Beat the system with charitable donations from your IRA

Bill Bischoff – March 12, 2019

If you've reached age 70½, you can make cash donations to IRS-approved charities out of your IRA. These so-called qualified charitable distributions (QCDs) can help you beat the federal income tax system in two different ways. Who wouldn't like that?

Even better, you may be able to implement the QCD drill starting with your 2018 tax year even though 2018 is in your rearview mirror. That's the situation if you turned 70½ last year and have not yet taken your initial IRA required minimum distribution RMD, which must be withdrawn by April 1.

Otherwise, you can do the QCD drill for this year (2019) as long as you will be age 70½ or older by 12/31/19.

Here's what you need to know for both situations:

Qualified charitable distribution (QCD) basics
Qualified charitable distributions (QCDs) can be taken out of your traditional IRA(s) free of any federal income tax hit. In contrast, other traditional IRA distributions are taxable (wholly or partially depending on whether you've made any nondeductible contributions over the years).

Unlike garden-variety charitable donations, you can't claim itemized deductions for QCDs. That's OK, because the tax-free treatment of QCDs equates to a 100% deduction because you'll never be taxed on those amounts. And you don't have to worry about tax-law restrictions that apply to itemized charitable write-offs.

What counts as a QCD?
1. It cannot occur before you, as the IRA owner or beneficiary, have reached age 70½.

2. It must meet the normal tax-law requirements for a 100% deductible charitable donation. If you receive any benefits that would be subtracted from a donation under the normal charitable deduction rules (such as free tickets to an event) the distribution cannot be a QCD. Beware of this rule!

3. It must be a distribution that would otherwise be taxable. A Roth IRA distribution can meet this requirement if it's not a qualified (meaning tax-free) distribution. However, taking QCDs out of Roth IRAs is generally inadvisable for reasons explained later.

Important point: If you inherited an IRA from the deceased original account owner, you too can do the QCD drill with the inherited account if you've reached age 70½.

$100,000 annual limit
There is a $100,000 limit on total QCDs for any one year. But if both you and your spouse both have IRAs set up in your respective names, each of you is entitled to a separate $100,000 annual QCD limit.

QCDs have five potential tax-saving advantages:

Advantage No. 1
QCDs are not included in your adjusted gross income (AGI). This lowers the odds that you will be affected by various unfavorable AGI-based rules, such as those that can cause more of your Social Security benefits to be taxed, less of your rental estate losses to be deductible, and more of your investment income to be hit with the dreaded 3.8% Medicare surtax (the so-called net investment income tax).

Advantage No. 2
QCDs always deliver a tax benefit while "regular" charitable donations might not. The Tax Cuts and Jobs Act (TCJA) almost doubled the standard deduction amounts for 2018-2025, and you only get a tax benefit from a charitable donation if your total itemizable deductions exceed your standard deduction. So higher standard deductions make it that much harder to claim itemized charitable write-offs.

For 2018, the standard deduction amounts are:

• $13,600 if you file as a single taxpayer and were 65 or older as of 12/31/18.

• $25,300 if you and your spouse file jointly and one spouse was 65 or older as of 12/31/18 or $26,600 if both spouses were.

• $19,600 if you file as a head of household and were 65 or older as of 12/31/18.

For 2019, the standard deduction amounts are:

* $13,850 if you file as a single taxpayer and will be 65 or older as of 12/31/19.

* $25,700 if you and your spouse file jointly and one spouse will be 65 or older as of 12/31/19 or $27,000 if both spouses will be.

* $20,000 if you file as a head of household and will be 65 or older as of 12/31/19.

These higher standard deduction amounts under the TCJA reduce the odds that you will be able to itemize deductions and gain any tax savings from "regular" charitable donations.

Advantage No. 3
A QCD taken from your traditional IRA counts as a distribution for purposes of the required minimum distribution (RMD) rules. Therefore, you can arrange to donate all or part of your annual RMD (up to the $100,000 limit) that you would otherwise be forced to receive and pay taxes on.

April 1 deadline: If you turned 70½ in 2018 but have not yet taken the RMD for your 2018 tax year, you must do so by April 1 of this year or face a 50% penalty on any shortfall (the difference between the RMD amount for your 2018 tax year and your IRA withdrawals during 2018 plus any taken this year through April 1).

Then you must take your RMD for the 2019 tax year by Dec. 31, 2019. In this situation, not taking advantage of the QCD option to fulfill your RMD obligations means having to take two taxable RMDs this year with the resulting double tax whammy. Not good! But if you go the QCD route you can replace those taxable RMDs with tax-free QCDs. But mind the April 1 deadline for the RMD for your 2018 tax year.

Advantage No. 4
Say you own one or more traditional IRAs to which you have made nondeductible contributions over the years. Your IRA balances consist partly of a taxable layer (from deductible contributions and account earnings) and partly of a nontaxable layer (from those nondeductible contributions). Any QCDs are treated as coming first from the taxable layer. Any nontaxable amounts are left behind in your IRA(s). Later on, those nontaxable amounts can be withdrawn tax-free by you or your heirs.

Advantage No. 5
QCDs reduce your taxable estate, although that is not an issue for most folks now that the federal estate tax exemption for 2019 has been supersized to $11.4 million for singles and effectively $22.8 million for married couples.

Are you a good QCD candidate?

If you can afford to donate IRA money, you can benefit tax-wise if you match one or more of the following profiles.

1. You won't itemize deductions this year due to the bigger standard deduction. So a "regular" charitable donation won't deliver any tax savings, but a QCD will. That's the first way to beat the system with a QCD.

2. You want to avoid being taxed on the RMDs that you must take this year from your IRA(s). Replacing taxable RMDs with tax-free QCDs is the second way to beat the system with a QCD.

3. You are looking for a quick-and-easy estate tax reduction strategy. This is a third way to beat the system with a QCD, but it only makes a difference if you're quite well off.

Should you consider taking QCDs from your Roth IRA?

Generally, no. That's because you and/or your heirs can take federal-income-tax-free Roth IRA withdrawals after at least one Roth account owned by you has been open for at least five years. Also, for an original account owner like you (as opposed to an IRA beneficiary), a Roth IRA is not subject to the RMD rules until after you pass on and somebody inherits the account. Bottom line: Because the tax rules for Roth IRAs are so favorable, it's generally best to leave your Roth balances untouched and earning more tax-free income rather than taking money out with QCDs.

The bottom line

The QCD privilege is a tax-smart opportunity for well-off seniors with more than enough money than for retirement and charitable inclinations. You can beat the system in several ways, and that's always good for your self-esteem. If you turned 70½ last year, mind the April 1 deadline if you've not yet taken your RMD for the 2018 tax year.