

## *IRA Charitable Rollover*

### Current Law Treatment of Charitable Contributions from Individual Retirement Accounts

If a donor withdraws funds from a traditional IRA in order to contribute to a charitable organization, the withdrawal must be reported as ordinary income to be taxed at regular income tax rates. Once the contribution has been made, the donor may then be entitled to an income tax deduction for the value of the charitable contribution, which can offset some or all of the taxable income generated by the withdrawal.

The general principle governing the tax treatment of retirement accounts is that all amounts should be taxed once. Thus, amounts that are contributed to a retirement account on a pre-tax basis are taxed as ordinary income when withdrawn. Similarly, tax-deferred earnings within a retirement account are also taxed as ordinary income when withdrawn. If any after-tax contributions have been made to a retirement account, they are not included in income when withdrawn, although tax deferred earnings from these after-tax contributions are subject to ordinary income tax.

(An exception to this general principle is the Roth IRA. Contributions to a Roth IRA are made with after-tax funds, and therefore are not subject to tax when withdrawn. In addition, a Roth IRA can distribute earnings tax-free, provided that the account has been open for at least five years and the owner is at least age 59½ when the withdrawal is made.)

Individuals can make both pre-tax and after-tax contributions to a traditional IRA. In practice, the taxpayer is allowed an adjustment to income for IRA contributions, subject to certain annual limits, effectively rendering those contributions “pre-tax.” When withdrawn, pre-tax contributions are included in the income of the account owner, and thus subject to federal income tax as well as state and local taxes as appropriate. If a portion of a withdrawal represents a return of an after-tax contribution to the IRA, then that amount is not included as income, having already been subject to income tax before being deposited in the IRA.

Individuals who withdraw funds from an IRA before they reach age 59½ incur a ten percent early withdrawal penalty. Under the minimum distribution rules, an individual must begin making withdrawals from their retirement plans, including IRAs, by April 1<sup>st</sup> of the year following the year in which he or she reaches age 70½. Roth IRAs are not subject to minimum distribution rules.

In general, individuals may rollover, or convert, various types of qualified retirement plans such as 401(k) and 403(b) accounts to an IRA without incurring tax on the rollover.

### How would the IRA Charitable Rollover proposal change these rules?

If the IRA Charitable Rollover proposal were enacted, a donor would be allowed to exclude from taxable income any IRA funds withdrawn and transferred to a charity either as an outright contribution or to a charitable remainder trust, pooled income fund or in exchange for a charitable gift annuity. This is the economic equivalent of taking the amount withdrawn from the IRA into income, and then claiming a full income tax deduction for the entire rollover amount.

There would be no charitable contribution deduction for such IRA Charitable Rollover contributions, but the donor would still be eligible to claim a charitable contribution deduction for other charitable contributions, including those made from after-tax IRA contributions.

Under the proposal included in S. 476, the CARE Act, beginning at age 70½, donors could make a tax free IRA Charitable Rollover to a charitable organization in the form of an outright gift. Similarly, donors age 59½ or older could fund a life-income gift (e.g., a charitable remainder trust, gift annuity or pooled income fund) using a tax free IRA Charitable Rollover. Of course, the income beneficiary of a life-income gift funded through an IRA Charitable Rollover would still be subject to income tax on the resulting distributions.

#### How does the IRA Charitable Rollover proposal encourage additional giving?

It is possible under current law for donors who itemize their deductions to avoid taxation of IRA withdrawals for charitable contributions by claiming a charitable contribution deduction to offset the amount of new taxable income created by the IRA withdrawal. However, many would-be donors are reluctant to willingly generate new taxable income (by making an IRA withdrawal) with only the promise of an offsetting deduction later. In addition, since the charitable contribution deduction is limited to a maximum of 50% of adjusted gross income in any one year, very generous donors must exercise care to ensure that their contributions do not exceed this limitation.

In the case of donors who do not itemize their deductions, and thus make all of their charitable gifts with after-tax funds, the proposal would offer an opportunity to significantly increase giving at no net increase in cost. A donor in the 15 percent bracket who withdraws \$100 from his or her IRA has, under current law, \$85 left after taxes to give to charity. If the IRA Charitable Rollover proposal is enacted, this same donor could withdraw \$100 from his or her IRA and have it sent directly to a charity. The donor would not have to pay taxes on the amount withdrawn, and the charity would receive a larger gift.

Donors contemplating using IRA funds to establish a life-income gift can find themselves paying income tax on phantom income as a result. Consider the following example where a donor incurs \$52,000 in taxes as a result of making a \$250,000 contribution to a charitable remainder trust:

A generous individual, age 65, has accumulated approximately \$1,000,000 in an IRA and other qualified retirement plans. This individual has determined that he or she needs only \$750,000 of these funds for retirement, and would like to withdraw \$250,000 to establish a charitable remainder annuity trust paying \$12,500 (5%) to him or her for life with the remainder going to charity.

In the top Federal income tax bracket (35%), the donor would owe an income tax of as much as \$87,500 on the \$250,000 withdrawal. However, depending upon exactly when the contribution to the charitable remainder annuity trust was made, the income tax charitable deduction would be about \$101,000.

Assuming that the donor decided to proceed with this contribution, he or she could still incur an income tax of about \$52,000 as a result of having made the contribution (\$250,000 IRA withdrawal, reduced by \$101,000 charitable contribution deduction, leaves \$149,000 taxable income which at 35% results in a tax of \$52,150).

How would the IRA Charitable Rollover interact with other charitable giving opportunities?

Most retirement accounts consist exclusively of pre-tax contributions and earnings. As a result, relatively few IRA Charitable Rollovers are likely to include deductible amounts. Since IRA Charitable Rollover contributions would not qualify for a charitable contribution deduction, generous individuals could make contributions from their IRAs in addition to other charitable contributions which would still be deductible. Thus, if the proposal becomes law, these new charitable rollover contributions would not “crowd out” other donations that qualify for the regular charitable contribution deduction.

The IRA charitable rollover provides an attractive incentive for charitable contributions from IRA funds that does not “compete” with other giving opportunities. Although generous taxpayer can now withdraw IRA funds for charitable contributions and, with careful planning, arrange for the charitable contribution deduction to eliminate the tax liability, the complexity of the two step transaction is a disincentive. The IRA Charitable Rollover proposal merely simplifies this transaction and allows generous Americans to use their IRA assets for charitable purposes in one step.

Whether or not a particular donor will take advantage of this new mechanism depends in large measure upon the size and composition of his or her overall financial situation. However, the IRA Charitable Rollover proposal will sweep away a critical tax barrier that currently discourages Americans from making appropriate use of their IRA assets for charitable purposes.