Planned Giving and the Roth IRA Conversion

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For many of us, and for many of our donors, our retirement plans are the largest or among the largest assets in our estate. Most of us are accustomed to putting before-tax earnings into an account that grows tax-free throughout our working lives. Some of us, (and some of our donors), have contributed to a Roth IRA as well, even though contributions to Roth IRAs have been limited by the donor's earned income (a single person cannot earn more than $105,000 and a married couple more than $167,000 before the ability to contribute to a Roth IRA quickly phases out)[1]. As we all know, a Roth IRA shifts the tax burden on the beneficiary from the time of distribution to the time of contribution. The owner of a Roth IRA contributes after-tax dollars to the plan, but then receives the benefit of tax-free growth and future distributions that are likewise tax-free.

For those with low enough income levels to participate, the Roth IRA has three main advantages that a regular IRA does not:

1. an owner will receive all distributions tax-free

[1] The phase-out process ranges from a Modified Adjusted Gross Income of $105,000 to $120,000 for single taxpayers and from $167,000 to $177,000 for couples filing jointly. This means that the amount one can contribute each year to a Roth diminishes as one moves from the lower to the higher end of these ranges, with the opportunity to contribute disappearing entirely as the taxpayer(s) pass the upper end of the limit.

- after five years from the beginning of the year in which an owner first contributed to or converted to a Roth IRA[2], and
- after age 59 ½ (except in special circumstances), or
- after death.

2. an owner can continue to contribute to a Roth IRA after age 70 ½ so long as he or she receives income at least equivalent to the amount contributed in the year the contribution was made.
3. an owner is not required to take mandatory distributions from a Roth IRA after age 70 ½.

Contributions to a Roth IRA are still limited by income restrictions, but beginning this year, anyone, regardless of income, can *convert* a regular IRA (or other qualified retirement plan), or a percentage of a regular IRA, into a Roth IRA.

Despite the above advantages of a Roth IRA, most people will probably not choose to convert, as anyone who converts a regular IRA (or other qualified plan) to a Roth will have to pay income tax on the amount in the plan (or at least on the amount funded originally with before-tax dollars and on all the growth, which for most plans constitutes the entire value of the plan). Even though in 2010 the taxpayer has the option of

[2] For account holders older than 59 ½, the five year holding period disappears for withdrawals of the converted assets. However, withdrawals from any growth beyond the amount converted will still be taxed if the account holder does not wait for five years. After that, all withdrawals from the Roth IRA are tax-free.

deferring that tax burden and spreading it over tax years 2011 and 2012, the tax may still loom large.[3]

The ideal candidates for conversion are people who will have a higher income in retirement than before retirement (not many people are so fortunate) and the (young) person who owns a plan that will enjoy significant tax-free growth before he or she intends to start distributions. With sufficient time and thoughtful investment strategies, a younger individual could well see the size of his or her Roth IRA grow considerably prior to "retirement," and thus be able eventually to withdraw enough tax-free income to more than make up for the tax paid on the original conversion.

But planned giving professionals need to take note of another important reason why our donors might want to convert their IRAs into Roths, a reason that has received little attention in the national press.

Remember that the distributions of a Roth IRA are tax free if made "after age 59 ½ *or after death*." A Roth IRA is not generally treated as Income with Respect to a Decedent (IRD), as is a regular IRA. If an owner of a Roth IRA dies and leaves his Roth to his or her children, the children will not have to pay taxes on that gift, as they would have to

[3] We should emphasize that an account holder does not have to convert an entire IRA and retains the option of converting only a portion, thus offering a chance to balance the tax obligations with the potential long-term benefits. An individual could also convert only the segments of a regular IRA invested in specific assets and can establish several different Roth plans as a result. For example, I might convert only the equity portion of my IRA investments, or I might convert the equity portion to one Roth plan and the bond portion of my IRA to another, so that I have the option of reverting to a regular IRA (with no tax obligation on the reversion—or, as the law suggests, the "recharacterization") in 2011 if one of them does not perform well.

under a traditional IRA. How many of us have said to our donors "please consider making our charity a beneficiary of your retirement plan because if anyone but your spouse inherits it, that person has to pay income tax on the amount"? Many of us have promoted making a charity the beneficiary of an IRA as the smartest tax move a donor can make. Some have gone so far as to scare donors into making a charity the beneficiary of their IRA by warning that "up to 80% of their retirement plan would go to the IRS" –a greatly suspect figure since relatively few Americans are likely ever to have to confront the estate tax, which makes up the bulk of that dreaded 80%. With a Roth conversion, donors *will* be able to give their retirement plans to their children, who will not be taxed at all on the proceeds. And we will *not* be able to say to our donors that giving a Roth IRA to charity is the best kind of tax planning.

So what *can* fundraisers say to donors about Roth IRAs and what might we expect from the new unlimited opportunity to convert?

<u>First, most of our donors will probably not convert their well-funded retirement plans to Roth IRAs.</u> The prospect of an additional and large tax liability holds little allure for most plan owners. Most IRA and retirement plan owners are not exceptionally wealthy, so that adding taxable income is likely to be a burden for most. Besides, most taxpayers are likely to be earning more now than they will in retirement, so the high tax bill in 2010 (or 2011 and 2012) may not be offset by the tax savings from tax-free

withdrawals at a later date, especially if the account owner is anywhere near retirement age.

> Jack's story: Jack is 65, with taxable income of $100,000 per year; he will retire next year and his taxable income is projected to drop to $75,000; his regular IRA is now worth $500,000. To convert he would see his taxable income skyrocket from $75,000 to $575,000 and his tax jump from roughly $15,000 to the range of $200,000. Even if he chooses to spread that tax liability over tax years 2011 and 2012, he will somehow have to find an "extra" $185,000 to cover the tax liability. The prospect of tax-free returns from his newly converted Roth IRA pales by comparison to his immediate need for cash to pay the taxes generated by the conversion. Even if his IRA is only $50,000 instead of $500,000, or if he elects to convert only 10% of his $500,000 IRA, his tax liability will almost double. For these reasons, Jack would still probably take the advice we have given over the past few years—that designating a charity as one of the beneficiaries of a qualified retirement plan is a smart tax move and a smart philanthropic move. Our past thinking remains pertinent for many of our donors. We should not abandon this advice even though we now must qualify our remarks in the light of current and possible estate tax legislation. We should also pay careful attention to whether the plans our donors have to work with are regular or Roth IRAs.

Second, we might suggest to our donors that a conversion to a Roth IRA offers them the perfect moment to give a large gift to charity. Yes, a Roth conversion will increase their income, but it also offers them a good reason to give a large gift during the same year they convert. Many donors will be able to offset part (or all) of their additional tax by giving to the charity of their choice.

For donors who would like to increase retirement income, conversion could be followed by a donation in the form of a deferred charitable gift annuity, especially one with a flexible start date. Such a gift could provide a triple benefit: it could generate a charitable tax deduction to offset the increased taxable income a Roth conversion would bring; it could guarantee an increased income for the future whenever the donor wished to receive it, and it would create a long-term gift to a charity important to the donor.

> Pete's story: Pete is a successful attorney, 50 years old, and eager to shelter as much of his income as he can for future access. He also has an old IRA that he began a number of years ago that is now worth $30,000. He would like the benefit of tax-free income in his retirement and is leaning toward converting this IRA into a Roth IRA, but he does not want to add another $30,000 to his income for 2010. Thus, this might be the perfect year for Pete to fund a deferred CGA that can also help him shelter more of his current income for future use. If Pete wishes to give $100,000 through a deferred flexible CGA (ensuring a supplemental income to him

of $9,800/year if he begins taking the deferred income at age 65), to a charity, he would generate an offsetting charitable tax deduction of roughly $31,000—enough to pay his tax on the IRA conversion. Thus Pete doubles his benefits: he gets the advantages of a Roth IRA in his retirement and he gets the benefit of more retirement income through a deferred CGA. His favorite charity also benefits.

Third, we should remember that a Roth IRA itself may become an important new source of charitable dollars. Because a plan owner can withdraw money from a Roth free of tax, a direct rollover to charity (even if the donor is over 70 ½) makes little tax sense. However, the donor could easily withdraw cash from the Roth and then, in a second separate step, contribute the cash to charity, thus generating a tax deduction for the contribution. By treating Roth IRAs as potential sources of charitable gifts in this way, our donors might well find themselves able to give more than they expected. Certainly, for us, having this kind of "free" access to funds in a qualified retirement plan would allow for more and larger immediate gifts than direct cash flow alone could provide.

Sara's Story: Sara, 70 years old and retired, is very generous but is usually makes her charitable gifts from her cash flow or from her investment account using appreciated securities. Unlike Jack, Sara is a conservative investor and her annual cash flow has dropped recently with the drop in interest rates. Likewise, her stock portfolio has experienced more volatility than in the past. Sara is reluctant to part

with large sums of either cash or stock as a result. Sara started a Roth IRA a number of years ago at the suggestion of her financial advisor, and contributed as much as she could every year she was working. Her Roth IRA may be a source of cash that she had not previously considered for making the gifts she wants to make. Like many of our donors, Sara's retirement fund is, by comparison with her other assets, a large sum and is usually not something she thinks about when making her gifts to charity. By withdrawing $10,000 from her Roth (tax-free) and contributing the cash to charity, Sara generates a $10,000 tax deduction, thus reducing significantly the tax on her regular income and helping her feel more secure with her normal cash flow. Or, as an alternative, and as a way of increasing her cash flow over time, she could withdraw (again tax-free) cash from her Roth, fund a Charitable Gift Annuity with her favorite charity, receive—most likely—increased, secure and partly tax-free income, a nice tax benefit now, and an opportunity to give more than she might otherwise have thought.

The unlimited conversion option for Roth IRAs will attract the attention of many of our donors. Our messages about the benefits of naming charitable organizations as beneficiaries of regular IRAs or other retirement plans will, therefore, remain valid and important as we head into 2010. But the opportunities to work with donors on potential new Roth IRAs offers yet another source of prospective gifts—so long as we approach our donors with solid information and with creative suggestions.