The Tax Advantages of Qualified Charitable Distributions From IRAs

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Article Highlights

- Making donations via qualified charitable distributions (QCDs) is more tax-efficient than withdrawing funds from an IRA and then donating the same amount to charity.
- Qualified charitable distributions not only reduce taxable income for those who claim the standard deduction, but can also reduce the amount of Social Security benefits that are taxed.
- Long-term capital gain tax rates and Medicare Part B and Part D premiums can be reduced if the QCD results in the taxpayer's income being below the respective thresholds.

The U.S. tax code allows someone who is already at least age 70½—not someone who will turn 70½ later this year—to directly transfer up to $100,000 of funds from their traditional individual retirement account (IRA) to a qualified charity.

Funds can be rolled from a 401(k) plan to an IRA and then transferred to a charity, but they cannot be directly transferred from a 401(k), SEP-IRA, or SIMPLE IRA. For example, a single individual with charitable intentions could arrange for a direct transfer of $5,000 from the IRA custodian (e.g., a brokerage firm) to a qualified charity; the donor would never receive the funds. This would be an example of a qualified charitable distribution (QCD) from an IRA.

As we explain in this article, the QCD strategy of donating IRA funds is often more tax-efficient than withdrawing the same amount of funds from an IRA and then donating these funds to the charity. In this latter withdraw-then-donate strategy, there is often "slippage" between the contribution amount and the reduction in the taxpayer's taxable income.

How Taxable Income Can Be Affected

Assume Jane, a single individual over age 70½, wants to contribute $5,000 to a qualified charity. We consider two charitable giving strategies. In the withdraw-then-donate strategy, Jane withdraws $5,000 from her IRA with the funds sent to her bank account. She then writes a check for $5,000 to the charity. In the QCD strategy, Jane makes the $5,000 contribution through a qualified charitable distribution from an IRA. That is, she instructs the IRA custodian to send the charity $5,000 directly from her IRA. With either strategy, the $5,000 would count toward meeting the taxpayer's required minimum distribution.

Table 1 presents a simplified Form 1040, used in this article to explain why the QCD strategy can be the more tax-efficient method of contributing funds.

Itemized Deductions

Initially, suppose Jane uses the withdraw-then-donate strategy. The $5,000 withdrawal (Table 1, item 6) increases her adjusted gross income (AGI). If—and we repeat, if—her $5,000 charitable contribution increases her itemized deductions (Table 1, item 12) by the same amount, the withdraw-then-donate strategy may be as tax-efficient as the QCD strategy. However, approximately two-thirds of taxpayers do not itemize; rather, they claim the standard deduction for their particular filing status. For these taxpayers, taxable income would be at least $5,000 higher with the withdraw-then-donate strategy than with the QCD strategy.

Furthermore, suppose Jane has $3,850 in other deductions. If not for the $5,000 charitable contribution, Jane would use the standard deduction for 2016 of $7,850 for a single taxpayer over age 65. With this contribution, she itemizes and deducts $8,850 [$3,850 + $5,000], $1,000 more than the $7,850 standard deduction amount. In this case, she only benefits from $1,000 of the $5,000 contribution. Thus, all else equal, Jane's taxable income would be $4,000 higher with the withdraw-then-donate strategy than with the QCD strategy. Jane would need to have $7,850 in other deductions, an amount equivalent to her standard deduction, to make the withdrawal-then-donate strategy match the tax effectiveness of the QCD strategy in this example.

Taxable Portion of Social Security Benefits

In the withdraw-then-donate strategy, the $5,000 withdrawal from Jane's IRA increases item 6 in Table 1—taxable amount of IRA distributions—by $5,000, which increases her provisional income (also called combined income) by the same amount. Provisional income (PI) is used to calculate the taxable portion of her Social Security benefits.

Jane's PI is basically everything in adjusted gross income except the taxable portion of Social Security plus half of Social Security benefits plus tax-exempt interest. For most single taxpayers, every dollar of PI between $25,000 and $34,000 causes $0.50 of Social Security benefits to be taxed. Every dollar of PI above $34,000 causes $0.85 of Social Security benefits to be taxed until fully 85% of Social Security benefits are taxed ($0.85 of every dollar in benefits), which is the maximum amount of benefits that can be subject to taxes. For example, if Jane had a PI of $34,100, she could owe taxes on $4,585 of Social Security benefits [0.5 × ($34,000 – $25,000) + 0.85 × ($34,100 – $34,000)].

The bottom line is that the $5,000 contribution made through the withdraw-then-donate strategy could cause as much as another $4,250 ($5,000 × 85%) of Jane's Social Security benefits to be taxable. In contrast, with the QCD strategy Jane never receives the $5,000, and thus it does not increase her provisional income. The PI threshold levels for married couples filing joint returns are $32,000 and $44,000, but the same principle applies: Each dollar withdrawn from the IRA in the withdraw-then-donate strategy would cause PI to increase by the same amount, which could cause the taxable portion of Social Security benefits to rise by as much as 85% of the withdrawal amount.

How an Increase in AGI Could Increase Total Taxes

With the withdraw-then-donate strategy, the taxpayer's AGI likely will be higher than with the QCD strategy. We now discuss several additional ways that a higher AGI could increase Jane's total tax.

Capital Gains

As we have seen, with the withdraw-then-donate strategy, Jane's taxable income could be $5,000 higher if she does not itemize deductions. In addition, the taxable portion of her Social Security benefits could be $4,250 higher. Combined, her taxable income from these two tax features alone could be $9,250 higher ($5,000 withdrawal and $4,250 in taxable Social Security benefits) with the withdraw-then-donate strategy than with the QCD strategy. We now present two ways this could affect the taxes she pays on capital gains.

First, if Jane's taxable income places her in the 15% or lower tax bracket, long-term capital gains would be tax-free. Long-term gains are gains on assets held at least one year and one day. For 2016, the top of the 15% tax bracket is $37,650 for a single taxpayer or married taxpayers filing separate returns but $75,300 for a married couple filing jointly. If the QCD strategy keeps the taxpayer's taxable income below these threshold levels, but the withdraw-then-donate strategy increases taxable income above these thresholds, the QCD strategy would eliminate income taxes on the taxpayer's long-term gains.

The second way that the QCD strategy could reduce capital gains taxes applies to higher-income taxpayers. The Affordable Care Act of 2010 included a provision for a 3.8% net investment income tax, which is also called the Medicare surtax. This tax applies to more than just capital gains. Net investment income (NII) includes taxable interest, dividends, capital gains, non-qualified annuity income, rents, royalties, passive income from business activities and undistributed investment income from a trust or estate (net of certain investment-related expenses). This Medicare surtax applies to the lesser of NII and the excess of modified adjusted

Table 1. Simplified IRS Form 1040

Item	Description (Form 1040 line number)
	For AGI
1	Wages, salaries, tips, etc. (Line 7)
2	Taxable interest (Line 8a)
3	Ordinary and qualified dividends (Lines 9a and 9b)
4	Business income (Line 12)
5	Capital gains (Line 13)
6	Taxable amount of IRA distributions (Line 15b)
7	Taxable amount of pensions and annuities (Line 16b)
8	Taxable amount of Social Security benefits (Line 20b)
9	Total income (Line 22) (add items 1-8 above)
10	For-AGI deductions (Lines 23-35)
11	Adjusted gross income (Line 37) (subtract item 10 from item 9)
	From AGI
12	Larger of itemized deduction or standard deduction (Line 40)
13	Exemptions (Line 42)
14	Taxable income (Line 43) (subtract items 12 and 13 from item 11)
15	Tax (Line 44)
16	Tax credits (Lines 48-54)
17	Tax payments (Lines 64-73)
18	Tax refund (Line 75) or Tax owed (Line 78) (subtract items 16 and 17 from item 15)

gross income above certain thresholds. Modified adjusted gross income (MAGI) for this Medicare surtax consists of AGI plus NII. This 3.8% surtax applies to single taxpayers or heads of households with MAGI exceeding $200,000. The income threshold is $250,000 for married couples filing jointly or qualifying widows and $125,000 for married individuals filing separately. The bottom line is that the QCD strategy may reduce or eliminate this Medicare surtax for higher-income donors relative to the withdraw-then-donate strategy.

Table 2. Medicare Part B and D Premiums for 2016

	Monthly Premium Amount	
Modified Adjusted Gross Income (MAGI)	Part B	Part D
Singles with MAGI ≤ $85,000, and Married couples with MAGI ≤ $170,000	Standard premium = $104.90	Your plan premium
Singles with MAGI above $85,000 up to $107,000, and Married couples with MAGI above $170,000 up to $214,000	Standard premium + $65.60	Your plan premium + $12.70
Singles with MAGI above $107,000 up to $160,000, and Married couples with MAGI above $214,000 up to $320,000	Standard premium + $138.70	Your plan premium + $32.80
Singles with MAGI above $160,000 up to $214,000, and Married couples with MAGI above $320,000 up to $428,000	Standard premium + $211.80	Your plan premium + $52.80
Singles with MAGI above $214,000, and Married couples with MAGI above $428,000	Standard premium + $284.90	Your plan premium + $72.90

Increase in Medicare Parts B and D Premiums

The size of Medicare Part B and Part D premiums are tied to the taxpayer's modified adjusted gross income two years hence. Thus, MAGI for 2014 affects the size of 2016 premiums. This MAGI is equal to AGI plus tax-exempt interest. Because it includes adjusted gross income, Jane's MAGI could be lower if she uses the QCD strategy instead of the withdraw-then-donate strategy.

Table 2 shows the Medicare Parts B and D premium schedule for most taxpayers who are considering a QCD in 2016. Recall that, to utilize the QCD strategy, a taxpayer must be at least 70½ years of age. Because most taxpayers begin Medicare at age 65, those with MAGI in 2014 at or below $85,000 (and married couples with MAGI at or below $170,000) pay the lowest monthly Medicare premiums of $104.90 per spouse. [Taxpayers who enrolled in Medicare Part B for the first time in 2016 and were below these MAGI limits would pay $121.80 per month, but prior enrollees who were paying $104.90 per month in 2015 had their premiums frozen.] Table 2 amounts assume that each spouse's Part B standard premium is $104.90 per month. However, if MAGI in 2014 exceeds these limits by $1, the 2016 monthly Medicare Part B premium rises by $65.60, and the Part D premium, if applicable, rises by $12.70.

If Jane's higher AGI and MAGI with the withdraw-then-donate strategy cause her MAGI to exceed $85,000 by even $1, her annual Part B and, if applicable, Part D premiums would be $939.60 higher [($65.60 + $12.70) × 12 months]. The corresponding annual premium increases for a single taxpayer at the three higher income thresholds listed in Table 2 are $2,058, $3,175.20, and $4,293.60. The annual premium increases are twice as high for a married couple filing jointly if both spouses are enrolled in Medicare. Thus, a $1 increase in MAGI could cause their annual premiums to rise by nearly $1,900 at the $170,000 threshold. There are separate income threshold levels for a married couple who lived together part of the year but filed separate tax returns. However, the principle remains the same: Medicare premiums can be lower for taxpayers who use the QCD strategy for donating funds.

Limitation of Medical and Dental Expense Deduction Tied to AGI

Table 3 presents a simplified version of Schedule A, Itemized Deductions. Item 1 limits deductible medical and dental expenses for a single taxpayer or a married couple eligible for the QCD strategy to expenses that exceed 7.5% of AGI; this threshold will increase to 10% of AGI in 2017. Because a taxpayer's AGI could be higher with the withdraw-then-donate strategy than with the QCD strategy, the QCD strategy could produce a lower total tax bill by setting a lower threshold for deducting medical expenses.

Limitation of Charitable Gift Deduction Tied to AGI

Item 4 of Table 3 shows the deductible amount of gifts to qualified charities. Gifts donated through the QCD strategy are not considered in Schedule A. The reason this could be important is that the maximum deduction for cash gifts for a year is limited to 50% of AGI. Unused portions can be carried forward up to five years.

Thus, cash gifts made through the withdraw-then-donate strategy are subject to this limitation, while cash gifts made through the QCD strategy are not recorded on Schedule A and thus are not subject to this limitation. By using the QCD strategy, a charitable-minded person could donate a larger amount without being subject to this limitation.

Limitation of Miscellaneous Itemized Expense Deduction Tied to AGI

Item 5 of Table 3 shows the total

Table 3. Simplified Form 1040, Schedule A (Itemized Deductions)

Item	Description (Form 1040, Schedule A line number)
1	Medical and dental expenses exceeding 10% or 7.5% of AGI (Line 1)
2	Taxes you paid (Lines 5-8)
3	Interest you paid (Lines 10-14)
4	Gifts to charity (Lines 16-18)
5	Job expenses and certain miscellaneous deductions exceeding 2% of AGI (Lines 21-23)
6	Other miscellaneous deductions (Line 28)
7	Total Itemized Deductions (Line 29) (add items 1 to 6)

of job expenses and other miscellaneous deductions that can be included on Schedule A. These expenses can be itemized to the degree they exceed 2% of AGI.

Because the taxpayer's AGI could be higher with the withdraw-then-donate strategy than with the QCD strategy, the QCD strategy could reduce the threshold for claiming miscellaneous deductions and thus produce a lower total tax bill.

Limitation of Itemized Deductions Tied to AGI

In Table 3, item 7 adds the amounts from items 1 through 6 to provide the initial estimate of total itemized deductions. However, for 2016, if this total exceeds $259,400 for a single taxpayer, $311,300 for a married couple filing jointly or qualifying widow(er), $285,350 for head of household or $155,650 for a married taxpayer filing separately, then this total itemized deduction may be reduced by up to 3% of the amount that the taxpayer's AGI exceeds the dollar amount for the taxpayer's filing status. Thus, because these higher-income taxpayers could have a higher AGI with the withdraw-then-donate strategy, they may lose some of their itemized deductions that they would not lose if they used the QCD strategy.

Limitations on Tax Credits Tied to AGI

Returning to Table 1, item 16 encompasses numerous tax credits, many of which are limited to taxpayers with AGIs below certain limits. Because a tax credit is a dollar-for-dollar reduction in the final tax bill, a tax credit would be particularly attractive. However, because the AGI limits are often low, we suspect these tax credits would apply to relatively few taxpayers who are wealthy enough to consider making a QCD from their IRAs. Furthermore, many of these credits apply mainly to younger individuals.

Tax credits for potential donors at least age 70½ who might benefit from them include the child and dependent care credit, the credit for the elderly and disabled, the adoption expenses credit and various business and energy credits.

Reduction in State Taxes Tied to AGI

Most state tax forms piggyback the federal tax forms. In particular, many state taxes are based on AGI or sometimes MAGI (i.e., AGI plus or minus certain items).

Therefore, if the taxpayer's AGI will be higher with the withdraw-then-donate strategy than with the QCD strategy, the QCD strategy could produce a lower state tax bill.

Charitable Giving Could Reduce Estate Taxes

Note that, if a contribution amount exceeds the required minimum distribution, either the withdraw-then-donate strategy or the QCD strategy would reduce future traditional IRA withdrawals and thus future income taxes. In addition, contributions made through either of these strategies could lower the taxpayer's estate taxes.

Summary

In this article, we explained some of the tax advantages of donating funds to a qualified charity through a qualified charitable distribution from an IRA rather than withdrawing these funds and subsequently donating them. These tax advantages exist for QCDs of up to $100,000 per year. ▲

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