Qualified Charitable Distributions

Direct gifts from IRAs can provide additional tax benefits

The Qualified Charitable Distribution (QCD) rules allow taxpayers to make IRA distributions payable directly to a qualified charity without treating the distribution as taxable income. This law permits up to $100,000 per taxpayer to be contributed directly from an IRA to charity. In addition, the distribution will count towards the IRA owner's Required Minimum Distribution (RMD) for the year.

The QCD rules were initially intended to expire after 2007, but have since been reenacted periodically over the years. The Protecting Americans from Tax Hikes (PATH) Act of 2015 made these rules a permanent part of the tax code.

Tax Rules

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

- The IRA account holder must be age 70½ or older as of the date of the distribution.
- Eligible recipients are public charities, excluding donor advised funds and supporting organizations.
- The exclusion from income only applies if the distribution otherwise would have been treated as taxable income (which leads to a planning opportunity – see below).
- The full payment to the charity would have been allowable for a charitable contribution.
- 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.

- Excluding the IRA distribution from income lowers the taxpayer's AGI, which provides several indirect tax benefits:
  - Married couples with AGI over $309,900 (singles over $258,250) in 2015 are subject to the itemized deduction phaseout 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 phaseout.

  - The 3.8% Medicare tax on investment income can also be avoided by using QCD. This tax is assessed on couples with Modified AGI over $250,000 (singles over $200,000), and the QCD technique can help keep a taxpayer below this threshold.
  - 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.
  - 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. This includes the following expenses:
    - Miscellaneous Itemized Deductions, which are only deductible if, in total, they exceed 2% of the taxpayer's AGI.
    - Medical Expenses, which for retirees are only deductible to the extent they exceed 10% of AGI (through 2016, the threshold is 7.5% of AGI for those age 65 or older).
- 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.

	Donate Stock from Taxable Account	Donate $30,000 RMD to Charity (QCD), Sell Stock from Taxable Account			
Cost Basis of Stock	n/a	$20,000	$15,000	$10,000	$5,000
Gain on Stock	n/a	**$10,000**	**$15,000**	**$20,000**	**$25,000**
Impact on Taxable Income					
IRA Distribution	$30,000	$0	$0	$0	$0
Capital Gain	0	10,000	15,000	20,000	25,000
Charitable Deduction	(30,000)	0	0	0	0
Phaseout of Itemized Deductions[1]	900	300	450	600	750
Net Increase to Taxable Income	$900	$10,300	$15,450	$20,600	$25,750
Combined federal, state ordinary tax	$384	$128	$192	$256	$320
3.8% Medicare tax on investment income	-	380	570	760	950
Capital gain tax	-	2,302	3,453	4,604	5,755
Total tax cost[2]	$384	$2,810	$4,215	$5,620	$7,025
Tax Advantage of Donating Stock Rather Than RMD	**n/a**	**$2,426**	**$3,831**	**$5,236**	**$6,641**

As this table shows, the greater the gain on the stock held by the taxpayer, the greater the tax benefit of donating that appreciated stock rather than donating the RMD and then selling the stock. The time value of money rules show that this tax benefit would be lessened the longer the gain on the stock is deferred into the future. If the taxpayer plans to hold the stock until death (thereby receiving a basis adjustment and eliminating the gain), then the QCD technique is slightly more attractive. Also, those required to take smaller RMDs from their IRA or in a lower ordinary tax bracket will see less of a difference between these two techniques.

In other words, unless one of scenarios described earlier applies, donating stock is usually a better tax strategy than using the QCD technique.

Tax Reporting

Taxpayers doing a QCD transaction should be aware that the custodian of the IRA will still report the distribution from the IRA as a regular withdrawal. The IRA owner will receive Form 1099-R reporting the entire distribution from the IRA, including the QCD, which should then be reported on line 15a of their Form 1040. On line 15b, the IRA owner will then enter the difference between the entire distribution amount and the QCD amount. The IRA owner should then write "QCD" next to line 15b identifying that the difference between the line 15a and 15b amounts is tax-free under this exception.

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[1] This assumes this couple is subject to the phaseout of itemized deductions, which is equal to 3% of income over $309,900.

[2] Assumes a 39.6% federal ordinary tax rate, 20% federal capital gain tax rate and 5% state tax rate. The combined tax rate is adjusted for the benefit of deducting the state tax.

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