Rules Are Tricky for Tax-Saving Via Qualified Charitable Distributions

Retirement Accounts and Charity

by Alexandra Armstrong, CFP, CRPC, and Christopher Rivers, CFP, CRPC

The holidays are a time when our thoughts often turn to others in need and to those causes and organizations with missions that are near and dear to our hearts. In our planning practice, we typically see an increase in charitable gifts near year-end.

Although these gifts aren't made solely with taxes in mind, it's important to understand the tax ramifications of a charitable gift, particularly in light of the recent changes to the tax code. With some careful planning, you can reduce your taxes while contributing to your favorite charities.

Charitable Deductions

The most common type of charitable gift is cash from a savings or brokerage account. In years past, this gift was tax-deductible, as long as you itemized deductions on your federal tax return. The Tax Cuts and Jobs Act of 2017, however, limited the ability for many taxpayers to deduct cash contributions. This tax bill increased the standard deduction in 2019 to $12,200 for singles and $18,350 for heads of households. The standard deduction for married couples is $24,400, and it jumps to $27,000 if both are over age 65. In addition, this act limited deductions on state and local taxes and eliminated entirely the items that fell under "miscellaneous itemized deductions."

As a result, it's more difficult for many taxpayers to accumulate deductions in excess of the standard deduction. This means that if you take the standard deduction, you don't get any additional tax benefit for contributing to charity. One way to ensure you can take a deduction for your charitable gift is to use a donor-advised fund, as detailed in our October 2018 column. But not everyone has the means to make a large transfer of assets to a donor-advised fund. For those over age 70½ there's another option — a qualified charitable distribution from an individual retirement account.

What's a QCD?

In a qualified charitable distribution, you transfer all or a portion of the required minimum distribution from your IRA account directly to a charity. Under current law this is limited to a maximum of $100,000. As a reminder, once you reach age 70½, you're required to take a distribution from your IRA account each year, based on an Internal Revenue Service formula. This distribution is typically taxable as ordinary income.

The QCD allows you to meet your required minimum distribution but doesn't recognize this income as taxable by sending the money directly to charity. The result is that you're able to make a charitable contribution and get a tax benefit for making the contribution, even if you don't itemize deductions. When making a QCD, the money sent from the IRA account is excluded from income entirely.

For this reason, it's a powerful tax-saving tool for those taking the standard deduction. There are some limits though on how this can be implemented.

What Are the Rules?

A number of conditions must be met to contribute directly from an IRA to a charity without recognizing the taxable income:

- **Only individuals can make QCDs**.
- **The IRA owner must actually be at least 70 years and 6 months old** on the date of the QCD. So this cannot happen just in the year you turn 70½; you must already be 70½ before making the donation.
- **The charitable recipient must be an organization** that qualifies for a charitable income tax deduction from an individual, other than a private (grant-making) foundation, a donor-advised fund or a supporting organization. One source to verify that a charity is qualified is the following IRS website:
  www.irs.gov/charities-non-profits/exempt-organizations-select-check
- **Individuals are limited to up to $100,000** of qualified charitable distributions in a single tax year. The limit is per person (as long as they both have IRAs) so a husband and wife can each contribute $100,000, for a total of $200,000 as a couple, but each individual must meet the requirements.
- **The charity that receives the donation** must provide a written contribution acknowledgment.
- **QCDs may be made from any IRA or individual retirement annuity** but not from a simplified employee pension, a 401(k) plan, a SIMPLE IRA (Savings Incentive Match Plan for Employees) or an inherited IRA.
- **If your IRA includes nondeductible contributions, QCDs are assumed to come from the pretax portion** of the account and specifically not from the after-tax portion. This isn't like other IRA distributions that are done pro rata.
- **The check has to be made out to the charity by your IRA custodian**. The check can be mailed directly to the charity or it can be mailed to you so that you can present it to the organization, but it's crucial that the check itself is issued by the IRA custodian and made out to that specific charity.

Can I Give More Than My Required Minimum Distribution to a Charity?

Yes. For example, if your RMD is $25,000 and you want to give $30,000 to the charity. You can do this from your IRA as long as the total amount you give is $100,000 or less.

Importance of Recordkeeping and Communication

From the IRS website: “How are qualified charitable distributions reported on Form 1099-R? Charitable distributions are reported on Form 1099-R for the calendar year the distribution is made.”

Although the distribution amount is reported on Form 1099R, we have found that there’s nothing on the 1099R indicating that the distribution is actually QCD. As a result sometimes accountants aren’t aware that a distribution is a QCD.

In fact, looking at the instructions for Form 1099R on the IRS website shows there’s no code for a QCD for box 7. As a result, your tax preparer may have no idea that you made a QCD from your IRA unless you notify the tax preparer. In addition, the QCD must be manually noted on your return. If you don’t discuss this with your tax preparer, there’s a good chance of the distribution being classified as taxable income!

What if I Do Itemize Deductions?

Although QCDs are more effective than simply donating by cash, in most cases they’re still not as effective as donating appreciated securities, if you do itemize deductions. In this scenario, you’re getting a tax deduction for the charitable gift and by donating appreciated shares, you’re using those shares without incurring a gain and thus avoiding tax on the gains. The tax benefit of donating securities therefore is twfold, the deduction against income and avoiding the gain.

Conclusion

Note that for smaller amounts (less than $500), the tax savings from a QCD will be minimal. If you’re planning to make a larger charitable contribution, please talk to your accountant about the most tax-efficient way to make the gift.

Making a QCD may be a very useful tax tool, however, as referenced above the rules must be carefully followed. To decide whether this is the best philanthropic tool for you, it is important to compare your gift to your income tax profile.

If you don’t have appreciated securities, or don’t itemize deductions, a QCD still provides a tool for you to contribute to organizations whose mission you support and to get a tax benefit for doing so. Whichever approach you use, make sure you do it sooner rather than later. Brokerage firms get very busy at year-end, so you want to make sure you allow ample time for the transaction to take place. As always, if you have any questions about the best way to do this, consult your financial planner or accountant.

Alexandra Armstrong is a CERTIFIED FINANCIAL PLANNER professional and Chartered Retirement Planning Counselor and chairman and founder of Armstrong, Fleming & Moore, Inc., a registered investment advisory firm located at 1800 M St. N.W., Suite 1010-S, Washington, D.C. 20036-5813, 202/887-8135.

Christopher Rivers, a CERTIFIED FINANCIAL PLANNER professional and Chartered Retirement Planning Counselor and co-author of this article is a principal of Armstrong, Fleming & Moore, Inc. Securities are offered through Commonwealth Financial Network, member FINRA/SIPC.

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