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CLIENT ALERT - TAX-FREE DIRECT CHARITABLE/IRA DISTRIBUTIONS

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Will Congress extend expired law retroactively for 2015? If so, when? What should donors do?

Doing it right to assure benefits—PRIMER

Will Congress extend expired Charitable/IRA law for 2015? The House passed a permanent extension in the Spring. The Senate Finance Committee reported out an extension retroactively for all of 2015 and prospectively for 2016. But the Senate hasn't voted yet. The SFC bill would extend about 50 other expired laws. The Charitable/IRA (and other charitable tax benefits) and business and personal tax benefits have expired several times over the years. Congress has extended those benefits often at the very end of the year—and even retroactively early in the year following expiration.

Will Congress once again extend the expired provisions at the end of 2015 or early 2016 retroactively for 2015? Will the charitable/IRA be available for donors in 2015 (assuming donors make qualified distributions from their IRAs directly to charities in 2015)?

I take my cue from an old Danish proverb: "It is difficult to predict, especially the future." This gem has many ostensible fathers—including Niels Bohr, Mark Twain, Samuel Goldwyn and Yogi Berra. Be mindful, however, that Yogi said, "I never said most of the things I said."

If an individual is planning to make a cash charitable gift in any event, making a direct IRA gift to the charity (if he hasn't already taken his required minimum distribution) "can't hurt" for both itemizers and nonitemizers.

For itemizers: A donor, age 70½ or older, who hasn't yet taken his RMD can direct a payment from his IRA to a qualified charity. He won't be taxed on the RMD (up to $100,000) if the law is extended retroactively for this year. If Congress doesn't act, the donor has an income tax charitable deduction, taking into account the adjusted gross income ceiling and five-year carryover rules. The donor should be mindful of any remaining carryovers from earlier years.

For nonitemizers: They'll make charitable gifts that they planned to make in any event. But, they won't be taxable on the distribution if the tax-free provision is available. Not being taxable on income is the equivalent of a deduction. So the direct transfer from an IRA to charity can be looked at as the nonitemizer's charitable deduction.

PRIMER

Tax-free direct charitable/IRA distributions (Tax-free charitable IRA rollover)—*maltum in parvo* (in a nutshell). An individual age 70½ or older can make direct charitable gifts from an IRA, **including required minimum distributions,** of up to $100,000 to public charities (other than donor advised funds and supporting

organizations) and not have to report the IRA distributions as taxable income on his or her federal income tax return. Most private foundations are ineligible donees, but private-operating and passthrough (conduit) foundations are. There is no charitable deduction for the IRA distributions. However, not paying tax on otherwise taxable income is the equivalent of a charitable deduction. Tax-free distributions are for outright (direct) gifts only—not life-income gifts.

Traditional and Roth IRAs only. Distributions from traditional and Roth IRAs are the only ones that are tax free. Distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (SEPs) aren't qualified charitable distributions; nor are distributions from Keoghs, 403(b) plans, 401(k) plans, profit sharing and other plans.

Doing a two step to qualify: (1) Roll over a non-qualified pension plan into a qualified IRA. That's generally tax free (make sure that's so). (2) The qualified IRA then makes the distributions directly to the charity.

Pointer on donor-advised funds of community foundations. As noted, IRA distributions to those funds don't qualify. But IRA distributions to a community foundation's endowment and field-of-interest funds do qualify—as long as the donor has no advisory rights.

Distributions from a qualified IRA must be made directly by the IRA's administrator or trustee to a qualified charity. A payment to the donor who one honko-second later gives it to the charity doesn't qualify (a honko-second is the shortest measure of time—the time that elapses between a traffic signal turning green and the driver of the car behind honking his horn).

The entire distribution must be paid to the charity with no quid pro quo. The exclusion applies only if a charitable deduction for the *entire* distribution would have been allowable (determined without regard to the generally applicable percentage limitations). Thus if the donor receives (or is entitled to receive) a chicken dinner in connection with the transfer to the charity from the IRA, the exclusion isn't available for *any* part of the IRA distribution.

Example. $100,000 from a donor's IRA is distributed to the charity. He receives (or is entitled to receive) a benefit worth $25. The entire $100,000 will be taxable to the donor.

Substantiation required. The exclusion won't be available if the IRA distribution to the charity isn't properly substantiated. The charity must give the donor a timely written acknowledgment that it has received the IRA distribution and that no goods or services were given in connection with the IRA distribution.

Favorable rules on charitable distributions when the donor had made earlier deductible and nondeductible contributions to his IRA. If the IRA owner has any IRAs that include contributions that were nondeductible when contributed to the IRA, a special rule applies in determining the portion of a distribution that is includable in gross income (but for the qualified IRA/charitable distribution) and thus is eligible for qualified charitable distribution treatment. The special rule works this way: The distribution is treated as consisting of income first, up to the aggregate amount that would be includable in gross income (but for the qualified charitable distribution) if the aggregate balance of *all* of the donor's IRAs were distributed during the same year. In determining the amount of subsequent IRA distributions includable in income, adjustments are to be made to reflect the amount treated as qualified charitable distributions.

Qualified charitable distributions—examples. These examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., 70½ or older, qualified public charity) and that no other IRA distributions are made during the year.

Example 1. Arnold, over 70½, has an IRA with a $100,000 balance, consisting solely of deductible contributions and earnings. He has no other IRA. The entire IRA balance is distributed to an IRC §170(b)(1)(A) charity (other than a supporting organization or a donor advised fund). Under earlier law, the entire $100,000 distribution would

have been includable in Arnold's gross income. Under the IRA/charitable distribution rules, the entire $100,000 distribution is a qualified charitable distribution and thus no amount is includable in his income. Further, the distribution is not taken into account in determining the amount of Arnold's allowable charitable deductions for the year.

Example 2. Barbara, over 70½, has a $100,000 IRA consisting of $80,000 of deductible and $20,000 of nondeductible contributions. $80,000 is distributed directly to charity. She has no other IRA.

Notwithstanding the usual treatment of IRA distributions, the distribution to the charity is treated as consisting of income first, up to the total amount that would be includable in gross income (but for the charitable IRA distribution rules). Under these rules, the entire $80,000 distributed to the charity is a qualified charitable distribution and no amount is included in Barbara's income as a result of the distribution. Further, the distribution isn't taken into account in determining the amount of Barbara's charitable deductions for the year. And when the $20,000 remaining in Barbara's IRA is distributed to her, it will not be subject to tax because it came from non-deductible IRA contributions when placed in her IRA.

You turn 70½ for purposes of qualifying for the IRA/charitable distribution when you are actually 70½. Professor Christopher R. Hoyt, University of Missouri-Kansas City, School of Law, highlights a major pitfall: "It is true that all distributions that are made at *any time during [the year that a person turns 70½]* can be applied toward satisfying the minimum requirement distribution to avoid the 50 percent penalty tax. But ONLY distributions that are made *on or after* attaining the age of 70½ qualify for the charitable exclusion! Play it safe and tell clients/donors not to have any distributions made to charity until at least one or two days after they reach age 70½."

Caveat on year-end charitable distributions. A donor who by U.S. mail sends checks and securities to a charity this year that are received by the charity next year has made a charitable gift this year. Will a distribution mailed by the IRA trustee/custodian to the charity this year, but received by it next year, qualify for tax-free treatment? Unless clarified by the IRS, make sure that the charity actually receives the distribution this year.

Death-time distributions to charity from IRAs—reminder. Current and continuing laws allow tax-free distributions to charities at death for both outright and charitable remainder gifts. Income in respect of a decedent (IRD) isn't taxable to charities and CRTs. When a CRT beneficiary receives payments, he or she will be taxable on the IRD. Less than one percent of estates are subject to the estate tax. If those estates have income in respect of a decedent, the IRA beneficiaries are entitled to itemized deductions on their income tax returns spread over their life expectancies for estate taxes attributable to their bequests. This should be considered when deciding whether to create a testamentary charitable remainder trust funded with an IRA. But this isn't an issue for over 99 percent of estates. Also, outright bequests of IRAs to charity avoid tax on the IRD. So give appreciated stock outright to family members who will get a stepped-up basis, and give the IRA and other IRD "items" to charity. The charity being tax exempt doesn't pay tax on the IRD. Other IRD items include: salary and wages earned before death but paid after death; accounts receivable; unpaid royalties; commissions and partnership income earned before death but paid after death; unpaid royalties; payments under installment obligations paid after death; and interest or dividends earned before death but paid after death.

For death-time transfers from IRAs, there isn't a ceiling or limitation on the types of charitable donees. Thus distributions to all private foundations and public charities (including supporting organizations and donor advised funds) qualify. **To avoid IRD concerns, the gift must be properly structured.**

Guidance from the IRS. In 2007, the IRS—fleshing out the Code and the explanation by the staff of the Joint Committee on Taxation—favorably filled in the blanks to some unanswered (and some already answered) questions:

- **Check payable to charity but delivered to the charity by the IRA owner.** The payment to the charity will be considered a direct payment by the IRA trustee to the charity and thus a qualified charitable distribution (QCD).
- **For inherited IRAs.** The exclusion from gross income for QCDs is available for distributions from an IRA maintained for the benefit of a beneficiary after the death of the IRA owner if the beneficiary has attained age 70½ before the distribution is made.
- **Multiple IRAs.** The income exclusion for qualified charitable distributions only applies to the extent that the aggregate amount of QCDs made during any taxable year for an IRA owner doesn't exceed $100,000. Thus distributions from multiple IRAs are capped at a maximum total of $100,000.
- **For married individuals filing jointly.** The limit is $100,000 per individual IRA owner.
- **QCDs don't affect the AGI deductibility ceiling.** Although charitable IRA distributions aren't deductible IRC §170 charitable contributions, QCDs that are excluded from income under IRC §408(d)(8) aren't taken into account for purposes of the AGI ceilings for traditional charitable gifts.
- **Substantiation requirements.** Although not deductible, QCDs must still satisfy the deductibility requirements under IRC §170 (other than the AGI percentage limits of IRC §170(b)) and the substantiation requirements under IRC §170(f)(8).
- **QCDs aren't subject to withholding.** An IRA owner who requests a charitable distribution is deemed to have elected out of withholding under IRC §3405(a)(2).
- **IRA trustees and custodians are off the hook.** In determining whether a distribution requested by an IRA donor satisfies the QCD requirements, the IRA trustee or custodian may rely upon reasonable representations made by the IRA owner.
- **Required minimum distributions.** A QCD is taken into account in determining whether the required minimum distribution (RMD) requirements have been satisfied.
- **Treatment of a QCD manqué.** If an intended QCD is paid to a charity but fails to satisfy IRC §408(d)(8)'s requirements, the amount paid is treated as (1) a distribution from the IRA to the IRA owner that is includable in gross income (under IRC §408 and §408A's rules), and (2) a contribution from the IRA owner to the charity that is subject to IRC §170's deductibility rules (including the AGI percentage limits and the substantiation rules).
- QCDs aren't prohibited transactions—even if used to satisfy pledges. The Department of Labor, which has interpretive jurisdiction under IRC §4975(d), has advised the IRS that a distribution made by an IRA trustee directly to an IRC §170(b)(1)(A) organization (as permitted by IRC §408(d)(8)(B)(I)) will be treated as a receipt by the IRA owner under IRC §4975(d)(9), and thus isn't a prohibited transaction and that's so even if the IRA owner had an outstanding pledge to the receiving charity.

IRS Notice 2007-7

Tax-free distributions from individual retirement plans for charitable purposes. When determining the portion of a distribution that would otherwise be includable in income, the otherwise includable amount is determined as if all amounts were distributed from all of the individual's IRAs.

Technical Corrections Act '07

Satisfying a pledge with an IRA distribution—IRS Information Letter. By analogy to Rev. Rul. 64-240, a taxpayer who satisfies a pledge by making a qualified charitable distribution under IRC §408(d)(8) from his or her IRA directly to a charitable organization would not include the distribution in gross income, the IRS said in a August 20, 2010 Information Letter to Harvey P. Dale, University Professor of Philanthropy and the Law, Director, National Center on Philanthropy and the Law at New York University Law School written by Michael J. Montemurro, Office of Associate Chief Counsel.

IRS's caveat. "This letter is an 'information letter', which calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. It is intended for informational purposes only and does not constitute a ruling. See section 2.04 of Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 7."

My caveat. To avoid income on satisfying a pledge with a distribution from an IRA, the distribution must qualify under the requirements outlined above.

Advantages of IRA/Charitable Distributions:

- A gigantic additional pool of funds is available for charitable gifts.
- The approximately two-thirds of taxpayers who take the standard deduction—and thus can't deduct their charitable gifts—can get the equivalent of a deduction by making gifts directly from their IRAs to qualified charities. Not being taxed on income is the equivalent of a deduction.
- Itemizers who bump into the adjusted gross income ceilings on charitable-gift deductibility can use distributions from IRAs to make additional gifts. Because they won't be taxed on the distributions, they have the equivalent of additional charitable deductions.
- The carryover can be saved. Deductible gifts made in a current year are taken into account before deducting a carryover from earlier years. Making a gift from an IRA (as opposed to making a gift with other funds or assets) means that a carryover can be used in the current year.
- The IRA/charitable distribution (by not increasing adjusted gross income as would be the case if the taxpayer withdraws IRA funds instead of using the charitable distribution) can avoid or minimize the reduction of otherwise allowable benefits that are keyed to adjusted gross income—the 10 percent AGI floor on casualty loss deductions, the 10 percent floor on medical and dental expense deductions, the 2 percent AGI floor on miscellaneous itemized deductions.
- As adjusted gross income increases, the following benefits can be reduced or eliminated: social security; savings bond interest exclusion for savings bonds used to pay for higher education tuition and fees; the adoption and child care credits; contributions to Roth IRAs; and passive activity losses and credits**.**
- If a donor's state income tax law doesn't allow charitable deductions (e.g., Connecticut): Making the gift from the donor's IRA to the charity can be the equivalent of a state income tax charitable deduction.

Caution. State laws differ so check out all the ramifications in your state. For example, in some states IRA distributions directly to the IRA owners aren't subject to state income tax. A distribution from the IRA to charity thus won't save state income taxes and the donor could lose a state income tax charitable deduction that might—depending on state law—be available for a gift from the donor to the charity. Of course, consider both the federal and state tax rules. *You may have heard this before:* Do the arithmetic under various scenarios.

PEP and Pease. The phase out of personal exemptions (PEP) and the reduction of otherwise allowable deductions under the so-called Pease provision can make IRA/charitable distributions especially attractive to high-income donors. Taking distributions from IRAs instead of directing those payments to charity can place high-income people in the income levels where PEP and Pease apply.

Reminder. It won't be a QCD if the IRA donor gets a chicken dinner or any other benefit. So don't fowl up an IRA distribution with a quid pro crow.