

The Cat's Meow: IRA Rollover Starts Third Life

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For reasons that remain obscure, cats are reputed to have nine lives. If that's true, the IRA Rollover is starting to exhibit feline qualities. Enacted in 2006, it expired at the end of the following year, was resuscitated in 2008, and died again last December. Last Friday afternoon President Obama signed into law a major tax bill that, among many other things, once again reincarnated this valuable fundraising tool.

Refuting speculation that they no longer enact legislation but only caterwaul and posture, the U.S. House and Senate, with remarkable efficiency and a show of bipartisanship, enacted the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the "Act") last Thursday night. Among its provisions is an extension of the IRA Rollover through the end of next year.

To make up for the short notice, the Act allows donors to treat IRA Rollover gifts made before February 1, 2011 as if made this year. Unfortunately, Congress ignored Conrad Teitell's suggestion that those who have already taken their 2010 minimum required distributions ("MRDs") from their IRAs be allowed to donate them to charities now and count them as 2010 IRA Rollovers.

This article discusses the one month grace period for 2010 IRA Rollovers and the MRD problem. Its main purpose, however, is to review the situations in which an IRA Rollover will be attractive. It's the best type of gift for some donors. For others, an IRA Rollover might not be cataclysmic, but a gift of a different kind of asset would yield a better result.

THE IRA ROLLOVER—A CATALOG OF KEY POINTS

With the current extension, a donor can make up to \$100,000 of IRA Rollover gifts^[1] during 2010 and again in 2011. To qualify for the favorable tax treatment afforded these gifts, a transfer of IRA assets to a charity must have the proper concatenation of features:

- Source of gift
 - The gift must come "directly" from the donor's IRA. The IRA custodian can satisfy this requirement by drawing a check payable to the charitable organization and mailing it to the donor, who can then transmit it to the charity.
 - An individual with a qualified retirement plan account such as a 401(k) can, in many cases, roll part of the account over to an IRA tax-free, then make an IRA Rollover gift.

- Permissible donees
 - The donee must be a public charity. It cannot be a private foundation.
 - The donee must not be a public charity that is classified as a "supporting organization."
 - The gift must not go to a donor advised fund administered by the donee public charity.
 - The gift can satisfy the donor's pre-existing pledge.
- Other requirements
 - The donor must be age 70½ or older when he or she makes the gift.
 - Only outright gifts qualify. The gift cannot fund a charitable remainder trust, charitable gift annuity, or charitable lead trust.
 - The gift must be in a form that is otherwise deductible. The donor must therefore substantiate the gift with a "contemporaneous written acknowledgment" issued by the donee.

A transfer that meets these requirements qualifies for the special tax treatment accorded IRA Rollovers. These tax benefits are intended to serve as a catalyst for philanthropy. Here is what a donor of a 2010 IRA Rollover gets (and doesn't get):

- The gift is excluded from the donor's federal gross income (and hence from federal taxable income) even though the gift is, strictly speaking, a withdrawal from an IRA.
- In contrast to most other charitable gifts, an IRA Rollover generates no income tax charitable deduction.
- Because the gift is not included in the donor's gross income, it does not cause the phase-out of other federal tax benefits, e.g., personal exemptions and itemized deductions.
- The gift counts towards the donor's MRD from the IRA for the year made.[2]

Timing Issues

As already mentioned, the Act allows a donor who makes an IRA Rollover gift before February 1, 2011 to treat it as if made during 2010. To do this, the donor must make an election according to regulations that the IRS will promulgate. Presumably, the election procedure will become available well before April 15, 2011, so that donors can make it when filing their 2010 federal income tax returns.

Despite Conrad Teitell's best efforts, an individual who has already taken the 2010 MRD from his or her IRA cannot donate all or part of that distribution to a charity and have it qualify for IRA Rollover treatment. The reason is that an IRA Rollover must go "directly" from the IRA custodian to the charitable donee. Individuals who have already taken their 2010 MRDs to avoid a late distribution penalty are not necessarily out of luck, however.

If a donor has already taken the 2010 MRD, makes a charitable gift this year and that gift falls within his or her annual deduction limit (50 percent of federal adjusted gross income for gifts of cash to public charities),

the resulting deduction will offset the gross income from the 2010 MRD. For such donors, the result is almost the same as if they had not taken a 2010 MRD but had made an IRA Rollover gift before February 1, 2011. In both scenarios the donor is allowed no income tax deduction for the gift, but has no taxable income as a result of the distribution from the IRA, either. The one difference is that the MRD increases the donor's gross income. That may cause phase-out of other federal tax benefits.

DONOR CATEGORIES

Donors for whom an IRA Rollover is normally the best way to make a major gift fall into three groups: the non-itemizer, the generous donor who has already exceeded his or her annual deduction limit, and the donor whose only suitable asset is an IRA or qualified retirement plan account.

The non-itemizer

The non-itemizer, by definition, does not claim an itemized deduction for a charitable contribution. Instead, this type of donor claims the "standard deduction." As a result, the fact that an IRA Rollover generates no income tax deduction is not a catastrophe.

In fact, just the opposite is true. Suppose the non-itemizer is contemplating a charitable gift of \$100,000 and is in the highest federal and Minnesota income tax brackets. The donor is considering whether to make an IRA Rollover gift and withdraw \$100,000 from his savings account to cover his own living expenses for the year, or whether to do the opposite: withdraw and spend \$100,000 from the IRA and donate \$100,000 of cash to charity. As Illustration 1 shows, the IRA Rollover gift is clearly the better choice.[3]

Illustration 1

- IRA Rollover/spend from savings account
 - No income tax deduction for IRA Rollover gift
 - Net available for spending: \$100,000 cash (no tax)
- Donate from savings account/withdraw assets from IRA for personal spending
 - No income tax deduction because donor is non-itemizer
 - Net portion of IRA withdrawal available for spending after tax: roughly \$60,000

The same is true if the donor is choosing between an IRA Rollover and a charitable gift of appreciated stock the donor has held long-term in his brokerage account. The IRA Rollover always leaves the donor with more to spend, although the difference will depend on the donor's basis in the stock. We leave the math to you. Please show all work

The very generous donor

Some donors are so generous that they give more than they can deduct. It sometimes even happens that one of these committed philanthropists has made so many charitable gifts that if he makes another major donation this year he will be unable to deduct it over the five-year carryforward period. Nevertheless, such a donor obviously has strong philanthropic motivation and may wish to make another gift in the current year to help out a favorite charity. For someone in this situation an IRA Rollover is ideal.

First, note that this hypothetical donor is in the same situation (for this year at least) as the non-itemizer. He will never be able to claim a deduction for yet another charitable gift he makes this year. If he is trying to decide which asset to give and which to spend for his own needs, the reasoning is the same as for the non-itemizer. The IRA Rollover is the gift of choice, and the donor should liquidate and spend a less heavily taxed asset. Suppose, however, that the donor's needs for the year have already been met. By making the IRA Rollover and saving cash and appreciated stock, he preserves those other assets for use as charitable gifts in later years, when he may be able to deduct them and reap a tax benefit.

The donor whose only available asset is his or her IRA

Some donors, especially professionals, hold all or most of their assets, other than their homes, in IRAs or qualified retirement plan accounts. For one of these donors, an IRA Rollover during 2010 or 2011 is trouble-free. The gift is not included in the donor's gross income, so it cannot generate any taxable income. The donor doesn't need to determine that the amount of the gift is within his or her annual deduction limit in order to be sure it generates a deduction that offsets the gross income from the IRA withdrawal.

Beware of Bogus Catechisms

In an excess of enthusiasm, some gift planners have made arguments for the IRA Rollover that just don't hold up. To avoid cat calls from donors' tax advisors, learn to distinguish these lame justifications from the legitimate ones we've discussed above.

"It is better to make a charitable gift with pre-tax dollars"

Some commentators have suggested that a donor who is an itemizer is better off making a major charitable gift as an IRA Rollover because the gift consists entirely of pre-tax dollars. As Illustration 2 shows, in a typical case this argument is simply wrong!

Illustration 2

- The donor is an itemizer and has sufficient federal adjusted gross income so that he can deduct a \$100,000 charitable gift in full this year
- Plan A

- The donor makes a \$100,000 IRA Rollover
- From his brokerage account the donor liquidates \$100,000 of stock that has a basis of \$80,000. He pays the tax on the gain out of the sale proceeds, and he spends the balance
- No income tax deduction for IRA Rollover
- Net available for spending:

▪ Gross proceeds	\$100,000
▪ Tax on gain: \$20,000 x 20 percent[4]=	(\$4,000)
▪ Net available for spending:	\$96,000
- Plan B
 - Donor makes charitable gift of \$100,000 of stock in his brokerage account that has an \$80,000 basis
 - Donor withdraws \$100,000 from IRA, pays tax on withdrawal, and spends the balance
 - Tax savings from \$100,000 charitable deduction: $\$100,000 \times 40 \text{ percent} = \$40,000$
 - Net available from IRA withdrawal:

▪ Gross withdrawal	\$100,000
▪ Tax	\$40,000
▪ Net	\$60,000
 - Total available for spending:

▪ IRA (Net)	\$60,000
▪ Tax Savings from charitable deduction	\$40,000
▪ Total	\$100,000

"It is better to retain non-IRA assets and leave them to children because they will be less heavily taxed when received"

Assume that a donor who is a surviving spouse will not exhaust his or her IRA during life and that the donor will leave the IRA balance to children at death. If the donor makes current charitable gifts out of non-IRA assets, children will typically receive more than if the donor made those same gifts in the form of IRA Rollovers, as Illustration 3 shows.

Illustration 3

- Assumptions
 - Donor makes \$100,000 charitable gift today, and the gift, if not an IRA Rollover, is fully deductible this year
 - Donor's ordinary income tax bracket: 40 percent

- Pretax return on assets: 8 percent
- After-tax return on assets: 6 percent
- Children's ordinary income tax bracket: 35 percent
- Donor reinvests any tax savings generated by charitable gift
- Donor dies in 15 years
- Plan A—Current gift of appreciated stock from brokerage account
 - Tax savings from charitable gift: $\$100,000 \times 40 \text{ percent} = \$40,000$
 - Value of reinvested tax savings in 15 years: $\$95,865$
 - Value of IRA assets in 15 years: $\$317,217$
 - Income tax to children on IRA: $\$317,217 \times 35 \text{ percent} = (\$111,026)$
 - Net IRA assets to children: $\$206,191$
 - Total to children before estate tax[5]: $\$302,053$
- Plan B—Current \$100,000 gift as IRA Rollover
 - Value of brokerage account stock in 15 years: $\$239,656$
 - Net to children before estate tax[6]: $\$239,656$

PRAGMATIC ADVICE: AVOID CATALEPSY

All development officers should understand why an IRA Rollover is ideally suited to some donor profiles, and they should be able to distinguish good arguments for an IRA Rollover from bogus ones. But every development officer also knows that some donors, when presented with tax illustrations, however simple, rapidly become catatonic. Suppose a donor does not fall into one of the profiles described above but doesn't care about numerical examples and is drawn to the IRA Rollover by its simplicity. What should a development officer do?

This is a delicate question. No development officer in his or her right mind would consign this donor's proposal to the catacombs by providing a detailed arithmetic proof that another type of charitable gift would be better. On the other hand, fundraisers should protect themselves against second-guessing by a donor's tax advisors. One possible compromise is to acknowledge the attractiveness of the IRA Rollover and simply ask the donor if he or she would like to explore the possible benefits of using another asset or would simply like to proceed. This seems like a responsible approach: it flags the issue of the choice of asset but does not put the brakes on the donor's philanthropic enthusiasm.

THE CAT'S IN THE BAG

As we've seen, the IRA Rollover is suitable for many donors, but not for all of them. The 2010-2011 extension may not catapult your fundraising program to a whole new level, but it can generate gifts you would not otherwise receive. This is especially true for the non-itemizer and the donor whose only liquid

assets are in his IRA or qualified plan account. Charities that have actively promoted the IRA Rollover over the past four years have reaped substantial benefits. When used effectively and carefully, this legislation can make you feel as if you're sitting in the catbird seat.

[1]The technical term for these gifts is "Qualified Charitable Distributions," but "IRA Rollover" is easier to say and more commonly used.

[2] Individuals who have already taken their 2010 MRDs to avoid a late distribution penalty cannot use that distribution to make an IRA Rollover gift. That two-step transaction would fail the first requirement listed above: the IRA Rollover gift must go "directly" from the donor's IRA to the charity. Below, we discuss when it makes sense for someone who has already taken a 2010 MRD from an IRA to use the MRD (or a portion) to make a charitable gift this year even without IRA Rollover treatment.

[3] Note that this argument holds even if the \$100,000 of IRA assets constitutes all or part of the IRA owner's MRD for the year.

[4] Donor's approximate combined federal and Minnesota capital gains tax rate.

[5] With the new \$5,000,000 federal estate tax exemption (\$10,000,000 for a married couple), estates of most donors will not face federal estate tax. In cases of taxable estates, the difference between Plan A and Plan B will be less.

[6] Step-up in basis in stock at donor's death.

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