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What's a QCD—and Why Taxpayers Need to Know the Answer Now

Thanks to tax-law changes, qualified charitable distributions are more attractive than ever for IRA holders

The new tax law makes a little-known tactic for making charitable donations more attractive for taxpayers with IRAs.

By
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Older adults who donate to charities—and don't like taxes—need to get very familiar, very quickly, with qualified charitable distributions.

That's the advice financial planners are giving clients as the new tax law takes effect. These instruments have been around since 2006. But big changes in how deductions work on federal tax returns mean that QCDs are garnering new attention and new fans.

"We've run [tax] projections for a number of clients using QCDs, and it's saving them a lot of money," says Helen Modly, a certified financial planner with Buckingham Strategic Wealth in Fairfax, Va. "I think more people are going to realize that this is an effective tax-planning strategy."

Of course, the calendar year is already winding down, and accountants and financial advisers are cautioning clients not to wait until late December to take advantage of QCD planning. Given that, here's a primer on QCDs:

What is a QCD?
A qualified charitable distribution is a withdrawal from an individual retirement account that is sent directly to a charity. In other words, the funds don't pass through your hands. You instruct your IRA custodian to send the money straight to the group or groups you specify.

Who can do this?
You must be age 70½ or older at the time of the donation.

How do I benefit from using a QCD?
A qualified charitable distribution allows a person to "do good" and, at the same time, reduce her/his taxes.

After you reach age 70½, you are required to withdraw funds annually from your IRA and report the distributions as income on your tax return. So, if you're required to withdraw $6,000 from your IRA in 2018, that will increase your income this year by $6,000.

But let's say you are charitably inclined and plan to donate money to a half-dozen groups before year-end. If you tell your IRA administrator to send $1,000 to each charity, those contributions—in the eyes of the Internal Revenue Service—will satisfy your RMD for the year. And you wouldn't need to include the $6,000, as you normally would, as income on your tax return.

Running the Numbers

How a qualified charitable distribution of $10,000 could help a couple's taxes. In this case, both spouses are older than 70½ and file a joint return.

	Without QCD	With QCD
Income before IRA	$200,000	$200,000
IRA required withdrawal	+$10,000	+$0
Adjusted gross income	$210,000	$200,000
Standard deduction*	–$26,600	–$26,600
Taxable income	$183,400	$173,400

Taxable difference	$10,000
x tax rate	24%
= tax saving	$2,400

*Standard deduction of $24,000 plus $1,300 for each individual age 65 or older.
Source: Michael G. Thompson; Galligan, Thompson & Flocas, LLP

As a result, your adjusted gross income, your taxable income—and, consequently, your tax liability—all end up being lower than they would otherwise. And you still get to support the charities you were planning to help in the first place. (More about "adjusted gross income" in a moment.)

What's happening this year? Why the new interest in QCDs?
A qualified charitable distribution preserves a way to donate money to charity and still enjoy tax benefits under the new tax law.

Traditionally, people who contribute large amounts to charity itemize their deductions; as such, they get a tax benefit for their gifts. Under the new tax law, many of these same people will be better off using the new and much larger standard deduction: $13,600 for individuals age 65 and older, and $26,600 for couples age 65 and older filing jointly. But in doing so—in not itemizing—they get no tax benefit from donating to charity.

This is where a QCD helps. First, if you give money to a charity—and, again, if you are 70½ or older—you can still get a tax break, only now it comes in the form of an IRA withdrawal (and the ability to exclude that income from your tax return), instead of an itemized deduction. Second, you get the new, sizable standard deduction—as much as $26,600—against other income.

Do I have to send all my required withdrawal from my IRA to charity?
No. You can send part of your RMD to charity and keep the rest. But the amount you keep would have to be reported as income on your tax return.

I'm just hearing about QCDs for the first time, and I have already taken my required minimum distribution for 2018. Can I still take advantage of a QCD?

If you have already taken your full RMD, you're out of luck.

In the eyes of the IRS, the first dollars that come out of your IRA each year are "deemed" to count toward your RMD, says Ed Slott, an IRA expert in Rockville Centre, N.Y. If your RMD for 2018 is, say, $6,000, and you have already pulled that amount from your retirement account, that money is taxable. "You cannot use the QCD on funds already withdrawn," Mr. Slott says.

But here are two additional, and more encouraging, scenarios. Again, let's say your RMD for this year is $6,000—and as of this month, you have pulled $4,000 from your IRA. At this point, you could apply the brakes and tell your IRA custodian to send the remaining $2,000 in required withdrawals directly to charity. In this case, $4,000 would be taxable income—but you could exclude $2,000 from your tax return as a QCD.

There is a second possibility: Many people take their RMDs late in the year. If you haven't withdrawn any funds from your IRA to date, you can still take full advantage of a QCD in 2018.

How much can I contribute to charity via a QCD?
You can transfer as much as $100,000 a year from your IRA to any combination of qualified charities, and none of that money would be taxed. And the limit is $100,000 a year per person—not per IRA, Mr. Slott notes.

In short, if you're feeling generous, you can do QCDs in excess of your required distribution.

Can I take a QCD and take an itemized tax deduction for a charitable gift?
No. You can't do both. There's no double tax break.

Are there other benefits to QCDs?
Again, a QCD isn't taxable income; as such, it "keeps those funds out of your adjusted gross income," says Peggy Stephan, a certified financial planner at Retirement Capital Strategies in San Jose, Calif. "And many things are tied to adjusted gross income that can cost you."

Among them, she says: the amount of Medicare premiums you pay, your ability to deduct certain items on your taxes, and taxation of Social Security benefits.

What can trip me up?
More things than you might imagine, which argues—if you're taking a QCD for the first time—for working with a tax professional and/or financial adviser.

To start, donations typically come from a traditional IRA or an inherited IRA. You can't use a 401(k) or 403(b). ("Active" SEP and Simple IRAs—those receiving employer contributions—also aren't eligible for QCDs. But "inactive" plans are.)

A Roth IRA qualifies, but given that distributions from Roths generally are tax-free to begin with, most people are better off skipping this option. If you're working with an inherited IRA, you still must pass the age test: 70½ or older at the time of the distribution.

The contributions must be made directly—again, they can't pass through your hands—to an eligible or "qualified" public charity, as defined and approved by the IRS. You can't transfer the IRA dollars to a donor-advised fund or a private foundation. And you can't receive any benefits in return from the charity that receives your donation.

Paperwork and record-keeping are crucial. You need to keep track of which charities are getting the distributions; you need documentation from the charities that they, in fact, received your funds; and you need to share all this information with your tax preparer (if you use one).

"Start planning early," Ms. Stephan cautions. "This is not something you want to do in the final days of the year."

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