Qualified charitable distributions: Everything you need to know

By **Michael Kitces** **July 25 2016**

It's about time.

For nearly a decade, the rules allowing for a tax-free Qualified Charitable Distribution directly from an IRA to a charity have been on-again, off-again, a part of the infamous Tax Extenders that would lapse and be reinstated every other year.

But the Protecting Americans from Tax Hikes Act of 2015 have finally made the QCD rules permanent, making it easier to engage in proactive charitable giving strategies that help to minimize the tax bite of an IRA's Required Minimum Distribution obligations.

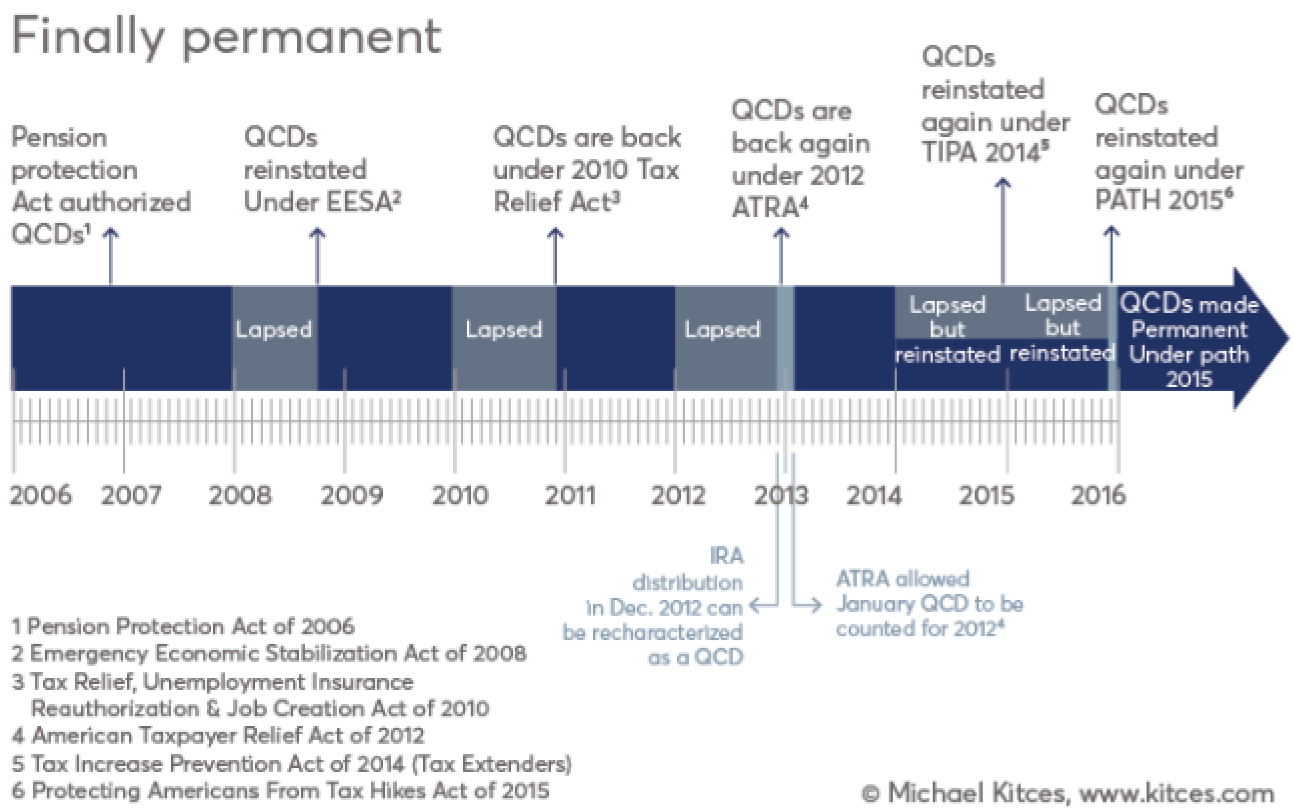
For an IRA distribution to qualify as a QCD, the check cannot be made payable to the IRA owner and instead must be made payable directly to the charitable entity.

However, obtaining the tax benefits for doing a QCD from an IRA to a charity requires meeting very specific requirements. They include a minimum age limitation, a maximum dollar amount limitation, and contributing to only certain types of eligible public charities, which render private foundations, donor-advised funds, and split-interest charitable trusts ineligible.

In addition, there is the most stringent requirement – though also the easiest to satisfy – that for an IRA distribution to qualify as a QCD, the check cannot be made payable to the IRA owner and instead must be made payable directly to the charitable entity. The check payable to the charity can, however, be sent to the IRA owner and forwarded on to the charity.

Fortunately, though, with QCDs made permanent under current law, at least IRA owners have the entire year to strategize and decide whether to engage in charitable giving. But once an RMD has been distributed, there's no way to undo it and turn it into a QCD later!

Now that QCDs are a permanent element of the tax law, and likely to remain in place for the foreseeable future, advisers have proactive tax planning opportunities—assuming all the requirements are met.



HOW TO DO A QUALIFIED CHARITABLE DISTRIBUTION

To complete a QCD from an IRA to a charity, the IRA owner must:

1) Already be age 70 ½ on the date of distribution
2) Submit a distribution form to the IRA custodian, requesting that the check be made payable directly to the charity
3) Ensure that no tax withholding is being done from the QCD to the charity (as the money must actually go to the charity to qualify, and as a non-taxable distribution no withholding should be necessary)
4) Send the check directly to the charity, or to the IRA owner to be forwarded along to the charity

Under IRS Notice 2007-7, Q&A-41, it is permitted for the check to be mailed to the IRA owner, as long as the check is payable to the charity.

While the process of completing a QCD to a charity is fairly straightforward, the key administrative requirement is that the distribution check must be made payable *directly* to the charitable entity. If the funds go to the IRA owner and are then passed along *to* the charity, it is still a taxable distribution to the IRA owner and not a QCD.

Under IRS Notice 2007-7, Q&A-41, it *is* permitted for the check to be *mailed* to the IRA owner, as long as the check is payable *to* the charity, but a check payable to the IRA owner that is merely endorsed over to the charity does not satisfy the QCD requirements.

REQUIREMENTS FOR A QCD FROM AN IRA

The core requirements for making Qualified Charitable Distributions from an IRA to a charity are contained in IRC Section 408(d)(8) ,as created under Section 1201 of the Pension Protection Act of 2006.

Under the QCD rules, the IRA owner must be at least age 70 ½ to donate the QCD to a charity.

Under IRS Notice 2007-7, Q&A-36, even a beneficiary of an inherited IRA can be eligible for a QCD, as long as the beneficiary themselves is at least age 70 ½ on the date of the distribution.

The maximum dollar amount of a QCD for any individual from his/her IRAs is limited to $100,000 per year. For QCDs, this annual limitation is done on a "per-taxpayer" basis, though as a per-taxpayer limitation a married couple can *each* do up to $100,000, as long as each taxpayer's QCDs come from his/her respective IRA.

The maximum dollar amount of a QCD for any individual from his/her IRAs is limited to $100,000 per year.

Only distributions from an individual IRA (including a rollover IRA) are eligible, and not from a SEP or SIMPLE IRA, nor from any type of employer retirement plan. Notably, a QCD is permitted from a Roth IRA as well, though most distributions from a Roth IRA are already tax-free and therefore QCD rules wouldn't be relevant anyway.

To qualify for QCD treatment, the rules also stipulate that the distribution must go to a public charity (as described in IRC Section 170(b)(1)(A)), and thus cannot go to a private foundation, nor (as specified in the tax code) may a QCD go to a charitable supporting organization or a donor-advised fund, either.

In addition, the charitable distribution from the IRA must be one that otherwise would have been eligible for a full charitable deduction under IRC Section 170. This "must have been eligible for a full deduction" rule ensures that the IRA donor does not receive any kickbacks or other "quid pro quo" benefits for the donation.

BENEFITS OF DOING A QCD FROM AN IRA

The benefit of doing a QCD from an IRA is that the distribution comes out of the IRA without any of the tax consequences that would otherwise apply to a withdrawal. Notably, there is no charitable deduction for making the QCD contribution to the charity, but only because by definition it was already entirely pre-tax , having come directly from a pre-tax IRA.

In addition, to the extent that the IRA owner had a Required Minimum Distribution (RMD) obligation for the year, the QCD is deemed to satisfy the RMD, even though the QCD is not taxable as an RMD otherwise would have been. And since an IRA owner must be age 70 ½ in order to do the QCD, by definition he/she will also have at least *some* RMD due for that tax year as well!

***Example 1a**. Harold just turned 71 years old and has an IRA with a $152,000 account balance. His RMD for the current year is $5,736. If Harold does a $5,000 QCD to his favorite charity, it will satisfy $5,000 of his RMD obligation (without any tax liability), leaving him with only another $736 to distribute (and report in income for tax purposes).*

Since an IRA owner must be age 70 ½ in order to do the QCD, by definition he/she will also have at least some RMD due for that tax year as well.

***Example 1b**. Continuing the prior example, if Harold instead did a $6,000 QCD from his IRA to a qualifying charity, his entire RMD will be satisfied (as his QCD is more than enough to cover the RMD obligation), and again there will be no tax consequences to the entire QCD (assuming it was otherwise eligible).*

USING A QCD FOR AN RMD OBLIGATION

One important caveat of using a QCD to satisfy an RMD obligation, though, is that an RMD is presumed to be satisfied by the *first* distribution that comes out of the IRA for the year. And because IRC Section 408(d)(3)(E) does not permit an RMD to be rolled over back into an(other) IRA, once an RMD occurs, it is irrevocably distributed (and taxable).

Example 2. Chuck had a $7,400 RMD obligation for the current 2016 tax year. In February, he took a $7,400 to satisfy his entire RMD. In March, Chuck realizes that it may have been better for him to do a QCD instead, as he was planning to contribute to charity later in the year anyway.

However, even if Chuck now does a QCD, it cannot be applied towards his RMD (which was already satisfied), nor can he undo his prior RMD (which is irrevocable once distributed). At best, Chuck can simply take the

$7,400 distribution he took from his IRA, donate it to a charity, and claim a $7,400 charitable deduction as an itemized deduction on Schedule A, and hope that it at least mostly offsets his prior taxable distribution.

In the context of a Roth IRA, a QCD is generally a moot point, because a distribution from a Roth IRA is typically *already* tax-free (either as a return of principal, or as a tax-free qualified distribution of growth), especially for someone who is already age 70 ½ (and therefore has likely had the Roth for more than the requisite 5-year period).

Nonetheless, to the extent that a distribution from a Roth IRA would actually be a *non-qualified* (i.e., taxable) distribution (e.g., because it's a distribution of Roth IRA growth and the 5-year rule has not been satisfied), it can be treated as a QCD if made directly to a charity.

PRE-TAX AND AFTER-TAX ORDERING RULES FOR QCDs

While a QCD is normally treated as a direct pre-tax contribution from an IRA to a charity, additional "ordering rules" are necessary to determine the tax consequences of a QCD when the available pre-tax IRA(s) include after-tax (non-deductible) contributions. A Roth IRA would follow the normal Roth distribution ordering rules under IRC Section 408A.

While a QCD is normally treated as a direct pre-tax contribution from an IRA to a charity, additional "ordering rules" are necessary to determine the tax consequences of a QCD when the available pre-tax IRA(s) include after-tax (non-deductible) contributions.

The good news is that the ordering rules of IRC Section 408(d)(8)(D) explicitly require that any qualified charitable distribution from an IRA is deemed to come from the taxable portion of the account first (as opposed to the 'typical' pro-rata rule), which actually helps to ensure the most favorable treatment. In addition, all IRA accounts are aggregated together to determine the total taxable amount that is potentially eligible for a (pre-tax) qualified charitable distribution.

Example 3a. *Jeremy has two IRAs. The first is the account to which he's made ongoing contributions for years, and it currently has a total of $21,000, of which $15,000 is after-tax (non-deductible) contributions. The second is a $158,000 rollover IRA of his prior 401(k) plan.*

If Jeremy were to take a $10,000 distribution from either IRA, then under the IRA aggregation rule the total non-deductible contributions are $15,000, the total IRAs are $179,000, and the IRA distribution would be $15,000 / $179,000 = 8.4% non-taxable and 91.6% taxable.

However, if Jeremy does a Qualified Charitable Distribution instead, the funds are deemed to come from pre-tax dollars first. Thus, even if he does the $10,000 QCD from the $21,000 IRA (which was $15,000 of after-tax and $6,000 of growth), the distribution is treated as being entirely pre-tax and eligible for QCD treatment, because the IRA aggregation rule treats all the IRA accounts as one collective account, regardless of where the after-tax contributions were actually made.

Notably, to the extent that a QCD uses up all the available pre-tax funds from *all* accounts, and only after-tax dollars remain available, a QCD of after-tax dollars from an IRA *will* be eligible for a charitable deduction, as though the after-tax funds were simply withdrawn in a non-taxable distribution and subsequently donated directly to the charity.

***Example 3b**. Continuing the prior example, if Jeremy's only IRA were the $21,000 account with $15,000 of after-tax contributions, and he did a $10,000 direct distribution to a charity, the first $6,000 would be treated as a QCD (not taxable, nor eligible for any charitable deduction), and the last $4,000 would be eligible for a charitable deduction on Schedule A (as though the last $4,000 was taken as a non-taxable distribution of after-tax dollars, and separately contributed to the charity).*

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