BAIRD
Private Wealth Management

Qualified Charitable Distributions

Direct gifts from IRAs can provide additional tax benefits

Charitable gifts made directly from an IRA can provide added tax benefits for many taxpayers, but they aren't right for everyone.

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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 eligible IRA owner to be contributed directly from their IRA to charity. In addition, the distribution can be used to fulfill the IRA owner's Required Minimum Distribution (RMD) for the year. As part of the SECURE Act 2.0, this $100,000 limitation will be adjusted for inflation beginning in 2024.

The initial QCD rules were intended to expire after 2007, but they were 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. A QCD can also be made from a beneficiary IRA, as long as the beneficiary is over age 70½ at the time of the gift. The age of the original IRA owner is irrelevant.
- The recipient of the QCD must be a public charity. Gifts to private foundations, donor advised funds and supporting organizations generally do not qualify for QCD treatment. Beginning in 2023, SECURE Act 2.0 allows IRA owners to utilize a QCD to fund a Charitable Remainder Trust (CRT) or Charitable Gift Annuity (CGA), subject to a $50,000 lifetime limit.
- Direct transfers to charity can only come from a traditional or Roth IRA. A QCD is not allowed from an employer plan, nor is it allowed from an ongoing SEP or Simple IRA.
- The full payment to the charity must otherwise be an allowable 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.
- 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 amount distributed to the charity is not limited to the RMD amount for the year, nor does the distribution have to be the RMD. IRA owners can withdraw – and keep – their RMD and still make additional distributions to charity from the account.

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. These 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:
    - 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.
    - Medicare premiums are adjusted upwards for those with income over certain thresholds. The QCD can help avoid this increase.
    - Some deductible expenses are subject to AGI thresholds, meaning they're only deductible if they exceed a certain percentage of AGI. For example, keeping AGI lower via the QCD technique can make it easier to deduct medical expenses, which are only deductible to the extent they exceed 7.5% of AGI.
    - 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.
- 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 (by not having to report the RMD as income), regardless of whether or not the taxpayer itemizes their deductions.
    - This is especially true as a result of the tax law changes taking effect in 2018. The combination of a larger standard deduction with the new caps on, or even elimination of, many itemized deductions means fewer taxpayers will be itemizing going forward. The QCD can be a way to still receive a tax benefit from the charitable gift.
- 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 coming from the pre-tax portion of the IRA first. 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 MAY STILL BE A BETTER ALTERNATIVE

While there are certainly cases where a QCD transaction provides a real tax benefit to the IRA owner, there are also cases where keeping the RMD and giving appreciated securities to charity will be a better tax strategy. For example, assume a taxpayer is considering two options:

- Gifting $30,000 from their IRA to charity, via the QCD, and then selling $30,000 of stock to fund their spending needs.
- Withdrawing $30,000 from their IRA to fund their spending needs, but then donating $30,000 of stock to charity and taking a tax deduction for the gift.

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 Donation of Stock	(30,000)	0	0	0	0
Net Increase to Taxable Income	$0	$10,000	$15,000	$20,000	$25,000
Federal Ordinary Income Tax – 37%	$0	$0	$0	$0	$0
Net Investment Income Tax – 3.8%	0	380	570	760	950
Federal Capital Gain Tax – 20%	0	2,000	3,000	4,000	5,000
Total Tax Cost	$0	$2,380	$3,570	$4,760	$5,950

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. In other words, taxpayers who use their RMD to cover their living expenses but also want to make charitable gifts may be better served by keeping their RMD and donating appreciated stock they own.

On the other hand, if the taxpayer plans to hold the stock until death (thereby receiving a basis adjustment and eliminating the gain) or otherwise has no need for their RMD, then the QCD technique becomes 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.

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 4a of their Form 1040. On line 4b, 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 4b identifying that the difference between the line 4a and 4b amounts is tax-free under this exception.