The Pension Protection Act of 2006: A Guide to Charitable IRA Rollovers

On Thursday, August 17th, President Bush signed the Pension Protection Act of 2006 that includes a long-awaited provision that will permit taxpayers to make direct charitable transfers from their Individual Retirement Accounts. In this article, Planned Giving Design Center Editor Marc D. Hoffman reviews the new rules and how donors, charities, and IRA administrators might respond.

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For the last ten years, the charitable community has been actively lobbying Congress for a change in tax law that would permit owners of IRAs and other forms of qualified retirement plans to make unlimited tax-free lifetime transfers from such plans to charity or to split-interest charitable gift planning vehicles such as charitable gift annuities and charitable remainder trusts.

On August 17, 2006, President Bush is scheduled to sign the Pension Protection Act of 2006 that includes provisions taking an important, but limited, first step towards that goal.

In a Nutshell

There have been many permutations of charitable IRA rollover legislation floating through Congress in recent years, so it is imperative that gift planners, charities, and donors understand what the new law permits and what it does not.

First, it is important to note the new rules apply only to outright *lifetime* transfers from IRA owners. The rules and benefits applicable to testamentary transfers remain unchanged.

In a nutshell, the new law provides an exclusion from gross income for otherwise taxable IRA distributions of up to $100,000 per year from traditional IRAs and Roth IRAs for "qualified charitable distributions" made during 2006 and 2007 by plan owners who have attained at least age 70½ on the date of distribution to charity.

The balance of this article will decipher this definition, answer some of the questions for which we have answers, and offer our thoughts for those we don't. For reference, refer to the text of the charitable provisions of H.R. 4 and the Joint Committee on Taxation's Explanation (both available in PDF format).

Which Plans Are Eligible?

As stated above, the exclusion applies to traditional IRAs and Roth IRAs only. Other forms of retirement plans such as 401(k), 403(b) annuities, defined benefit and contribution plans, profit sharing plans, Keoghs and employer sponsored SEPs and SIMPLE plans are NOT eligible.

Comment: Owners of ineligible plans may consider rolling amounts into a qualifying IRA to take advantage of the new rules; however, how receptive will a new trustee be to opening a new account only to receive a distribution request shortly thereafter?

What are the Effective Dates?

The new rules are effective for transfers made during 2006 and 2007. We presume the standard delivery rules will apply. Therefore, distribution must be delivered or postmarked to the charity no later December 31st of the year for exclusion.

Who Can Exclude IRA Distributions?

The exclusion applies to individuals who have reached age 70½ **by the date of contribution**. It is important to distinguish this rule from the rule that requires plan participants to begin receiving minimum required distributions in the same year they reach 70½ (if they have already begun receiving distributions) and no later than April 1st of the year following the year in which they attain age 70½ (if they have not). Therefore, donors, their advisors, and helpful charities will want to check the calendar to make sure this important test is satisfied.

Limitation on Amount

The amount that can be excluded from a plan owner's income is limited to $100,000 per taxpayer per year. Therefore, a married couple could donate up to $200,000 provided each spouse owns at least one IRA and can each make a qualified charitable distribution of $100,000 from their plans. Amounts exceeding this amount are treated under the old rules.

Can qualified charitable distributions be applied in satisfaction of a plan owner's minimum required distribution requirements for the year?
Yes. If, for example, a participant is required to withdraw 5% from their IRA for the year, they can direct the entire amount to charity in satisfaction of their minimum required distribution.

What about income tax withholdings from amounts distributed to charity?
The Treasury will prescribe rules under which IRA owners are deemed to elect out of withholdings on amounts distributed to charity.

Qualified Charitable Distribution Defined

A *qualified charitable distribution* ("QCD") is any distribution from a traditional IRA or Roth IRA made directly by the IRA administrator to an organization described in section 170(b)(1)(A)[1] that would have been taxable if distributed to the plan participant.

In addition, the definition of a QCD specifically excludes distributions to *donor advised funds* or *supporting organizations* [as described in section 509(a)(3)], even if maintained by an otherwise qualified organization.

Comment: With respect to the restriction against donor advised funds, University of Missouri Kansas City tax law professor Christopher R. Hoyt makes a very important observation we hope Congress will hear:

"It is unfortunate that donor advised funds and private foundations were excluded from the charitable IRA rollover. They could help to assure that IRA dollars are actually used for charitable purposes. IRA administrators would also find it helpful if they could just issue a single check for $20,000 to a donor advised fund and then let the donor advised fund issue numerous charitable grants of $500 or $1,000. To elaborate, this legislation essentially makes every IRA of every person over the age of 70½ into a charitable donor directed fund (not just a donor advised fund)."

Can a donor direct their contributions to other types of funds?
Yes. Donor advised funds and supporting organizations are not the only types of segregated funds operated by community foundations and other charitable organizations. For example, field of interest funds, designated funds, scholarships, and restricted or general endowments, for which donors or their designees have no advisory rights, are perfectly suitable recipients for charitable IRA rollovers.

Does a QCD include contributions in exchange for a charitable gift annuity that is issued by an otherwise qualified charity or to a split-interest charitable trust that names an otherwise qualified charity as a beneficiary?
No. The technical explanation states, "The exclusion from income applies only if a contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations." Thus, split interest gifts of any type do not qualify.

Can the donor receive any quid pro quo benefits in exchange for their contribution?
No. If the donor receives any benefit of value (of other than intangible religious benefits) that would otherwise reduce their charitable deduction, the exclusion is not available with respect to **any part** of the IRA distribution. Therefore, charitable donees should be particularly careful regarding how lavishly they thank their donors and that nothing of value is exchanged in connection with the gift.[2]

Can the distribution be payable to the plan participant who then endorses the check to a qualified charity?
No. In order to avoid constructive receipt by the plan owner, the check must be payable "directly" to the charity.

How are nonqualified distributions treated?
Distributions that do not meet the requirement of the new rules are treated under existing rules. In essence, they will be taxable to the plan participant, who must then claim an itemized income tax charitable deduction following contribution.

Is a gift receipt required?
Absolutely. The technical explanation states, "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."[Emphasis added] Accordingly, it is imperative the charitable donee provide the donor with a contemporaneous written acknowledgement of the gift as described in Treas. Reg. section 1.170A-13(f), as they would with any other outright contribution. However, charities might want to take their acknowledgements a step further by adding the gift is not being used to fund a donor advised fund or supporting organization. See our sample acknowledgement following the end of this article.

Connecting the Dots between Donor and Donation
This raises an interesting administrative issue. The technical explanation states the donor must obtain written substantiation from the donee. But how does the charity know who the donor is if the check comes from the administrator? This problem is analogous to a charity receiving a gift of stock from a donor's brokerage firm via a DTC transfer without being informed as to account of origin-the so-called "mystery gift".

If the check is coming directly from the plan administrator, steps should be taken to ensure the charity is expecting it and knows the identity of the donor. Ideally, the transmittal and draft should identify and account owner as the donor. Donors may also be wise to contact the charity independently and let them know a gift is on the way. See our sample notification letter following the end of this article.

As an alternative donors may want to request the check, payable to the charity, be mailed to them personally. The donor, then, can deliver the check to the charity. However, trustees may be uncomfortable with this and prefer to send the check to the charity directly—particularly if the distribution is occurring close to the end of the year when qualification for exclusion is at stake.

Favorable Treatment for Nondeductible Contributions

Qualified charitable distributions include amounts that otherwise would be taxable if distributed to the plan participant. Some plan owners, however, make non-deductible contributions to their IRAs that if withdrawn would be considered a tax-free return of nondeductible contributions. Such distributions are not deemed to be a QCD. However, the Act provides special new rules that are very favorable to taxpayers. Simply stated, taxable distributions are considered distributed first:

Example
Suppose a donor owns one IRA with a total value of $100,000 of which $80,000 consists of deductible contributions and earnings, and the remaining $20,000 of nondeductible contributions. Under present law, if the plan owner takes a distribution of from their IRA, a prorata portion will be treated as a nontaxable return of nondeductible contributions. If, for example, the owner withdraws $80,000 from the plan, the owner will realize $64,000 of income [$80,000 x (1 - ($20,000 / $100,000))], with the remaining $16,000 tax-free.

Under the new law, if the plan owner makes a qualified charitable distribution of $80,000, the entire $80,000 will be treated as having been distributed from deductible contributions and plan earnings (i.e., taxable distributions). The $20,000 remaining in the plan will be considered nondeductible contributions.

Donating Nondeductible Contributions
Continuing with this example, if the plan owner donates the entire $100,000 plan balance to charity, he or she will be deemed to have made a QCD of $80,000 and a nonqualified charitable distribution of $20,000. The donor should then claim an itemized income tax charitable deduction for $20,000. From a compliance standpoint, however, how would this gift be substantiated? Would it be a safer bet for the donor to instruct their administrator to distribute $80,000 directly to charity and thereafter withdraw the remaining $20,000 personally and make a separate donation personally? The donor would then receive two separate substantiation letters: one for the exclusion amount of $80,000 and one $20,000 that could be used to substantiate the income tax charitable deduction.

Multiple IRAs Aggregated to Determine QCD
For purposes of determining QCD, all traditional and Roth IRAs owned by the participant are treated as one account. For example, if an individual owns two IRAs, each with a total fair market value of $100,000 of which $50,000 consists of nondeductible contributions, the plan own can donate one of the accounts in its entirety and treat the entire distribution as a QCD. The remaining IRA will be treated as consisting entirely of nondeductible contributions.

Who verifies if the distribution is qualified and how is the exclusion claimed?

The $64,000 question regarding charitable IRA rollover is, "Who is responsible for determining if the distribution is a QCD?" We've believe it should be the plan owner.

Because of the mobile nature of IRAs, most financial institutions do not track a plan owner's nondeductible contributions. That is the responsibility of the plan owner. Further, even if the trustee did track that information, because a plan owner's IRAs are aggregated for purposes of determining if a charitable distribution is being made from an otherwise taxable distribution, in the event they own more than one IRA and hold them at different financial institutions, one trustee would not have all the data. This is not to say an administrator could not, as a service, assist their client in working through the numbers; however, we believe the ultimate responsibility to determine if a distribution is qualified will fall on donors and their tax advisors.

Regarding how the exclusion is claimed, keep in mind that the folks in the Forms and Publications division at IRS are digesting this bill at the same time we are. Furthermore, they will need to incorporate its provisions for the 2006 tax year. Because the exclusion is scheduled to expire at the end of 2007, it probably won't merit a regulation project; rather, we expect to see IRS Notices, Revenue Procedures or similar.

Because administrators do not track the taxable portions of IRAs, the Form 1099-R [PDF] issued to the plan owner making a QCD might not differ much from an otherwise taxable distribution. This presumes, however, the 2006 form (which has not yet been released) remains unchanged.

If the current form is used, we think it might be completed as follows: First, even though a check is being issue in the name of a charity, the *Recipient* of the 1099-R would still be the plan owner. Box 1 would include the amount of the *Gross distribution*. Box 2, *Taxable amount*, would be left blank, and Box 2b *Taxable amount not determined*, would be checked. At this point, we can only speculate if IRS will provide a special *Distribution Code(s)* for Box 7. Within Box 7, the *IRA* box would be checked.

Regarding how taxpayers will claim the exclusion on their tax returns, Laura Peebles, CPA, PFS, from the national office of Deloitte Tax suggested we might see a Worksheet that taxpayers can use to calculate their QCD and determine any net taxable income amount that would then fall onto the 1040. "A worksheet would be faster for IRS to implement than a form change because the latter requires OMB approval that might not be as practical at this stage in the year: or, they could go through with a change to the IRA Form itself. We probably won't have any hints about what IRS is thinking until they come out with something, so now is the time to speak up if people have suggestions," Peebles said. Use the "Commenting on Forms and Publications" link on the IRS website's "Forms and Publications" page.

Professor Hoyt concurred by suggesting, "The best solution can be seen on the front page of the Form 1040. For IRA distributions (and social security distributions) there are two lines: *total distributions and taxable distributions.* Under current law, if an IRA distribution is rolled over, you report the total distribution on the first line and the taxable distribution is "zero". So, all we do for the *charitable* IRA rollover is the same."

A related question involves who is responsible in performing the due diligence to determine if a charity is a qualified organization and if the gift will be put to a qualified use (i.e., non-DAF and non-SO). Based on the fact this is an exclusion claimed by the plan owner, we hope IRS doesn't place any increased burden on the trustee/administrator but, as with determining QCD, leaves that responsibility to the plan owner.

Who Benefits from the New IRA Rollover Rules?

Non-Itemizers
First and foremost, because qualified charitable distributions from IRAs will eliminate the need for donors to claim an income tax charitable deduction, non-itemizers will enjoy the equivalent of a charitable deduction. In fact, some donors who were itemizing for the sole purpose of claiming deductions for their charitable gifts may longer need to do so if they fund their gifts from their IRAs.

The new rules may also be attractive to residents of states with no state income tax (such as Florida, Texas, Nevada, and Washington) because relatively fewer taxpayers in those states itemize (because they have no state income tax to deduct against their federal tax).

Donors Whose Charitable Deductions Are Maxed Out
At the opposite end of the financial spectrum may be donors who have maximized their ability to claim income tax deductions due to the 50% of AGI percentage limitation. These donors will find they can give more because QCDs operate independently of the percentage limitation rules and, therefore, don't affect other gifts to which the limitations apply.

Donors Subject to Tax Friction
Under the old rules, donors making gifts from their IRAs would have to take the distribution into their taxable income and then claim an offsetting income tax charitable deduction. However, the result is not always a wash.

For higher income earners, the impact of receiving additional income on the taxability of social security payments, the deductibility of medical expenses, miscellaneous itemized deductions (subject to the two percent of AGI limitation), the phase-out of itemized deductions and child tax credit, and application of the alternative minimum tax can often result in a net income tax cost of making a charitable gift.

Qualified charitable distributions from IRAs can eliminate this friction and need to perform trial income tax calculations to analyze their net income tax effect (caveat, see discussion of state income issues below).

Donors in States that Don't Allow Charitable Deductions
Some states do not allow itemized deductions for state income tax purposes. In addition, some states (which include some of the same states that don't allow itemized deductions) do not tax retirement plan distributions or otherwise cap the amount of retirement plan

distributions subject to state income tax. It is beyond the scope of this article to analyze the benefit of QCDs on a state by state basis; however, we can make some general observations.

In states that do not allow itemized deductions, plan owners who made taxable withdrawals from their IRAs and then donated them under the old rules had to pay state income tax for the privilege of making a charitable gift. Because states generally follow federal income inclusion rules, QCDs should be excluded for state income tax purposes under the new law. Accordingly, taxpayers residing in these states will benefit, if their state continues to follow the federal rules. To the extent states exclude all or cap the amount of plan distributions that are taxable, the relative benefit of the new rules may be reduced.

For example, the new rules may be particularly attractive to taxpayers residing in Indiana and Ohio because those states tax retirement distributions and do not allow itemized deductions. At the other end of the spectrum, Illinois taxpayers will see no change at the state income tax level because itemized deductions are not allowed and retirement plan distributions are excluded. Residents of New Jersey and Michigan (which cap the amount of retirement distributions subject to state income tax) may enjoy a partial benefit. Again, this is not an exhaustive list of all states affected. As has always been our mantra here at the PGDC, check state law and run the numbers!

Charities
Last but not least, because the new rules make the equivalent of a charitable deduction available for non-itemizers and otherwise remove much of tax friction associated with making gifts from IRAs, charities should be able to benefit from a new asset pool and new group of donors. However, as with the temporary charitable giving incentives contained within the Katrina Relief Act, the charities that will benefit will be those that clearly communicate the new rules and opportunity to their donors, and are prepared to help them through the process.

Conclusion

Although the Pension Protection Act of 2006 does not include all of the flexibility we had hoped for, it is certainly a good start. And, as Chris Hoyt reminds us, "Although the new law *permits* distributions to be made from IRAs directly to charities, it does not *compel* IRA administrators to make such distributions when they receive instructions from the IRA account owner. The charitable sector needs to be supportive of the needs and concerns of IRA administrators in order for the full potential of charitable IRA rollover to actually be realized." We couldn't have said it better!

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Sample Documents

Sample Request from Plan Owner to Administrator for Charitable Distribution from Individual Retirement Account

RE: Request for Charitable Distribution from Individual Retirement Account

Dear Sir or Madam:

Please accept this letter as my request to make a direct charitable distribution from my Individual Retirement Account # (Account Number) as provided by the Sec. 1201 of the Pension Protection Act of 2006 and Sec. 408(d)(8) of the Internal Revenue Code of 1986, as amended.

Please issue a check in the amount of $____________ payable to the organization at address below:

(Legal Name of Charity)
Address
City, State, Zip
Attn: Name

In your transmittal to the charity, please memorialize my name and address as the donor of record in connection with this transfer. Please copy me on your transmittal.

(Optional paragraph for requests occurring close to year-end) It is my intention to have this transfer qualify for exclusion during the (2006 or 2007) tax year. Therefore, it is imperative this distribution be postmarked no later than December 31, 200_.

If you have any questions or need to contact me, I can be reached at (telephone).

Thank you for your assistance in this matter.

Sincerely,

(Plan Owner)

Sample Letter from Donor Informing Charity of Forthcoming Qualified Charitable Distribution from Administrator

Dear Sir or Madam:

It is my pleasure to inform you that I have requested a qualified charitable distribution from my Individual Retirement Account payable to your organization in the amount of $______________ from my plan trustee/administrator, (name of trustee/administrator).

It is my intent to comply with the requirements of Sec. 1201 of the Pension Protection Act of 2006 and Sec. 408(d)(8) of the Internal Revenue Code of 1986, as amended, in connection with this gift.

Accordingly, upon your receipt of payment from my trustee/administrator, please send me a contemporaneous written acknowledgement that states the amount of my gift, that

no goods or services were transferred to me by your organization in consideration for this gift, and that my gift will not be placed in a donor advised fund or supporting organization.

If you have any questions or need to contact me, I can be reached at (telephone).

Sincerely,

(Donor)

Sample Contemporaneous Written Acknowledgement from Charity to Donor

Dear (Donor):

Thank you for your gift in the amount of $__________ from your Individual Retirement Account. We are writing to acknowledge that we received your gift directly from your plan trustee/administrator and that it is your intention for all or a portion of your gift to qualify as a qualified charitable distribution from your IRA under section 408(d)(8) of the Internal Revenue Code.

In that connection, we warrant to you that our organization is qualified under section 170(b)(1)(A) of the Internal Revenue Code and that your gift was not transferred to either a donor advised fund or a supporting organization as described in section 509(a)(3).

We further warrant that no goods or services of any value were or will be transferred to you in connection with this gift.

Please retain this letter with your important tax documents and provide a copy to your tax preparer.

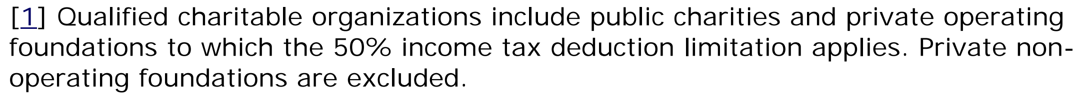
Thank you for your generous contribution to our organization.

Sincerely,

(Charity)

Disclaimer: This article is based on our initial analysis and impressions of H.R. 4 — The Pension Protection Act of 2006. Although we have made every effort to ensure its accuracy, it is not to be construed as legal, accounting, tax, investment, or other professional advice. We urge you to seek competent counsel prior to relying on the opinions expressed herein.

Footnotes



[1] Qualified charitable organizations include public charities and private operating foundations to which the 50% income tax deduction limitation applies. Private non-operating foundations are excluded.

[2] *See* IRC 170(f)(8) and 6115.

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Mr. Hoffman has been a platform speaker at the National Committee on Planned Giving and AFP National Conferences, and is a founding board member and past president of the Orange County and Inland Empire Planned Giving Roundtables. He is also a founding and current faculty member of the American Institute for Philanthropic Studies' Certified Specialist in Planned Giving program at California State University Long Beach.
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