Early planning on qualified charitable distributions can mean bigger tax savings

When required minimum distributions begin, QCDs can reduce or eliminate the income tax on the RMD income — if the timing is right.

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- By Ed Slott

Timing is everything and that goes for qualified charitable distributions as well. That's why QCD planning should be addressed early in the year to maximize the tax savings on required minimum distributions.

QCDs are direct transfers from individual retirement accounts to qualified charities. They can only be done from IRAs — not from company plans — and not even from active SEP or SIMPLE IRA plans (although they can be done from inactive SEP and SIMPLEs).

The tax benefit is that these transfers from an IRA out to charities are not included in the IRA owner's income, making them the preferred way to give to charity.

IRAs are the best assets to give to charity since they're loaded with taxes. Any time IRA funds can be withdrawn tax-free, that's something that should be taken advantage of, and qualified charitable distributions provide that opportunity. But year after year, most people still give the old-fashioned way by writing a check to a charity in December and receiving no tax benefit. Advisers should help clients change those old habits and show them how to increase their tax savings by using QCDs, but QCDs need to be properly timed to maximize the benefit.

Most people don't receive any tax benefits for their charitable donations since they don't itemize their deductions. Instead, they use the larger standard deduction. The QCD not only replaces the itemized deduction but goes one better. It's an exclusion from income, which reduces adjusted gross income, a key figure on the tax return that determines the level of other tax benefits, deductions and credits. Itemized deductions only reduce taxable income.

QCDs are only available to IRA owners and IRA beneficiaries who are 70½ or older, and for this rule, you must actually be 70½. For example, if someone will turn 70½ tomorrow, they don't qualify today. Donor advised funds and private foundations don't qualify for QCDs. QCDs are meant for direct gifts from the IRA to the charity. They are limited to $100,000 annually per IRA owner (not per IRA account).

Even though the SECURE Act raised the RMD age to 72, the QCD age remains at 70½, so QCDs can be used for charitable giving even before RMDs begin.

The big tax benefit, though, is when RMDs begin, since QCDs can reduce or eliminate the income tax on RMD income — if the timing is right.

The problem is that most people do their giving in December at holiday time. Advisers need to educate RMD clients that for QCDs, January is the new December. It's best to do QCDs early in the year before any RMDs are taken. If the RMD is taken before the QCD, that RMD income can't be offset by a QCD done later in the year. The tax rules state that the first dollars withdrawn from an IRA in a year where an RMD is due will first go to satisfy the RMD. This is known as the "first dollars out rule," and that's what creates this QCD timing quirk.

EXAMPLE

Jane is subject to RMDs. Her RMD for 2022 will be $5,000, and she also makes annual charitable gifts of $5,000, so she'd like to have her 2022 donations eliminate the tax on her RMD. But if Jane takes her 2022 RMD before doing a qualified charitable distribution, her $5,000 RMD will be included in income and a QCD can no longer offset her $5,000 RMD income. Yes, Jane can still do a QCD later in the year for $5,000 and that will be excluded from income, but because Jane did the RMD first, she will have to withdraw a total of $10,000 from her IRA instead of $5,000. And she will still owe tax on her $5,000 RMD, which could have been avoided by reversing the order. (If Jane needed the $5,000 RMD say for expenses, then there's not a problem and she'll pay the tax on those funds.)

However, if Jane did the $5,000 QCD in January (or at any time before taking an RMD), then the QCD would satisfy her 2022 RMD and she would not have to take any 2022 RMD. She would only have withdrawn $5,000 and it would all be excluded from income. That's the right way to do QCDs.

QCD TAX TRAP CAUTION

The SECURE Act eliminated the age restriction on making tax-deductible IRA contributions. But this provision came with a poison pill for QCDs. If a client wishes to take advantage of the QCD, advise them not to contribute to a deductible IRA because taking the tax deduction could eliminate the QCD tax benefit and make the QCD taxable. If the client really wishes to contribute to an IRA after age 70½ and also wants to gain the QCD benefit, have them contribute to a Roth IRA instead, if they qualify under the Roth IRA income limits.

ENHANCED 2022 QCD TAX BENEFITS

Beginning in 2022, two charitable tax breaks for making cash donations are gone. First, the $300/$600 tax deduction for non-itemizers is no longer available, and the 100% of AGI itemized deductions goes back to 60%. This leaves fewer avenues to gain tax benefits for charitable gifts. That in turn makes QCDs more valuable, since they can replace these tax breaks and then some.

January is the new December for saving taxes on QCDs. Watch the timing!