

GIFTS OF RETIREMENT PLAN ASSETS TO CHARITY – NEW OPPORTUNITIES UNDER THE PENSION PROTECTION ACT OF 2006

by Rennie C. Rutman

On August 17, 2006 President Bush signed the Pension Protection Act of 2006. One section of this Act encourages taxpayers to make charitable gifts directly from their IRAs by providing donors with a host of tax advantages.

I. The Pension and Protection Act of 2006

One provision of the Act, effective immediately, provides an exclusion from gross income for otherwise taxable IRA distributions of up to \$100,000 from traditional IRAs for "qualified charitable distributions" made during 2006 and 2007 by plan owners who are at least 70-1/2 years old on the date of the gift. In addition, the qualified charitable distributions will apply towards any required minimum distribution.

II. Qualified Charitable Distributions, Defined

Qualified charitable distributions may be made from traditional IRAs and Roth IRAs, but not from 401(k)s, 403(b)s, SEP-IRAs or SIMPLE IRAs. The gift must be made no earlier than the day on which the plan owner attains age 70-1/2. The transfer must be made directly from the plan custodian; the transfer cannot be made from the plan owner. Distributions to charitable organizations which are commonly thought of as "public charities" (e.g. the American Cancer Society, the Red Cross) qualify but distributions to private foundations generally do not qualify. Finally, the charitable contribution must be one which would otherwise satisfy all requirements for deductibility, including the requirement that the gift be adequately substantiated, but excluding the requirement (discussed below) prohibiting current deductions for contributions in excess of 50% of the taxpayer's contribution base.

III. Effect of Pre-Act Inclusion in Gross Income and Post-Act Exclusion

In general, with certain restrictions, taxpayers can make deductible and nondeductible contributions to their traditional IRAs. Contributions to Roth

IRAs are nondeductible.¹ Assuming that the contributions to an IRA are deductible when made, then they are wholly includible in income when withdrawn. If the contributions (or a part of them) are nondeductible when made, then the nondeductible portion is not includible in income when withdrawn.

A. Background and Summary

Under pre-Act law (and under post-Act law for non-qualified charitable distributions), a distribution from a retirement plan or a traditional IRA is *included* in a taxpayer's gross income. Assuming the distributed amount is then gifted to charity, the taxpayer may receive an income tax deduction for that gifted amount. However, due to certain restrictions in the Internal Revenue Code discussed below, the amount of the gift is not, as a practical matter, always truly *deductible* in that it may not be one which will reduce the taxpayer's total tax liability. However, under the Act, if the gift is a qualified charitable distribution, it is wholly excludible from gross income (up to \$100,000 per taxpayer per year) irrespective of the restrictions alluded to above.

In addition, under pre-Act law (and under post-Act law for non-qualified charitable distributions) the increase in the taxpayer's reportable gross income by the amount of the IRA distribution to

¹ In the case of withdrawal from a Roth IRA that is "not qualified", there is hierarchy that is utilized in order to determine the portion of the distribution which is deemed to be attributable to earnings, contributions and distributions. Specifically, the following are deemed distributed as part of the withdrawal, in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contribution – which refer to conversion of amounts in a traditional IRA to a Roth IRA; (3) non taxable conversion contribution; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

the plan owner may engender several potentially negative tax consequences that may not be offset by the deduction even if the gift is currently deductible. However, since the Act *excludes* the qualified charitable distribution from the computation of the taxpayer's gross income, those negative tax consequences are avoided as first listed and further detailed below:

1. No Requirement of Itemization — taxpayers who do not itemize their deductions may make a qualified charitable distribution.
2. State Income Tax Benefits — Ohio does not provide a state income tax charitable deduction for a gift to charity, but by excluding the IRA distribution amount from adjusted gross income (the Ohio income tax base), Ohio residents will now, in effect, receive a state law charitable deduction for the qualified charitable distribution.
3. No Interference with Other Income Sensitive Tax Benefits - the qualified charitable distribution will not interfere with the taxpayer's ability to take other income sensitive deductions or qualify for lower tax rates for certain types of income, such as Social Security benefits.

1. Itemization

Under pre-Act law (and under post-Act law for non qualified distributions), the charitable deduction is only available for those who itemize their deductions. Thus, even if all of the requirements for deductibility are met (e.g. substantiation, appropriate recipient organization, etc.), if the standard deduction is higher than the combined total of all itemized deductions, the taxpayer receives no tax savings due to the gift for charity. Senior citizens, who likely have no home mortgage financing interest (a major itemized deductions for younger taxpayers), generally elect the standard deduction in lieu of itemization. Thus, the inclusion in gross income

of the distribution from the IRA triggers income tax with no corresponding deduction.

Under the Act, a qualified charitable distribution is excluded from gross income and thus no itemization is required in order to offset the distribution. A taxpayer who makes a qualified charitable distribution may take her standard deduction and still effectively receive a deduction for the qualified charitable distribution.

2. Denial of State Income Tax Deduction

The State of Ohio does not provide a state income tax deduction for charitable contributions. Thus, if a taxpayer receives an IRA distribution and then gifts the amount distributed to charity, the initial inclusion in gross income of the distribution amount increases his state income tax base and the resulting tax liability and there is no deduction available. Therefore, Ohio residents ultimately pay state income tax on amounts gifted to charity.

Under the Act, a qualified charitable distribution is entirely excluded from gross income and thus does not affect the tax base of Ohio residents. This effectively creates a state law charitable deduction for the qualified charitable distribution.

3. Interference with Other Deductions and Exemptions and Favorable Tax rates

In addition to the "50% Limitation" discussed below, there is a host of restrictions relevant to most itemized deductions, including, but not limited to charitable deductions, which causes the deductions to be phased out for taxpayers whose total income exceeds certain amounts. Thus, if the distribution from the IRA is deemed to be included in the taxpayer's income (as it is under pre-Act law and is under post-Act law for non-qualified distributions), the taxpayer may have to sacrifice other deductions and exemptions and credits which may be phased out or eliminated due to his increased gross income.

Similarly, due to the exclusion of the distribution from gross income, provisions of the Internal Revenue Code which require that certain other items of income be taxed at higher rates if total gross income exceeds certain levels are not triggered. The most significant example to those

age 70-1/2 is the rule on the taxation of Social Security benefits which requires that when a taxpayer's income exceeds a certain amount, his benefits become taxable.

IV. Two Other Critical Changes – Disregard for Purposes of the 50% Limitation and Favorable Treatment of Non-Deductible Contributions

A. The "50% Limitation"

In addition to the exclusion of a qualified charitable distribution from gross income, the Act eliminates a restriction, often referred to as the "50% Limitation", relevant to the deductibility of qualified charitable distributions, and this change favorably impacts the deductibility of even non-qualified charitable distributions.

Specifically, the amount of a charitable deduction available to a taxpayer for her donation to public charities is currently "limited" in that it may not exceed 50 percent of the taxpayer's contribution base. A taxpayer's contribution base is her adjusted gross income for the year computed without regard to any net operating loss carrybacks to the taxable year.

Under the Act, a qualified charitable distribution does not factor into the equation when determining if the total amount gifted by the taxpayer for the taxable year exceeds 50% of the taxpayer's contribution base.

Under the Act, the only limitation on the excludable amount of the qualified charitable distribution is that it not exceed \$100,000 per taxpayer per year. The taxpayer's contribution base is irrelevant. The effect of the elimination of this restriction is two-fold.

First, this permits a greater tax benefit for a gift of IRA assets than might have been available under pre-Act law for those with more modest contribution bases/adjusted gross incomes. For example², if a taxpayer had a contribution base of

\$20,000 and then received an IRA distribution of \$90,000, her contribution base would be \$110,000. If she made a donation of the entire \$90,000 IRA distribution, under pre-Act law only \$55,000 would be deductible this year, since the deduction is limited to 50% of the taxpayer's contribution base. Under the Act, if the \$90,000 distribution is a qualified distribution, it is effectively entirely "deductible" this year in that the distribution is not included in income in the first place and, therefore, need not be washed out with a corresponding deduction.

Second, the inapplicability of the restriction to a qualified charitable distribution permits taxpayers to receive a deduction for non-qualified gifts in an amount up to 50% of their contribution base. In other words, under pre-Act law a gift of non-IRA assets of an amount equal to 50% of the taxpayer's contribution base *plus* any additional gift of IRA assets would effectively render the IRA gift non-deductible.

For example, assume that a taxpayer age 71, has a single traditional IRA with \$100,000 comprised solely of deductible contributions. Assume that he donates the entire IRA to the American Cancer Society, and he also donates another \$25,000 from a non-retirement account to the same organization. Assume that he itemizes his deductions. Also assume his contribution base (aka his adjusted gross income) is \$70,000 not including the \$100,000 IRA distribution. Under the pre-Act law, his \$125,000 contribution could be deducted only up to 50% of his contribution base, or up to \$85,000 (which is 50% of \$70,000 adjusted gross income + \$100,000 of the increase in his adjusted gross income due to the IRA distribution). The balance would not be deductible this year. Under the new law, the \$25,000 donation from non-IRA assets is entirely deductible under the "50% of contribution base (adjusted gross income) limitation" since it is less than 50% of his \$70,000 contribution base or \$35,000. The additional \$100,000 *qualified charitable distribution* is not factored into the analysis as it is excluded from gross income. Thus, under the pre-Act law, a total gift of \$125,000 generated only a \$85,000 tax deduction in the current year; under the new law, it

² This example and those which follow cannot identify and address all variables which may be relevant in a particular circumstance. These examples are intended as general illustrations, only. There are many factors and variables not mentioned in this Article and the

examples which may alter the effect a qualified charitable distribution may have on a taxpayer's overall tax liability.

generated what amounts to a full \$125,000 deduction.

B. Favorable Treatment for Non-Deductible Contributions

In addition, the Act provides favorable treatment for those account holders with deductible and non deductible components of traditional IRAs.

Under pre-Act law (and under post-Act law for non-qualified distributions) when a distribution is taken from a traditional IRA which is comprised of deductible and non-deductible contributions, a portion of each distribution is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, and all distributions during any taxable year are treated as a single distribution. Thus, part of each distribution will be both taxable and non-taxable. Under the new law, a qualified charitable distribution from an IRA is treated as being distributed from "taxable income first", so that the taxpayer can effectively cause the non-deductible (and thus non-taxable) portion of his account to remain available for later distributions.

For example, assume that a taxpayer has a single traditional IRA with a balance of \$100,000, consisting of \$30,000 of nondeductible contributions and \$70,000 of deductible contributions. He distributes \$70,000 to the Salvation Army. Under pre-Act law, a portion of that distribution would be treated as a non-taxable return of non deductible contributions. The nontaxable portion of the distribution would be \$21,000, determined by multiplying the amount of the distribution (\$70,000) by the ratio of the nondeductible contributions to the account balance (\$30,000/\$100,000). Accordingly, under present law, \$49,000 of the distribution (\$70,000 minus \$21,000) would be includible in his income.

Under the new law, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the Act), or \$70,000. Accordingly, under this provision, the entire \$70,000 distributed to the

charitable organization is accounted for first and is a qualified charitable distribution. Thus, none of it is includible in the taxpayer's gross income. In addition, for purposes of determining the tax treatment of later distributions from the IRA, the \$30,000 remaining in the IRA is treated as comprised solely of nondeductible contributions that will not be taxed when withdrawn.

In addition, all IRAs are aggregated when determining how much of the gifted IRA is deemed to consist of taxable income. Thus, for example, if an IRA owner has two separate IRAs, each worth \$100,000 and each consisting of \$50,000 of deductible contributions and \$50,000 of non-deductible contributions, the taxpayer can make a qualified charitable distribution of either one of the IRAs and the entire distributed IRA is deemed to cannibalize the taxpayer's deductible contributions. Thus, assuming that there is no subsequent increase in the amount of income inside the remaining IRA, the taxpayer could take a distribution of that entire IRA and all amounts distributed would be non-taxable to him.

V. Conclusion

The Pension Protection Act of 2006 eliminates several of the negative tax effects engendered by gifts of retirement plan assets to charity and provides an opportunity for taxpayers to increase their total tax-effective gifts. Coupled with the provisions which provide tax favorable treatment of otherwise non-deductible contributions to retirement plans, the Act could provide substantial tax savings to charitable minded taxpayers. However, unless additional legislation extends the incentive, it will be a brief window of opportunity for gifts made from January 1, 2006 through December 31, 2007.