January is the new December for charitable contributions

Qualified charitable contributions can help offset the tax bill from required minimum distributions — but only with the right timing

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- By Ed Slott

Required minimum distributions from retirement accounts resume in 2021 after being waived for 2020. By acting early in the year, advisers can help clients reduce their RMD tax bill with qualified charitable distributions, if they qualify.

The QCD tax benefit only applies to owners and beneficiaries of individual retirement accounts who are 70½ or older. Even though the age at which the RMD requirement kicks was raised to 72 by the SECURE Act, the QCD age remains at 70½. This gap can allow IRA owners who are not yet subject to RMDs to use QCDs, if they are at least 70½.

QCDs cannot be made from employer plans like 401(k)s and 403(b)s. In addition, donor-advised funds, including other supporting charitable entities and private foundations, do not qualify for QCDs. Up to $100,000 per year can be given with QCDs (not per IRA account, but per person). The QCD must be done as a direct transfer from the IRA to the charity.

QCD TAX BENEFIT

QCDs allow qualifying clients to receive a tax benefit for their charitable gifts. The funds leaving the IRA to be given to the charity are not a taxable distribution — the distribution is excluded from income.

Most people no longer receive tax benefits for their charitable donations because they take the standard deduction, as opposed to itemizing deductions. The QCD provides a better tax benefit than an itemized deduction anyway, because the QCD is an exclusion from income and can lower adjusted gross income. An itemized deduction does not reduce AGI. The QCD benefit is in addition to the standard deduction.

For those who are resuming RMDs this year, donating to charity via a QCD can offset the RMD income — but only if the QCD is properly timed.

If the RMD is taken before the QCD, it will be taxable, and it cannot be offset with a QCD done later in the year. That's why advisers should let clients know that when it comes to making charitable gifts, January is the new December. Most people tend to do their giving in December at holiday time, but by then it may be too late to gain the tax benefit of offsetting RMD income, due to what's known as the "first dollars out rule."

FIRST DOLLARS OUT RULE

Under the tax rules, the first dollars distributed from a retirement account in any year that the client is subject to an RMD are deemed to go to satisfy that RMD. That's why those who wish to reduce their RMD income with QCDs should do the QCD with the first distributions out of the IRA by transferring the amount they wish to give directly from the IRA to the charity, before taking any RMD for the year.

Example: IRA owner Mary is 75 and subject to RMDs in 2021. Her 2021 RMD amount is $5,000. Mary would like to make charitable contributions for 2021 but usually waits until December to do that. She takes her $5,000 RMD in February 2021, and then does a $5,000 QCD in December thinking it will offset the $5,000 RMD income. But it won't, and Mary won't be happy at tax time. Mary will still have $5,000 of taxable income from the IRA RMD since that RMD was taken before the QCD.

In all, Mary has withdrawn $10,000 from her IRA; $5,000 is taxable and the $5,000 that went to the charity is excluded from income.

What should Mary have done? She should have done the $5,000 QCD early in the year before taking any RMD. If she had, that QCD would have satisfied her 2021 RMD and no additional funds would need to be withdrawn from her IRA unless she wished to make additional withdrawals. The better result: Mary would have withdrawn only $5,000 from her IRA and none of it would have been taxable. Plus, the QCD would have satisfied her 2021 RMD.

QCD TAX TRAP WARNNG

The SECURE Act removed the restriction on individuals who are 70½ or older making contributions to traditional IRAs. But that good news came with a poison pill that could also eliminate the QCD benefit. If a tax-deductible contribution is made, and the client also wants to do a QCD, they may lose the QCD tax benefit and might have to include the QCD as taxable income. Advice: Don't do this. Instead, recommend that the client make the contribution to a Roth IRA, or if married, have one spouse do the tax-deductible IRA and the other do the QCD from their traditional IRA.