

## **Smart Tax Planning: Pairing a Roth IRA Conversion** **with a Donor-Advised Fund**

In 2010, individual taxpayers have the opportunity to convert traditional individual retirement accounts (IRAs) to Roth IRAs without regard to income limitations. This presents a unique opportunity for high-income taxpayers who were previously thwarted from making a Roth IRA conversion, by reason of the income limitations, to convert to a Roth IRA.

The decision to convert from a traditional IRA to a Roth IRA is a complex one that should be made only after consultation with a tax and financial planning professional and consideration of (i) your current marginal income tax rate, as compared to your expected marginal income tax rate in retirement, (ii) the source of funds to pay the resulting income tax liability, and (iii) your desire to defer distributions beyond your lifetime.

The benefits of a Roth IRA conversion can be enhanced by pairing the conversion with a charitable gift. The income recognized on the conversion of the IRA to a Roth IRA can be offset by an income tax charitable deduction to a charitable organization, such as a Donor-Advised Fund at The Community Foundation *Serving Richmond and Central Virginia*. The timing of the Roth IRA conversion and the charitable gift is critical to the success of the planning strategy. The year in which income is recognized from a Roth IRA conversion must match the year in which the offsetting charitable deduction is generated. If you plan to make charitable gifts, either through annual giving or through a bequest, you should consider pairing a Roth IRA conversion with a Donor-Advised Fund at The Community Foundation *Serving Richmond and Central Virginia*.

The following summary addresses some of the basics of IRAs, Roth IRAs, converting to a Roth IRA, and the tax considerations and benefits associated with pairing a Roth IRA conversion with a charitable gift.

### **Individual Retirement Account Basics**

Traditional IRAs are generally funded with pre-tax dollars and grow on an income tax deferred basis until distributions are made. Any individual with compensation-related income may annually contribute up to \$5,000 (\$6,000 in the case of an individual age 50 or over) to an IRA. In the case of married taxpayers with modified adjusted gross income (MAGI) in excess of \$109,000 (\$65,000 for unmarried taxpayers), the contribution is non-deductible for income tax purposes.

Often, when an individual terminates employment with a particular employer (whether through retirement or otherwise), they will “roll over” monies held in a qualified plan, such as a 401(k) plan, profit sharing plan, money purchase plan, or other plan into a “roll over” IRA account. A “roll over” IRA is eligible for a Roth conversion, discussed below. When a taxpayer

reaches age 59-1/2, he or she may make a penalty free withdrawal from the IRA. At age 70-1/2, all taxpayers must begin receiving minimum required distributions from an IRA. The minimum required distributions are generally paid over the taxpayer's life expectancy, which is determined by reference to IRS actuarial tables.

At death, if an IRA is payable to a designated beneficiary, the designated beneficiary may "stretch" the minimum required distributions over his or her life expectancy. For example, John, age 80, is obligated to receive a minimum required distribution based on his age and life expectancy. If John dies and leaves his IRA to his daughter, Mary, age 42, Mary is required to withdraw distributions from the IRA based on her (much longer) life expectancy. This allows a larger portion of the assets to remain inside the IRA and grow in a tax-deferred environment.

In sum, contributions to a traditional IRA may (or may not) be tax deductible. The assets within the IRA accumulate on an income tax-free basis until withdrawn. Assets may be withdrawn from the IRA, penalty free, at age 59-1/2 and must begin to be withdrawn at age 70-1/2. IRAs payable to a designated beneficiary may be "stretched" out and distributed over the designated beneficiary's life expectancy.

### **Roth IRAs**

By contrast, all contributions to a Roth IRA are non-deductible. The maximum amount that may be contributed to a Roth IRA, like a traditional IRA, is \$5,000 (or \$6,000 in the case of a taxpayer age 50 or over). A married taxpayer whose MAGI exceeds \$176,000 (\$120,000 in the case of single taxpayers), however, is ineligible to make any contribution to a Roth IRA. The income limitations on Roth IRAs put them out of the reach of many high income individuals.

The income tax benefits of a Roth IRA are quite remarkable. Like a traditional IRA, the inside growth and earnings of a Roth IRA are income tax free. More importantly, however, distributions from a Roth IRA are completely income tax free.

**Example.** Oscar has a traditional IRA and a Roth IRA. Oscar is in a combined 40% federal and state income tax bracket. Oscar withdraws \$10,000 from his traditional IRA and \$10,000 from his Roth IRA. Oscar is required to pay tax of \$4,000 (40% of \$10,000) attributable to the withdrawal from the traditional IRA; Oscar pays no tax on the withdrawal from the Roth IRA.

Taxpayers with Roth IRAs are subject to an early withdrawal penalty for distributions before age 59-1/2 (like traditional IRAs). Unlike traditional IRAs, taxpayers with Roth IRAs are not required to receive minimum required distributions beginning at age 70-1/2. A Roth IRA can also be "stretched" by a designated beneficiary (although the designated beneficiary would be subject to the minimum required distribution rules).

The combination of (i) the tax-free build up of Roth IRA assets, (ii) the ability to receive tax-free distributions, and (iii) the avoidance of the minimum required distribution rules at age 70-1/2 for the account owner makes a Roth IRA an exceptionally compelling retirement investment vehicle.

The following chart summarizes some of the differences between traditional IRAs and Roth IRAs:

<b>Feature</b>	<b>Traditional IRA</b>	<b>Roth IRA</b>
Deductible Contribution	Yes (if modified adjusted gross income (MAGI) is less than \$109,000 for married taxpayers and \$65,000 for single taxpayers); No, if above those amounts	No
Income Limitation on Contribution	No	Yes (if MAGI exceeds \$176,000 for married taxpayers and \$120,000 for singles, contribution amount reduced to \$0)
Amount of Contribution	\$5,000 (plus \$1,000 makeup for taxpayers 50 and over)	\$5,000 (plus \$1,000 makeup for taxpayers 50 and over)
Growth of Assets in Account Tax Free	Yes	Yes
Penalty Free Withdrawal at Age 59-1/2	Yes	Yes
Minimum Required Distributions at Age 70-1/2	Yes	No
Distributions Subject to Income Tax	Yes	No
Stretch IRA At Death	Yes, subject to minimum required distributions for designated beneficiary	Yes, subject to minimum required distributions for designated beneficiary

### **Roth IRA Conversion**

Prior to 2010, taxpayers could convert their traditional IRAs to a Roth IRA if their MAGI was less than \$100,000. In 2010, the \$100,000 MAGI limitation is removed and taxpayers, regardless of income level, can convert a traditional IRA to a Roth IRA.

If a taxpayer converts a traditional IRA to a Roth IRA, he or she will be treated as recognizing all of the income upon conversion. For a 2010 conversion, one-half of the value of the IRA will be included in the taxpayer's gross income in 2011, and one-half of the value of the

IRA will be included in the taxpayer's gross income in 2012. A taxpayer can opt-out of such treatment and elect to recognize the full amount of the IRA as taxable income in 2010.

**Example.** George has a traditional IRA valued at \$500,000. He is in a combined 40% income tax bracket for federal and state tax purposes. George elects to convert his entire IRA to a Roth IRA in 2010. George will recognize an additional \$250,000 of income in 2011 and 2012 (one-half of the value of the converted IRA recognized as income in 2011 and 2012). Assuming no change in tax rate, George will pay an additional \$100,000 of tax (40% of \$250,000) with his 2011 tax return and an additional \$100,000 of tax with his 2012 tax return.

The conversion of the traditional IRA to a Roth IRA is treated as a deemed distribution of the entire IRA and, therefore, it is subject to income tax. For taxpayers under age 59-1/2, the conversion will not trigger the 10% penalty tax for early withdrawal. If, however, the taxpayer uses funds from the converted IRA to pay the tax liability, he or she will trigger the age 59-1/2 penalty.

**Example.** Same facts as prior example, except that George is 55 years old and pays his \$200,000 additional tax liability (\$100,000 in 2011 and \$100,000 in 2012) from funds withdrawn from the IRA. This will trigger the 10% penalty for distributions prior to age 59-1/2, and George will be required to pay an additional \$20,000.

A Roth IRA conversion is not an "all or nothing" proposition. An individual may make a partial conversion of a traditional IRA to a Roth IRA. This may make good sense in a number of situations, including circumstances where an individual owns an asset in an IRA that they expect to appreciate significantly in the future.

**Example.** John has a \$400,000 traditional IRA. After consulting with his tax and financial advisors, he concludes that it would be beneficial to convert \$250,000 of his traditional IRA to a Roth IRA. John converts \$250,000 of his IRA to a Roth IRA and retains \$150,000 in a traditional IRA.

Finally, it should be noted that an "inherited" IRA, such as one owned by a designated beneficiary after the original owner's death, is ineligible for a Roth conversion.

### **The Decision to Convert**

As discussed earlier, the decision to convert from a traditional IRA to a Roth IRA is a complex one that should be made only after consultation with a tax and financial planning professional. A few rules of thumb emerge when analyzing the decision to convert to a Roth IRA:

- If your current marginal income tax rate, as compared to your expected marginal income tax rate in retirement, will be the same, a conversion tends to make more sense. If your

income tax rate in retirement will go down from your current marginal tax rate, the decision is not as clear.

- A factor that compounds this decision is the possibility that income rates may rise in future years. Many of the tax cuts that were passed during the Bush administration are set to expire in 2011, and it is not clear whether the Bush tax cuts will be extended into the future.
- If you have a strong desire to defer distributions beyond your lifetime, a Roth conversion tends to make more sense. A Roth IRA enhances this feature because the minimum required distributions rules do not apply to Roth IRAs. There are several considerations that may factor into your decision, including:
  - Your age at the time of the conversion. The younger you are, the longer you have to benefit from the inside growth and buildup of the Roth IRA without the requirement to withdraw assets to satisfy minimum required distributions.
  - Your need or desire to spend meaningfully from the IRA during retirement. If you do not plan to rely on Roth IRA for post-retirement income, a conversion makes sense since Roth IRAs are not subject to the minimum required distribution rules.
  - Your desire to transfer the IRA at death to beneficiaries who will “stretch” out the distributions during their lifetime. Because the minimum required distribution rules do not apply to a taxpayer during their lifetime, more assets can be left to designated beneficiaries who can then “stretch” the Roth IRA and receive tax-free distributions during their lifetime.
- If you have funds outside of the IRA to pay the resulting income tax liability, the benefits of a Roth IRA make more sense.
  - **Example.** Charlie converts his \$300,000 IRA to a Roth IRA. The resulting tax (at a 40% rate) of \$120,000 is paid from Charlie’s IRA. The result is that Charlie’s Roth IRA balance is reduced from \$300,000 to \$180,000. Charlie’s IRA will need to grow by 67% to get back to the original \$300,000 amount.

## Combining a Roth IRA Conversion with a Charitable Gift

The uncertainty associated with future income tax rates and the benefit of paying the income tax liability associated with a Roth IRA conversion leads some taxpayers to consider pairing a Roth IRA conversion with a charitable gift.

Contributions to a tax-exempt charitable organization will generate an income tax charitable contribution deduction to the donor in the year in which he or she makes the gift to charity. A gift of cash or long term capital gain property (property held for investment for more than one year) to a public charity, such as a church, school, museum, or Donor-Advised Fund, like The Community Foundation *Serving Richmond and Central Virginia*, will generally produce an income tax deduction equal the fair market value of the contributed cash or assets. A gift of cash to a public charity will give rise to an income tax deduction that is deductible by the donor in the year of the gift of up to 50% of the donor's adjusted gross income (AGI). A gift of appreciated long term capital gain property (such as appreciated marketable securities) will give rise to an income tax deduction that is deductible by the donor in the year of the gift of up to 30% of the donor's AGI. Any portion that is not deductible in the current year may be carried forward for up to 5 years.

**Example.** Alexander makes a \$100,000 cash gift to a public charity in 2010. His AGI in 2010 is \$150,000. Alexander may deduct \$75,000 of his contribution (50% of \$150,000 AGI) in 2010. The remaining \$25,000 of his contribution may be carried forward to 2011 and deducted in that year (or future years through 2015).

**Example.** Amanda makes a \$100,000 gift of appreciated securities to a public charity in 2010. Her AGI in 2010 is \$200,000. Amanda may deduct \$60,000 of her contribution (30% of \$200,000 AGI) in 2010. The remaining \$40,000 of her contribution may be carried forward to 2011 and deducted in that year (or future years through 2015).

An individual considering a Roth IRA conversion should consider making a charitable contribution to a Donor-Advised Fund at The Community Foundation *Serving Richmond and Central Virginia* in the year that corresponds with the year in which income from a Roth IRA conversion will be recognized.

As discussed above, the general rule is that a 2010 Roth IRA conversion will cause taxpayers to recognize one-half of the conversion related income in 2011 and one-half of the conversion related income in 2012, unless an election is made to recognize all of the income in 2010. An individual electing to recognize Roth IRA conversion income in 2010 should, therefore, make a corresponding charitable contribution deduction in 2010.

The benefit of using a Donor-Advised Fund at The Community Foundation *Serving Richmond and Central Virginia* is that a donor can make a contribution in 2010, thereby giving

rise to an immediate income tax deduction in 2010. The funds will be held in an account in the name of the fund donor and the donor can recommend grants from the fund in future years.

### **Scenarios Illustrating Tax Benefits**

Olivia is an entrepreneur. She has three teenage children and is interested in involving them in philanthropy as they get older. She is concerned about mitigating income and estate taxes. For purposes of the following discussion, assume the following facts:

- Olivia has a \$250,000 traditional IRA that she wishes to convert to a Roth IRA.
- Olivia also has a \$750,000 investment portfolio that is not held in a retirement plan or IRA (the Investment Account).
- Olivia's AGI for 2010, before the Roth IRA conversion is \$600,000 and Olivia is in a combined 40% federal and state income tax bracket.
- Olivia plans to pay the income liability attributable to her Roth IRA conversion, if any, from her Investment Account.
- Olivia plans to pay the income tax liability attributable to her Investment Account and, as later discussed, the Charitable Lead Annuity Trust from other assets, accounts, or resources.
- Olivia annually gifts \$25,000 to various charities and plans to continue that giving pattern for the foreseeable future. Olivia intends to use the assets held in her Investment Account to fund these gifts.
- All of the assets grow at a constant rate of 7% per year. This is based on an 8% gross rate of return, and a 1% fee for investment management, administrative expenses, or other fees. Obviously, this is a hypothetical assumption and there is no guarantee that the assumed rate of return will be achieved.

Olivia is considering three options. The first option is a basic conversion of her IRA to a Roth IRA, with the payment of the resulting tax liability from her Investment Account. Her second option is to convert her IRA to a Roth IRA and make a gift to a Donor-Advised Fund in the same year in which the Roth IRA conversion related income will be recognized. The third option is a Roth IRA conversion paired with the creation of a charitable lead annuity trust that makes an annual annuity payment to a Donor-Advised Fund; at the expiration of the term of the charitable lead trust, the assets pass to Olivia's children. Each of these options is discussed in detail below, and a summary comparison of the outcomes can be found on page 12.

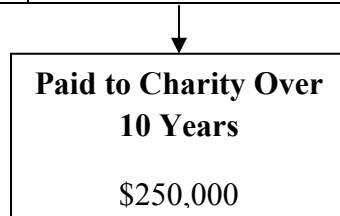
**Example 1 – Roth Conversion – Taxes Paid from Investment Account – No Charitable Gift**

In Example 1, assume that Olivia simply converts her traditional IRA to a Roth IRA and pays the resulting income tax liability (assumed to be 40% of \$250,000 or \$100,000) from her investment account. The resulting tax consequences and asset values are set forth below:

<b>Roth IRA</b>	<b>Investment Account</b>	<b>Income Tax For IRA Conversion</b>	<b>Donor-Advised Fund</b>
\$250,000	\$650,000	\$100,000	\$0

At the end of 10 years, assuming a 7% annual return (net of fees) and \$25,000 of annual gifts from the Investment Account, the results are as follows:

<b>Roth IRA Year 10 Value</b>	<b>Investment Account Year 10 Value</b>	<b>Income Tax For IRA Conversion</b>	<b>Donor-Advised Fund Year 10 Value</b>
\$491,787	\$933,237	\$100,000	\$0



**Example 2 – Roth Conversion – Charitable Contribution to Donor-Advised Fund**

In Example 2, Olivia converts her traditional IRA to a Roth IRA. Olivia elects to have the full amount of income resulting from the conversion recognized in 2010. In 2010, Olivia also creates a Donor-Advised Fund at The Community Foundation *Serving Richmond and Central Virginia* and retains the right to recommend grants to various charities from her Donor-Advised Fund. Olivia transfers \$250,000 from her Investment Account to the Donor-Advised Fund. The tax consequences associated with the Roth conversion and the charitable gift are set forth below:

Income from Other Sources	\$600,000
Roth Conversion Related Income	+ <u>\$250,000</u>
Total Adjusted Gross Income	\$850,000
Charitable Contribution	- <u>\$250,000</u>
Taxable Income	\$600,000

Olivia's AGI is \$850,000 and assuming her Investment Account is comprised of long term appreciated securities, her \$250,000 contribution is subject to the 30% AGI limitation (30% of \$850,000 is \$255,000). As a result, the full amount of her \$250,000 contribution is tax deductible in 2010. In future years, Olivia will direct that \$25,000 of annual charitable gifts be made from her Donor-Advised Fund.

As a result of this planning, Olivia eliminates any additional income tax liability associated with the Roth IRA conversion and she funds her charitable gifts for the next decade, in advance, through the creation of a Donor-Advised Fund that results in an immediate income tax deduction.

<b>Roth IRA</b>	<b>Investment Account</b>	<b>Income Tax For IRA Conversion</b>	<b>Donor-Advised Fund</b>
\$250,000	\$500,000	\$0	\$250,000

At the end of 10 years, assuming a 7% annual return (net of fees) and \$25,000 of annual gifts from the Donor-Advised Fund to charities designated by Olivia as the donor advisor, the results are as follows:

<b>Roth IRA Year 10 Value</b>	<b>Investment Account Year 10 Value</b>	<b>Income Tax For IRA Conversion</b>	<b>Donor-Advised Fund Year 10 Value</b>
\$491,787	\$983,575	\$0	\$146,376

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<b>Paid to Charity Over 10 Years</b>
\$250,000

### Example 3 - Roth Conversion and Charitable Lead Annuity Trust

Individuals who are interested in (i) making a Roth IRA conversion, (ii) making a charitable gift, and (iii) furthering estate planning goals should consider pairing a Roth IRA conversion with a charitable lead annuity trust or “CLAT.”

A charitable lead annuity trust is a trust that provides for the payment of a fixed annuity to a specified charity, such as a Donor-Advised Fund, for a stated term. At the expiration of the term, the assets remaining in the trust are distributed to the donor’s children. If the CLAT is structured as a “grantor trust” for income tax purposes, the donor will be entitled to claim an immediate income tax charitable deduction equal to the present value of the future annuity payments passing to charity. The value of the remainder interest will be treated as a taxable gift to the donor’s children.<sup>1</sup>

**Example.** In April 2010, Olivia creates a grantor charitable lead annuity trust that is funded with \$500,000 with a 5.872% annual payment (\$29,355 per year) to a Donor-Advised Fund for a term of 25 years. At the expiration of the term, the remaining assets are distributed to Olivia’s children. The present value of the \$29,355 annual annuity payment to charity is determined, actuarially, to be \$499,956. Therefore, Olivia receives a \$499,956 income tax deduction in 2010. Olivia is also treated as making a \$44 taxable gift to her children that will consume a tiny portion of her \$1 million lifetime gift tax exemption.

The following is a summary of the results if Olivia converts her Roth IRA and, in the same year in which the income is recognized, contributes \$500,000 to a grantor charitable lead annuity trust.

Income from Other Sources	\$600,000	
Roth Conversion Related Income	+ <u>\$250,000</u>	
Total Adjusted Gross Income	\$850,000	
Charitable Contribution	- <u>\$255,000</u>	(\$244,956 carry forward)
Taxable Income	\$595,000	

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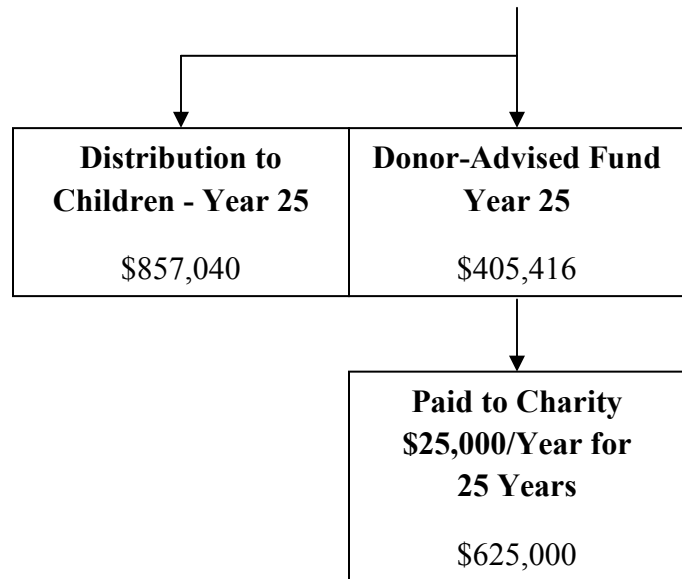
<sup>1</sup> For estate tax reasons, it is not recommended that the taxpayer creating a CLAT serve as an advisor to the Donor-Advised Fund that is the charitable recipient of the CLAT; however, family members of the taxpayer may serve as donor advisors. For income tax purposes, the donor is treated as the owner of the CLAT during his or her lifetime and must include all of the CLAT’s income and gain in his or her income. In addition, if the donor dies during the term of the CLAT, there will be income tax recapture for a portion of the prior deduction.

Olivia's AGI is \$850,000 and assuming her Investment Account is comprised of long term appreciated securities, her \$499,956 contribution is subject to the 30% AGI limitation (30% of \$850,000 is \$255,000). As a result, \$255,000 of her charitable contribution is currently deductible and \$244,956 is carried forward for the next 5 years. Assuming Olivia is in the 40% income tax bracket, the \$244,956 income tax deduction that is carried forward has a tax benefit of \$97,982.

<b>Roth IRA</b>	<b>Investment Account</b>	<b>Income Tax For IRA Conversion</b>	<b>Charitable Lead Annuity Trust</b>
\$250,000	\$250,000	\$0	\$500,000

At the end of 25 years, assuming a 7% annual return (net of fees) and \$29,355 of annual gifts from the CLAT to a Donor-Advised Fund advised by Olivia's family members (with \$25,000 of this amount distributed annually from the Donor-Advised Fund to various charities and the remaining amount, \$4,255 reinvested in the Donor-Advised Fund), and with Olivia paying the income tax associated with the CLAT from other sources, the results are as follows:

<b>Roth IRA Year 25 Value</b>	<b>Investment Account Year 25 Value</b>	<b>Income Tax For IRA Conversion</b>	<b>Charitable Lead Annuity Trust</b>
\$1,356,858	\$1,356,858	\$0	\$29,355/Year For 25 Years



The tax benefits of a CLAT in this context are remarkable. In this example, Olivia eliminated any income tax liability associated with the Roth IRA conversion, funded \$625,000 of charitable gifts over a 25 year period, and transferred \$857,040 to her children with a nominal gift tax cost. In addition, the Donor-Advised Fund holds \$405,416 of assets that can be distributed to charities designated by Olivia's family in future years.

## Summary of Results

As shown in the table below, the value of the Investment Account in the second example exceeds the value of the Investment Account in the first example by \$50,338. In addition, the Donor-Advised Fund is larger by \$146,376 in the second example. This results in a \$196,714 improvement in the overall results, as compared to the first example. By avoiding the application of \$100,000 in income tax upon the Roth IRA conversion, those dollars (and the growth on those dollars) can be used for charitable giving in future years.

The third example illustrates the benefit of combining the Roth IRA conversion with the estate planning advantages associated with a charitable lead trust. In this case, Olivia's family transfers \$625,000 to charity over 25 years, retains another \$405,416 in the Donor-Advised Fund to be distributed to charity in future years, and transfers an additional \$857,040 to her children gift-tax free.

<b>Asset</b>	<b>Example 1 – Roth Conversion Only</b>	<b>Example 2 – Roth Conversion and Donor- Advised Fund</b>	<b>Example 3 – Roth Conversion and Charitable Lead Annuity Trust</b>	<b>Example 3 – Roth Conversion and Charitable Lead Annuity Trust</b>
	<b>Year 10 Result</b>	<b>Year 10 Result</b>	<b>Year 10 Result</b>	<b>Year 25 Result</b>
<b>Roth IRA</b>	\$491,787	\$491,787	\$491,787	\$1,356,858
<b>Investment Account*</b>	\$933,237	<b>\$983,575</b>	\$491,787	\$1,356,858
<b>Taxes</b>	\$100,000	\$0	\$0	\$0
<b>Donor-Advised Fund**</b>	\$0	<b>\$146,376</b>	\$88,561	<b>\$405,416</b>
<b>Charity</b>	\$250,000	\$250,000	\$250,000	<b>\$625,000</b>
<b>Children</b>	\$0	\$0	\$0	<b>\$857,040</b>

\* The difference in the value of the Investment Account, as compared between Examples 1 and 2, is due to the fact that the \$25,000 annual withdrawal of funds from the Investment Account in Example 1 slightly erodes the opportunity for annual growth.

\*\*The Donor Advised Fund is not legally considered a personal asset of Olivia.

## Conclusion

The opportunity to convert from a traditional IRA to a Roth IRA has exceptional benefits including, most notably, the ability to make tax-free withdrawals and the opportunity to avoid the application of the minimum required distributions rules. Nevertheless, this opportunity comes with a significant income tax cost – the obligation to recognize the full amount of the IRA conversion in income. Congress provides relief to taxpayers by allowing them to spread out the payment of the income tax liability into two future years, but it does not eliminate the liability.

Charitably inclined individuals have a unique opportunity to mitigate the payment of the income tax liability resulting from a Roth IRA conversion by pairing such a conversion, in the same year as the recognition of income, with a corresponding charitable gift to a Donor-Advised Fund. A Donor-Advised Fund at The Community Foundation *Serving Richmond and Central Virginia* allows a donor to obtain an immediate income tax deduction to offset the gain recognized upon conversion, while giving the taxpayer the ability to fund gifts to charities in future years.

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