Qualified Charitable Distributions

Direct gifts from IRAs can provide additional tax benefits

TAX RULES

In order to be considered a Qualified Charitable Distribution, the following conditions must be met:

1) The IRA account holder must be age 70½ or older as of the date of the distribution.
2) Eligible recipients are public charities, excluding donor advised funds and supporting organizations.
3) The exclusion from income only applies if the distribution otherwise would have been treated as taxable income.
4) The full payment to the charity would have been allowable for a charitable contribution.
5) The distribution must be a direct transfer from the IRA trustee to the charity. The IRA owner cannot use the QCD as a way to reimburse themselves for gifts they previously made on their own.

TAX BENEFITS OF A QUALIFIED CHARITABLE DISTRIBUTION

Prior to the QCD rules, a taxpayer could take a distribution from their IRA (which would be included in their Adjusted Gross Income, or AGI), donate the same dollar amount to a charity, and offset the IRA income by claiming an itemized deduction for the donation. In most cases, the two amounts would offset each other and there would be no net impact on the taxpayer's taxable income. For an IRA distribution treated as a QCD, however, the taxpayer neither reports the income as part of their AGI nor claims a charitable deduction. This treatment may seem to provide the same tax benefit as just donating the cash from the RMD, but it does offer some unique benefits.

1) Excluding the IRA distribution from income lowers the taxpayer's AGI, which provides several indirect tax benefits: ○ Married couples with AGI over $320,000 (singles over $266,700) in 2018 are subject to the itemized deduction phase out and begin to lose their deductions as their AGI increases. The QCD technique will help keep the IRA distribution from being included in AGI and thereby reduce the impact of this phase-out.

2) The 3.8% Medicare tax on investment income can also be avoided by using QCD. This tax is assessed on couples with Modified AGI

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over $250,000 (singles over $200,000), and the QCD technique can help keep a taxpayer below this threshold.

3) The amount of Social Security benefits that are taxable is driven by the recipient's Modified AGI. A lower AGI could keep a larger amount of a retiree's Social Security benefits tax-free.
4) Some deductible expenses are subject to AGI thresholds, meaning they're only deductible if they exceed a certain percentage of AGI. Keeping AGI lower via the QCD technique can make it easier to claim more of these deductions, e.g., medical expenses, which are deductible to the extent they exceed 7.5% of AGI.

In order to receive a tax benefit for a charitable contribution, a taxpayer must itemize their deductions instead of claiming the standard deduction. If the taxpayer doesn't have enough other expenses to justify itemizing, the tax benefit of the charitable contribution would be lost. By following the QCD rules, the tax benefit of the charitable gift is realized, regardless of whether or not the taxpayer itemizes their deductions. This benefit usually applies only to those making smaller charitable gifts. The tax deduction for charitable gifts is limited to a percentage of the taxpayer's AGI. The QCD rules allow taxpayers to realize the tax benefit of the gift without being subject to this limitation.

For taxpayers whose IRA contains both pre-tax and after-tax money, the QCD provides a unique opportunity. When a normal distribution is taken from an IRA, it is considered a pro rata distribution from the pre-tax and after-tax portions of the account. A QCD, however, is treated as only coming from the pre-tax portion of the IRA. As a result, a QCD can be an efficient way to use the pre-tax money while leaving the after-tax money in the IRA.

Example: A taxpayer has an IRA worth $50,000, of which $10,000 comes from after-tax contributions. If this taxpayer makes a QCD of $40,000 to a charity, it would all come from the pre-tax portion of the account. The remaining $10,000 would all be tax-free when withdrawn from the IRA, either as part of a regular withdrawal or a Roth conversion.

GIFTS OF APPRECIATED STOCK ARE OFTEN A BETTER ALTERNATIVE

While there are certainly cases where a QCD transaction provides a real tax benefit to the IRA owner, in most cases keeping the RMD and giving appreciated securities to charity will be a better tax strategy.
For example, assume a taxpayer is subject to a $30,000 RMD from their IRA, and is considering giving that directly to charity as a QCD. They also own stock worth $30,000 that could be donated to charity in lieu of the QCD technique. The first column in the table below shows the tax impact of keeping the RMD and donating the stock to charity. The next four columns show the tax impact of giving the RMD to charity but then selling the stock, assuming different cost basis amounts and therefore different capital gains upon the sale.