What You Need To Know About IRAs and The "Charitable Rollover"

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Status of the Charitable IRA Rollover

There is a lot of talk now in the planned giving community about charitable gifts being made from IRAs ("Individual Retirement Accounts"). In 2006, Congress passed legislation allowing tax-free rollovers from a donor's IRA to qualified charities. The charitable IRA rollover is one of a number of temporary tax provisions that require annual renewal. These temporary tax provisions are typically extended late in the year and made retroactive to the beginning of that year.

At any planned giving event these days, one can hear the questions repeated through the crowd. "Has it passed yet?" "Where exactly does it stand?" What we know right now is that the law that includes the charitable IRA rollover has not been extended for 2015. Nonetheless, most experts predict passage of a version of the law late in 2015 (or perhaps very early in 2016) that will be retroactive to January 1, 2015. Donors can act now in anticipation of passage of the charitable IRA rollover retroactive for 2015. Our advice and attendant cautions on making a gift in anticipation of the enactment of the charitable IRA rollover legislation can be found here.

Rules Governing IRAs

While we are on the subject of IRAs, we have found that many gift planners and fundraising professionals are unfamiliar with the basic aspects of IRAs. Consequently, we thought it might be helpful if we provided a general overview of IRAs - what they are, how they work, and how they may be relevant already to gift planning. In so doing, we hope that our clients can better understand the potential value of the charitable IRA rollover. By the way, we should note that this article is about standard or "traditional" IRAs. There are other types of IRAs (such as Roth IRAs) that do not operate the same way as traditional IRAs and are not relevant to this discussion.

IRAs were created by landmark legislation in 1974 known as the Employee Retirement Income Security Act of 1974 ("ERISA"). This legislation came about as a result of chronic failures and widespread abuses occurring in a large number of traditional pension plans, also known as defined benefit plans. ERISA introduced the concept of defined contribution plans that created retirement vehicles that offer tremendous flexibility and tax savings for Americans. These "qualified retirement plans" are tax-exempt accounts that allow individuals to save for retirement on a tax-advantaged basis. These qualified retirement plans postpone taxation on earned income contributed to these accounts. The concept is relatively simple – income that would otherwise be taxable is contributed to a qualified retirement plan and not taxed while it remains in the plan. The qualified plan is completely tax-free: income generated by investments and capital gains realized from investment activity within the plan are not taxed as long as they remain in the plan.

Taxation of these retirement plan assets occurs only when the account owner withdraws them from the plan, which is generally upon retirement. Qualified retirement plans allow withdrawals upon reaching the age of 59 ½. (Withdrawals taken prior to age 59 ½ are subject to a 10% penalty tax.) Most workplace savings plans, such as the 401(k), are transferred to the employee's self-directed IRA soon after retirement. Distributions from the IRA are taxed as ordinary income at the owner's current marginal income tax bracket.

Traditional IRAs also have a requirement that the owner MUST begin taking distributions upon reaching the age of 70 ½. While the distributions are voluntary prior to that age, they are calculated by

the entity administering the account once the owner reaches 70 ½, and they are mandatory. Each year the account owner receives official notification that they must take at least a certain amount during the calendar year. This amount is known as the Minimum Required Distribution or "MRD." The MRD is computed based on the IRA account balance and the plan owner's age: the older the plan owner, the greater the fraction of the IRA account balance the plan owner must withdraw as MRD. The penalty tax for not taking one's MRD is 50%!

Some IRA account owners would actually prefer not to take their MRD, or at least not the total amounts required, but they have no choice. As mentioned above, at retirement most employers require the employee to take all of the money in the workplace savings plan. If the individual simply received the money outright, it would all be taxed at the person's current income tax bracket and would no longer be exempt from ongoing taxation. Transferring the balances in the former employer's retirement fund into a rollover IRA achieves a seamless transition from one tax-exempt vehicle to another. By the way, we in planned giving should be careful about how we refer to the charitable IRA rollover. Rollover IRAs are prevalent and popular among a large number of people in non-charitable situations as described above. Consequently, the term rollover IRA or IRA rollover is used extensively in wealth management and retirement planning circles. Gift planners need very clearly to distinguish the charitable IRA rollover provision from the ubiquitous rollover IRA / IRA rollover. Confusing the two concepts could have disastrous consequences.

Charitable Gifts from IRAs

There is no reason why charitable gifts – and even split-interest charitable gifts – cannot be made using funds from a person's IRA, either during life or at death, under existing tax laws. Individuals already can use IRA distributions to make gifts to charity, whether or not the charitable IRA rollover is enacted. The money taken out of the IRA – either as an MRD or as an amount in excess of the MRD – is taxed at the person's marginal income tax bracket, and the contribution to charity earns an income tax charitable deduction. The potential disincentive to make lifetime gifts from an IRA is that the charitable deduction and subsequent tax savings may not completely offset the tax assessed on the IRA distribution (based on issues such as whether state law allows income tax charitable deductions, non-itemizing donors, and reductions in deductions for itemizers). The disincentive for funding split interest gifts such as gift annuities and charitable remainder trusts from IRA assets is that the deduction will not completely offset the income taxes due from the donor's withdrawal of the money from the IRA.

In summary, most of us would welcome the passage of the charitable IRA rollover provision. It would encourage a certain level of increased charitable giving and would provide owners of large IRAs with a solution to the "problem" of having to take large amounts out of their accounts once they reach 70 ½ years old. Even if the charitable IRA rollover passes and is consistent with previous years, however, the provision will not apply to retirement vehicles other than IRAs, and it will not be available to transfers that establish life income gift arrangements.

We hope this article has been helpful. Please feel free to contact us if you have any questions or comments.