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Qualified Charitable Distribution Planning

Wealth Strategy Insights

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QCD: Income Tax Reduction by Charitable Giving

OVERVIEW

With the passage of the SECURE Act in 2019 and the SECURE 2.0 Act in 2022, and the IRS's conflicting guidance along the way, many taxpayers have had their fill of the Required Minimum Distribution ("RMD") rules for IRAs. There is, however, a taxpayer-friendly IRA rule that more taxpayers should be paying attention to and potentially taking advantage of.

Initially introduced in 2006 on a temporary basis and made permanent in 2015, a qualified charitable distribution ("QCD") is an otherwise taxable distribution from an IRA that is excluded from gross income as long as the distribution is paid directly by the IRA trustee to eligible charitable organizations.

QCD REQUIREMENTS

In order to have the IRA distribution qualify as a QCD and have the otherwise taxable distribution be excluded from tax, several requirements must be met.

Type of IRA. QCDs can only be made from traditional or Roth IRAs. As a result, QCDs cannot be made from on-going employer-sponsored retirement plans, including SIMPLE IRAs and SEP IRAs to which a contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contribution would be made.

QCDs can, however, be made from inherited IRAs, as long as the other QCD requirements are met.

Age Requirement. Despite the SECURE Act and the SECURE 2.0 ACT changing the RMD age from age 70 ½ to age 72 or later[1], a distribution made on or after the date the IRA owner attains age 70 ½ can still qualify as a QCD. It is important to note that the determination date is not the year in which the IRA owner/beneficiary turns age 70 ½, but the specific date on which the individual attains age 70 ½.

This age 70 ½ threshold also applies to inherited IRA beneficiaries wishing to do a QCD.

Directly to Eligible Charitable Organizations. To qualify as a QCD and the associated tax exclusion, the distribution must be made directly to the charitable organization from the IRA custodian.

[1] The SECURE Act increased the RMD age to age 72. The SECURE 2.0 Act increased the RMD age in two phases. RMDs will begin at age 73 for those taxpayers who were born in the years between 1951 and 1959. RMDs will begin at age 75 for those taxpayers who were born in year 1960 or thereafter.

Directly to Eligible Charitable Organizations (Continued). An IRA owner/beneficiary who instead receives the distribution and then immediately contributes the funds to the charitable organization will not be able to exclude the distribution amount from his/her gross income[2].

Eligible Charitable Organizations and Contributions Otherwise Entirely Deductible. Not all types of charitable recipients will qualify the distribution as a QCD. Generally, only direct distributions to 501(c)(3) public charities will qualify the distribution as a QCD[3]. Despite being maintained and operated by a public charity, distributions to donor advised funds ("DAFs") do not qualify as QCDs[4]. Similarly, distributions to private foundations will also not qualify as QCDs[5].

In addition to the distribution having to be made to an eligible charitable organization, any distribution must be otherwise entirely deductible as if it were made directly by the IRA owner/beneficiary[6]. If the deductible amount is reduced because of a benefit received by the donor in exchange, or if a deduction is not allowable because donor did not obtain sufficient substantiation, the QCD tax exclusion will not be available with respect to any part of the IRA distribution.

No Double Dipping and Contribution Substantiation. A donor executing a QCD who itemizes deductions may not also take a charitable contribution deduction for the amount of the distribution already treated as a QCD. Further, the donor must still meet all charitable contribution deduction substantiation requirements, such as obtaining written acknowledgement of their contribution from the charitable organization.

MAXIMUM ANNUAL QCD EXCLUSION AMOUNT

Donors taking advantage of the QCD exclusion are limited in the amount they can exclude from gross income each year.

For tax year 2023, the maximum amount that can be excluded from the taxpayer's gross income is $100,000. This amount will be adjusted for inflation for the first time in 2024 and is expected to be increased to $105,000. It is important to note that this is a per taxpayer annual limit, and married taxpayers each have their own respective $100,000 annual exclusion amount.

As referenced in footnote three (3), beginning in 2023, qualifying IRA owners and beneficiaries can also elect to make one (1) lifetime QCD to a charitable remainder trust ("CRT") or a charitable gift annuity ("CGA"). The lifetime QCD to such an entity cannot exceed $50,000. This amount will also be adjusted for inflation beginning in 2024 and is expected to be increased to $53,000. Importantly, donors electing to take advantage of their one (1) lifetime QCD to these entities must reduce their "normal" QCDs in the same year by the amount of the "special" QCD to the CRT or CGA.

[2] Assumes a traditional IRA distribution. The taxpayer may still be eligible to receive a charitable contribution deduction for his/her contribution to the charitable organization.

[3] Beginning in tax year 2023, individuals can also make one (1) lifetime QCD to a Charitable Remainder Unitrust ("CRUT"), a Charitable Remainder Annuity Trust ("CRAT"), or a Charitable gift annuity ("CGA"). The lifetime QCD to such an entity cannot exceed $50,000 (indexed for inflation, beginning in 2024).

[4] The taxpayer may still be eligible to receive a charitable contribution deduction for his/her contribution to the DAF.

[5] The taxpayer may still be eligible to receive a charitable contribution deduction for his/her contribution to the private foundation.

[6] Determined without regard to any adjusted gross income percentage limitations.

STRATEGIC PLANNING WITH QCDS

RMD Satisfaction. IRA owners and beneficiaries that have annual RMD requirements can satisfy a portion or all (up to the $100,000 for tax year 2023 and expected to be $105,000 for tax year 2024) of that RMD requirement by executing a QCD. This allows the IRA owner/beneficiary to not only exclude the RMD from his or her gross income, but also benefit charity at the same time. As mentioned above, the taxpayer does not additionally receive a charitable contribution deduction for the amount distributed to charity.

Adjusted Gross Income ("AGI") and Taxable Income Minimization. The amount of a taxpayer's AGI, subject to modification in certain circumstances, can have an impact on multiple facets of a taxpayer's overall financial picture and tax obligations. AGI is the determining factor for certain items including, but not limited to:

- The taxation of Social Security benefits
- Medicare Part B Premium amounts
- The ability to deduct traditional IRA contributions
- The ability to make Roth IRA contributions
- The applicability of the 3.8% surtax on net investment income
- The deductibility of medical and dental expenses
- The deductibility of charitable contributions for individuals
- The deductibility of miscellaneous itemized deductions[7]
- The deductibility of student loan interest
- Child and dependent care credits
- Earned income tax credits
- Electric vehicle tax credit

While ultimately dependent on each taxpayer's individual circumstances, the above items generally result in better tax outcomes for taxpayers with lower AGIs.

Similarly, and maybe more impactful, the taxable income of a taxpayer, which is generally calculated by subtracting the taxpayer's standard deduction or itemized deductions from AGI, is what determines what tax bracket an individual is in and how much tax an individual ultimately pays.

As a result, a QCD may help a taxpayer remain in a lower tax bracket, avoid phase-outs and special rules based on the AGI or taxable income of the taxpayer, and ultimately see an overall financial benefit compared to similar taxpayers who choose not to utilize a QCD.

AGI limitations on Charitable Contributions. As mentioned above, the deductibility of charitable contributions can be dependent on an individual taxpayer's AGI. More specifically, taxpayers itemizing their deductions can only deduct charitable contributions up to a certain percentage of their AGI. The percentage will depend on the type of asset donated (cash vs. appreciated property) and the charitable status of the recipient (public charity vs. private grantmaking foundation).

Charitably inclined taxpayers who have maxed out or will max out their available charitable contribution deduction due to AGI limitations, can utilize a QCD to accomplish additional tax-advantaged charitable giving up to $100,000 (adjusted for inflation beginning in 2024) with the entire QCD amount excluded from their AGI and taxable income.

Benefitting From Charitable Giving Without Itemizing Deductions. But for tax years 2020 and 2021 when taxpayers were able to deduct up to $600 of charitable contributions without itemizing their deductions, taxpayers do not receive a benefit from their charitable contributions unless they itemize their deductions. Further, since the passage of the Tax Cut and Jobs Act of 2017 increased the standard deduction ($27,700 for married couples filing jointly in 2023) and added a $10,000 cap on the state and local tax deduction, significantly fewer individuals have been itemizing their deductions. As a result, these individuals receive no tax benefit from their charitable contributions.

[7] Miscellaneous itemized deductions are currently not deductible under the Tax Cut and Jobs Act of 2017. They are currently legislated to return for tax year 2026.

Benefitting From Charitable Giving Without Itemizing Deductions (Continued). Taxpayers who utilize a QCD, on other hand, regardless of whether they itemize their deductions or take the standard deduction, will still receive a tax benefit from their charitable contributions by having the otherwise taxable distribution excluded from their AGI and taxable income.

Lower future RMDs (70 ½ vs. 72/73/75). The manner in which the QCD rules are drafted by the IRS provides a tax planning opportunity for taxpayers. As mentioned above, the QCD rules allow individuals aged 70 ½ or older to make QCDs, which is up to fifty-four (54)[8] months before they are required to start taking RMDs.

While making a QCD in the years before RMDs kick in will not reduce a donor's taxable income in the year of contribution, making a QCD during this window does allow individuals to potentially lower the value of their IRAs prior to being subject to RMDs, which could reduce the amount of their otherwise taxable RMDs in the future.

State Income Tax Savings. Not all states follow the federal rules for itemizing deductions, nor do all states provide any state tax benefit for charitable contributions. As a result, a taxpayer might not receive a state income tax benefit for charitable contributions claimed as an itemized deduction but could benefit at the state level from excluding the RMD from income all together through a QCD.

QCD REPORTING ON FORM 1040

A QCD must be reported on the federal income tax return for the year during which the QCD was made. The IRA owner/beneficiary will receive Form 1099-R which will show any IRA distributions made during the year, including both regular distributions and QCDs.

It is important to note that the Form 1099-R will not explicitly indicate there was a QCD, and it is up to the taxpayer to identify what part of the distribution is excluded from income. This Form 1099-R reporting, or lack thereof, can result in taxpayers inadvertently including the QCD in income if they are not careful.

Like other IRA distributions, QCDs must be reported on line 4 of Form 1040 (2022 Form 1040). If part or all of an IRA distribution is a QCD, enter the total amount (including the QCD amount) of the IRA distribution on Line 4a.

Then, if the full amount of the distribution is a QCD, enter zero (0) on Line 4b. If only part of the distribution is a QCD, the remaining taxable portion is reported on Line 4b. Either way, "QCD" should be written next to Line 4b to ensure the IRS is aware of the QCD.

TAKEAWAYS

RMDs from traditional IRAs and certain inherited IRAs generally cannot be avoided and the rules regarding if and when RMDs are required seem to be constantly changing and frustrating taxpayers along the way.

The QCD, however, is one very taxpayer-friendly IRA provision that charitably minded individuals should consider annually as they review their overall financial picture. Strategic use of a QCD can provide these individuals with not only a mechanism to fund their charitable giving, but they might also achieve an overall financial benefit along the way.

[8] The Secure 2.0 Act of 2022 increased the RMD age in two phases. RMDs will begin at age 73 for those taxpayers who were born in the years between 1951 and 1959. RMDs will begin at age 75 for those taxpayers who were born in year 1960 or thereafter.

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