

Qualified Charitable Distributions

Direct gifts from IRAs can provide additional tax benefits

The Qualified Charitable Distribution (QCD) rules allow taxpayers to make IRA distributions payable directly to a qualified charity without treating the distribution as taxable income. This law permits up to \$100,000 per taxpayer to be contributed directly from an IRA to charity. In addition, the distributions will count towards the IRA owner's Required Minimum Distribution. The QCD rules were recently extended through 2011 with the passage of The Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act in December 2010.

Tax Rules

In order to be considered a Qualified Charitable Distribution, the following conditions must be met:

- The IRA account holder must be age 70½ or older as of the date of the distribution.
- Eligible recipients are public charities described in IRC Sec. 170(b)(1)(A), excluding donor advised funds and supporting organizations (as described in IRC Sec. 509(a)(3)).
- The exclusion from income only applies if the distribution otherwise would have been treated as taxable income (which leads to a planning opportunity – see below).
- The full amount would have been allowable for a charitable contribution.
- The distribution must be a direct transfer from the IRA Trustee to the charity. The IRA owner cannot use the QCD as a way to reimburse himself for gifts he made on his own.

IRA distributions that qualify as a QCD do not have to be included in the taxpayer's Adjusted Gross Income for the year. However, the taxpayer is also not entitled to a charitable contribution deduction for that amount.

Tax Benefits of a Qualified Charitable Distribution

Prior to the QCD rules, a taxpayer could take a distribution from their IRA (which would be included in their AGI), donate the same dollar amount to a charity, and offset the IRA income by claiming an itemized deduction for the donation. In most cases, the two amounts would offset each other¹ and there would be no impact on the taxpayer's taxable income. For an IRA distribution treated as a QCD, however, the taxpayer neither reports the income as part of their AGI nor claims a charitable deduction. This treatment may seem to provide the same tax benefit as the pre-QCD rules, but it does offer some unique benefits.

¹ Due to the Itemized Deduction Phaseout rules, the increase in AGI from the IRA distribution would have resulted in a loss of itemized deductions for higher-income taxpayers. However, those rules are repealed for 2010-2012. Should the QCD rules be extended into a year when the phaseout rules apply, there would be an additional tax benefit to electing QCD treatment.

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- Excluding the IRA distribution from income lowers the taxpayer's AGI, which provides several indirect tax benefits:
 - The amount of Social Security benefits that are taxable is driven by the recipient's Modified AGI. A lower AGI could keep a higher amount of a retiree's Social Security benefits tax-free.
 - Several types of deductible expenses are grouped into a category called Miscellaneous Itemized Deductions. These expenses are only deductible if, in total, they exceed 2% of the taxpayer's AGI². By keeping the IRA distribution out of AGI, they are more likely to get a benefit from these deductions.
 - Losses from rental real estate are limited for taxpayers with higher levels of AGI. Those losses could become deductible by keeping AGI lower.
- In order to receive a tax benefit for a charitable contribution, a taxpayer must itemize their deductions instead of claiming the standard deduction. If the taxpayer doesn't have enough other expenses to justify itemizing, the tax benefit of the charitable contribution would be lost. By following the QCD rules, the tax benefit of the charitable gift is realized, regardless of whether or not the taxpayer itemizes their deductions. This benefit usually applies only to those making smaller charitable gifts.
- The tax deduction for charitable gifts is limited to a percentage of the taxpayer's AGI. The QCD rules allow taxpayers to realize the tax benefit of the gift without being subject to this limitation.
- For taxpayers whose IRA contains both pre- and after-tax money, the QCD provides a unique opportunity. When a normal distribution is taken from an IRA, it is considered a pro rata distribution from the pre-tax and after-tax portions of the account. A QCD, however, is treated as only coming from the pre-tax portion of the IRA. As a result, a QCD can be an efficient way to use the pre-tax money while leaving the after-tax money in the IRA.
 - Example: A taxpayer has an IRA worth \$50,000, of which \$10,000 comes from after-tax contributions. If this taxpayer makes a QCD of \$40,000 to a charity, it would all come from the pre-tax portion of the account. The remaining \$10,000 would all be tax-free when withdrawn from the IRA, either as part of a regular withdrawal or a Roth conversion.

The QCD rules are scheduled to expire again at the end of 2011. While these rules have been extended before, there is no guarantee it will happen again. Taxpayers contemplating charitable gifts who also have to take a distribution from their IRA should consider the merits of combining these two items.

² Expenses in this category include, but are not limited to, investment expenses, tax preparation fees, unreimbursed business expenses and safety deposit box rental.

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