 (birth years 1937–46) owned an IRA or Keogh plan account, 41.9% of American households in which the head of the household was between ages 65 and 74 (birth years 1927–36) owned an IRA or Keogh plan account, but only 25.5% of American households in which the head of the household was age 75 or older (birth years 1926 and before) owned an IRA or Keogh plan account. (A Keogh plan is a tax-deferred retirement savings plan for people who are self-employed.) Copeland, supra, at 9.

Since 1974, when Congress enacted the Employee Retirement Income Security Act (ERISA), IRAs have become the vehicle of choice for retirement savings for many Americans. Traditional IRAs are particularly attractive retirement vehicles because investment earnings are generally exempt from taxation until withdrawn. (Other types of IRAs, such as the Roth IRA, offer different tax benefits.) Indeed, at the end of 2003, Americans held $3.0 trillion in IRAs, making them the largest component of all U.S. retirement assets, comprising 26% of those assets. Sarah Holden et al., *The Individual Retirement Account at Age 30: A Retrospective*, II ICI Perspective No. 1 (Feb. 2005). In particular, American families in the top 10% of net worth saw the percentage of their financial assets attributable to IRAs increase from 38.9% in 1992 to 54.3% in 2001. Copeland, supra, at 15. The Employment Benefit Research Institute projects that IRAs will continue this growth in the future, strengthening their position as the primary source of retirement income. Jack VanDerhei & Craig Copeland, *The Changing Face of Private Retirement Plans*, EBRI Issue Brief No. 232 (Apr. 2001), at 16–17. As illustrated by these statistics, estate planning clients are more and more likely to have significant portions of their wealth held in retirement accounts, and particularly in IRAs.

Problems with the Current System

Under current law, if a client would like to make a charitable donation during life, a gift of IRA assets is generally a bad choice. If a donor withdraws funds from an IRA to make a donation to charity, the donor must report that withdrawal as ordinary income to be taxed at ordinary income tax rates. Once the contribution has been made, the donor may be entitled to a charitable deduction that will reduce the tax cost. For example, if a donor withdrew $20,000 from an IRA (or directly rolled it over to charity), he would need to include that $20,000 in gross income. Ideally, he also would be entitled to a $20,000 itemized deduction.

For many contributors, however, the income tax charitable deduction is not available to offset the entire amount of taxable income generated by the IRA withdrawal in the year of the gift. For example, a donor making a very large gift of IRA assets will likely be unable to claim a full charitable deduction to offset the tax cost of the withdrawal. This is primarily because of two features of the tax code: (1) in any given year, a donor may deduct no more than 50% of his or her adjusted gross income for cash donations to public charities (30% for cash donations to private foundations) and (2) total itemized deductions for taxpayers in upper income brackets can be reduced by 3% of adjusted gross income in excess of an inflation-adjusted threshold ($150,500 in 2006, but only half that amount for married taxpayers filing separately), but such deductions cannot be reduced below 80% of the original amount. The IRS estimates that approximately 5.2 to 5.7 million taxpayers were subject to the itemized deduction phaseout each year from 2001–03. *Individual Income Tax Returns, Preliminary Data*, Stat. Inc. Bull., Data Releases, Winters 2002–03, 2003–04, 2004–05. Even for donors who would not otherwise be subject to the 3% phaseout, a large withdrawal from an IRA could increase income to the point at which the taxpayer *is* subject to the 3% reduction.

Consider an unmarried donor with $70,000 in income from sources other than IRA assets. If the donor decided she had ample retirement assets and wished to make a large gift to her favorite public charity, she might withdraw $100,000 from her IRA. The withdrawal would increase her adjusted gross income to $170,000. Under the rule that the donor's charitable deduction cannot exceed 50% of her adjusted gross income, the donor could only deduct $85,000 of her $100,000 gift from income. Further, the $100,000 withdrawal from the donor's IRA increases her income to the point at which she is subject to the 3% reduction of itemized deductions. As a result, the donor's charitable income tax deduction would be further reduced from $85,000 to $84,610 (for 2006). The remaining $85,390 of the donor's income would be fully taxable at the donor's marginal income tax rate of 25%. As a result, the charitable gift of $100,000 would cost the donor approximately $3,848 (25% of $15,390—the amount the donor's taxable income increases).

The cost of the gift also increases because of the phaseout of the deduction for the personal exemption, which is reduced by 2% for each $2,500 of adjusted gross income in excess of certain inflation-adjusted thresholds (which depend on the filing status of the taxpayer). An increase in adjusted gross income from $70,000 to $170,000 will reduce the personal exemption from $3,300 to $2,948 for a single taxpayer in 2006, resulting in an additional $88 of tax (25% of the $352 reduction), which increases the approximate total cost of the gift to $3,936.

It is important to note that the donor would be able to carry over the remaining $15,000 that she is unable to deduct in the year of the gift because of the 50% adjusted-gross-income limit. She could deduct all or a portion of the $15,000 in each of the next five years until she has used all of the $15,000, but she cannot use any carryover deduction remaining after five years. Such a carryover, however, does not alleviate the problem, because the donor cannot carry over the amounts she is unable to deduct in the year of the gift because of the 3% reduction to her charitable deduction or the reduction to her personal exemption. Further, the donor will not recoup any earnings she would otherwise have made on the $3,750 of additional tax paid on the deferred deduction (25% of the $15,000 carryover) from the time when she pays the tax until the time she may be able to recover that amount by taking a carryover deduction against her taxable income in a future year.

The two-step "withdraw and deduct" scheme is also problematic for donors who wish to contribute IRA assets to charity, but do not itemize deductions. These taxpayers must treat the IRA withdrawal as income, but will receive no offsetting deduction. For example, if a donor does not itemize, a $10,000 withdrawal from his IRA will generate approximately $3,500 in income tax, at the highest marginal rate. The donor contributes the $10,000 to his favorite public charity, but he will not take the corresponding itemized deduction. Therefore, his gift to charity will have cost the donor $3,500. The IRS estimates that approximately 65% of taxpayers do not itemize. *Individual Income Tax Returns, Preliminary Data 2003*, Stat. Inc. Bull., Data Release, Winter 2004–05, at 8. These taxpayers receive no tax benefit from donating IRA assets to charity.

In addition, under the current system, donors wishing to use withdrawn IRA dollars to fund a deferred giving vehicle, such as a charitable remainder trust, pooled income fund, or charitable gift annuity, may not deduct the full

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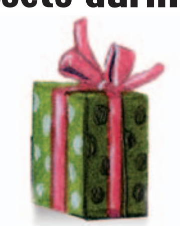


value of the withdrawn funds. Many donors wishing to make gifts to charity are concerned about insuring against the uncertainty of future events. Deferred giving arrangements allow such donors to receive a charitable deduction *and* maintain an income stream for life (or for the life of a spouse). In addition, using a charitable remainder trust for a deferred gift allows the donor to maintain control over how the assets in the trust are invested. Naturally, if a taxpayer chooses to use a deferred giving vehicle, she would be entitled to a charitable deduction equal to only the fair market value of the share that will ultimately go to the charity. For example, suppose that in January 2006, a donor aged 71 withdrew $200,000 from her IRA and transferred that $200,000 to a charitable remainder trust that would pay her an annuity of $10,000 annually until her death, and then pay out the remaining assets in the trust to her favorite charity. Determined according to the IRS actuarial tables, and using an assumed discount rate of 5.4%, the actuarial value of the annuity stream would be $85,983 and the value of the charity's interest would be $114,017. Therefore, the donor would take $200,000 into income, but only be entitled to a deduction of $114,017—57% of her total contribution. In addition, the donor would be subject to the 3% phaseout described above, further reducing her allowable deduction.

Giving Incentives

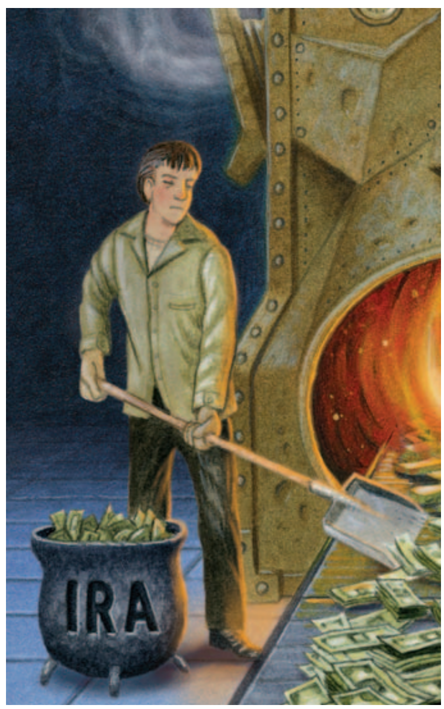
The current income tax system discourages donors from making charitable gifts of IRA assets during life. But giving IRA assets (as opposed to other types of assets) to charity during life has significant advantages from an estate planning perspective. A primary goal of lifetime giving for a donor with significant wealth often is to reduce the size of his taxable estate. As described above, for many would-be donors, making a lifetime charitable gift of IRA assets presents the risk of significant income tax cost. For these donors, a charitable gift of appreciated property (real estate or stock) would be a superior option under the current system. This is because if the donor sold the appreciated property, he would recognize gain equal to the sale price minus his basis in the property. If he instead transferred that property to a public charity, he would get a deduction for the full fair market value of the property (up to 30% of his adjusted gross income and subject to any phaseout of his itemized deductions) and would avoid paying tax on the gain.

By way of illustration, if a donor wished to make a lifetime gift of $200,000 to his favorite charity, and owned both $200,000 in appreciated property with a basis of $50,000 and $200,000 in an IRA, he would do better by contributing the appreciated property. In that case, he would avoid paying approximately $22,500 in capital gains tax (15% on $150,000) and would receive a charitable deduction for all or a portion of the $200,000. If he instead made the gift from the IRA, he would risk *increasing* his income tax liability, as described above.

From an estate planning perspective, however, it would be preferable for the donor to give the IRA assets. If he did so, he would reduce the size of his taxable estate with assets that constitute "income in respect of a decedent" (IRD) under Code § 691. Generally, IRD refers to assets that represent unrealized income that, had the decedent lived, would have been included in his gross income. Examples of IRD assets include annuities, deferred compensation arrangements, installment sale notes, and the like. IRAs are also IRD assets. Unlike bequests of other types of property, inherited IRD assets are *not* exempt from income tax. Thus, if the decedent's estate receives income from an IRD asset, it will have to pay income tax on that income. Likewise, if an IRD asset is transferred to a person, that person will have to pay tax on income generated by the IRD asset. (The recipient of the IRD asset will, however, be entitled to an offsetting deduction for estate tax paid because of the inclusion of the IRD asset in the decedent's gross estate.) The effect of federal estate tax and federal income tax on a gift of an IRD asset significantly reduces the benefit to the recipient of the IRD asset.

For example, assume that a widow dies in 2006 and has a gross estate of $5 million, which she has left entirely to her daughter. An IRA holds $100,000 of the $5 million. The IRA will be taxed at the estate tax rate for 2006 of 46%. This reduces the IRA to roughly $54,000. If the IRA is directly transferred to the daughter, the daughter will have to pay income tax at her marginal tax rate on the $100,000, but she will be entitled to deduct the $46,000 already paid in estate tax. Thus, her net taxable income will be $54,000. If the daughter is in the highest income tax bracket, she will incur income tax on that amount approximately equal to $18,900, making the net after-tax amount the daughter receives on the $100,000 IRA only $35,100. This amounts to an effective tax rate of 64.9%. The amount the daughter receives is further reduced if the IRA is also subject to state estate or income tax.

Reconsider the donor described above who wished to make a lifetime gift of $200,000 to his favorite charity and had $200,000 in appreciated property with a basis of $50,000 and $200,000 in an IRA. By making the lifetime gift to charity from the donor's IRA instead of giving the appreciated property, the donor would retain the appreciated property in his estate, which can be transferred to his heirs much more tax-efficiently than the IRA assets. Assuming the appreciated property is not an IRD asset, neither the donor's estate nor his heirs would pay



any income tax on receipt of the appreciated property because such property would be exempt from income tax. In addition, the appreciated property would receive a full step-up in basis to the estate tax value of the property at the death of the decedent, such that no one would ever pay income tax on the gain accumulated during the decedent's life. (It is important to note that, under current law, the donor could achieve a similar result by waiting to make the charitable gift until his death and bequeathing the IRD assets to his favorite charity.)

Thus, if a donor could make a charitable gift during life from IRA assets without incurring any income tax cost, the donor could achieve significant tax savings by removing IRD assets from his estate and transferring non-IRD assets to his heirs at death.

Proposals for a Tax-Free Charitable Rollover

The six bills pending in Congress at the time of this writing, which would allow taxpayers to make direct, tax-free gifts of IRA assets to charity, have had varied legislative success. The first of these bills is The Marriage, Opportunity, Relief, and Empowerment Act of 2005 (S. 6), introduced by Sen. Rick Santorum (R-Pa.) on January 24, 2005. Under the provisions of S. 6, donors aged 70$^1/_2$ or older could make tax-free rollovers of IRA assets directly to charity, and donors aged 59$^1/_2$ or older could make tax-free rollovers to deferred giving arrangements. On introduction, S. 6 was referred to the Senate Finance Committee, and no further action has been taken on the bill to date.

The second major piece of legislation dealing with the IRA charitable rollover is the Public Good IRA Rollover Act, introduced on June 30, 2005, by Sen. Byron Dorgan (D-N.D.) in the Senate (S. 1366) and on April 13, 2005, by Reps. Wally Herger (R-Cal.) and Earl Pomeroy (D-N.D.) in the House (H.R. 1607). The Public Good IRA Rollover Act would allow IRA owners aged 59$^1/_2$ or older to roll over IRA assets to a charitable deferred giving vehicle. Donors aged 70$^1/_2$ or older could also make direct gifts of IRA assets to charity without taking the contributed amount into income. Both S. 1366 and H.R. 1607 have been referred to committee.

The CARE Act of 2005 (S. 1780) and the Charitable Giving Act (H.R. 3908), introduced in September 2005, each includes a version of the IRA charitable rollover. The CARE Act, like the Public Good IRA Rollover Act, would allow IRA owners aged 59$^1/_2$ or older to roll over IRA assets to a charitable deferred giving vehicle, and donors aged 70$^1/_2$ or older could make direct contributions of IRA assets to charity without incurring any income tax.

The Charitable Giving Act would allow donors aged $70^1/_2$ and older to roll over amounts from an IRA directly to charity, or to a deferred giving vehicle. Both bills are being considered in committee.

Finally, the Senate's version of the tax reconciliation bill, the Tax Relief Act of 2005 (S. 2020), contains a provision for a tax-free IRA charitable rollover. Under S. 2020, taxpayers aged $70^1/_2$ and older could make tax-free contributions of IRA assets directly to charitable organizations. The House reconciliation bill (H.R. 4297) differs dramatically, however, from the Senate bill and does not include a charitable rollover provision. Most commentators predict that a conference between the House and the Senate will be long and arduous because of major differences in each chamber's approach to alternative minimum tax (AMT) relief and extension of the 15% rate on capital gains and corporate dividends. It is unknown how the IRA charitable rollover provision will fare during conference negotiations in early 2006.

All of these bills have several features in common. First, tax-free charitable distributions can only be made from IRAs described under Code § 408. Distributions from 401(k) plans, 403(b) plans, profit-sharing plans, and pension plans will not qualify for the tax-free charitable rollover. Of course, many taxpayers will roll over such non-IRA plans to IRAs on retirement.

Second, if Congress enacts a version of the IRA charitable rollover that allows gifts to a deferred giving arrangement, only gifts to certain deferred giving arrangements, referred to in the proposed legislation as "split-interest entities," will qualify for tax-free rollover treatment under that provision. The proposed legislation defines "split-interest entities" as including only (1) charitable remainder trusts that are funded exclusively from tax-free charitable IRA rollovers, (2) pooled income funds that account separately for amounts contributed from a tax-free charitable IRA rollover, and (3) charitable gift annuities. Further, gifts to a split-interest entity will not qualify for tax-free rollover treatment if anyone other than the donor, the donor's spouse, or a charity holds an income interest in the gifted property.

Third, if gifts to split-interest entities are permitted under the enacted legislation, special rules will apply to the income tax treatment of amounts distributed to the income beneficiary from qualifying split-interest entities. Ordinarily, payments to the noncharitable beneficiary of a charitable remainder trust are deemed to be made first from the trust's ordinary income for the taxable year of the distribution and the trust's undistributed ordinary income from prior years, then from the trust's capital gain income for the taxable year of the distribution and the trust's undistributed capital gain income from prior years, and last from (nontaxable) trust principal. Under the proposed legislation, all distributions from a qualifying charitable remainder trust will be treated as ordinary income in the hands of the beneficiary. For pooled income funds, under current law, all income earned in a taxable year must be paid to the income beneficiaries. Ordinarily, these payments are treated as ordinary income or capital gain income in the hands of the income beneficiary in proportion to the amount of ordinary income and capital gain income earned by the fund in that taxable year. Under the proposed legislation, however, all income distributions from the portion of a qualifying pooled income fund attributable to contributions from a tax-free charitable IRA rollover will be ordinary income to the recipient. Under current law, if a donor purchases a charitable gift annuity from a charity he wishes to support, ordinarily, a portion of each annuity payment is deemed to be a return of the donor's original investment in the annuity contract and is tax-free. Under the proposed legislation, however, no portion of the annuity payments from a charitable gift annuity purchased with funds from a tax-free charitable IRA rollover will be treated as the donor's original investment in the contract. The entire annuity payment will be taxable at ordinary income and/or capital gains rates.

Fourth, unless the IRA funds are transferred to such a qualifying deferred giving arrangement, the entire donation must qualify for the income tax deduction under the current system. Thus, no tax-free rollover will be available for IRA distributions that are used to purchase items at auction, to purchase tickets to a charity benefit dinner, to pay membership dues to fraternal orders and similar groups, or for any other use from which the donor would receive some benefit in exchange for the donation.

Finally, if an IRA owner made non-deductible contributions to her IRA, she cannot use those funds in a tax-free charitable rollover. Any gifts to charity from nondeductible contributions would be subject to the "withdraw and deduct" scheme currently applicable to all charitable gifts of IRA assets. (Distributions to an IRA owner from nondeductible contributions are not included in taxable income, however, so there will be no tax liability for such gifts, and the donor would still be entitled to a charitable deduction.)

Conclusion

The IRA charitable rollover currently enjoys widespread bipartisan support. Indeed, the IRA charitable rollover has received more legislative attention in the 109th Congress than in any prior Congress, which bodes well for ultimate passage given that both the Senate and the House have passed one or more versions of the charitable rollover in prior years. If the IRA charitable rollover is enacted as part of any of the bills currently being considered (or at some time in the future), estate planners and their clients will gain a new mechanism for tax-advantaged charitable giving. Donors will be able to make lifetime gifts to charity of IRD assets, removing these potentially problematic assets from their gross estates. Further, using IRD assets for lifetime giving will allow donors to retain income-tax-neutral assets in their estates, which, under current law, can be transferred, with the accompanying step-up in basis (if the assets are appreciated assets), at death. ■