Top 10 Rules to Know About Qualified Charitable Distributions

For IRA owners interested in donating to charity this holiday season, a qualified charitable distribution from an IRA may be an option. These 10 rules outline how a QCD should be done to benefit an eligible charity, with a favorable tax outcome for the client before year-end.

For nonprofit organizations, the “giving season” is the last few months of the year. Donors give 24% of their total annual donations between Thanksgiving and New Year’s Day, and 42.7% of high-net-worth donors give more donations between October and December than the rest of the year, the National Center for Charitable Statistics reports. Your clients with IRAs will likely make qualified charitable distributions (QCD) from their IRAs as it gets closer to the end of the year.

QCDs can be a favorable way to make donations from retirement assets to charities because a distribution that meets the requirements as a QCD is excluded from gross income (nontaxable). So here are 10 features and requirements that apply to QCDs, as listed below.

1. QCDs have a dollar limit

An individual can make a QCD of up to $100,000 for a calendar year. For married couples, each spouse is subject to a separate $100,000 limit, leading to a total of $200,000 for a married couple.

2. December 31 deadline

The distribution must be processed by the end of the year to be considered a QCD for the year. As a result, all distributions that are processed between January 1 and December 31 of a

calendar year can be treated as a QCD for that calendar year, as long as they meet other requirements.

3. A 70½ age minimum

The account owner must be at least age 70½ on the date the QCD is processed. According to the tax code, an individual reaches age 70½ six months after the date he or she turns age 70. Distributions processed before then are not eligible to be treated as QCDs.

4. They can only be made from IRAs

QCDs can only be made from IRAs, including inherited IRAs. An exception to this rule is that QCDs cannot be made from SEP and SIMPLE IRAs that are ongoing. A SEP or SIMPLE IRA is ongoing if an employer contribution is made for the plan year ending with or within the account owner's tax year in which the distribution is made.

If an individual wants to use amounts held in an employer-sponsored retirement plan, such as a pension, 401(k), or 403(b) plan, to make a QCD, that individual must first roll over the amount from the plan to an IRA. Then the QCD can be made from the IRA.

Of course, the amount must be eligible for rollover to be considered a valid rollover to the IRA. Amounts not eligible for rollover include required minimum distributions (RMDs). Therefore, any RMD due from the plan for the year must be distributed to the participant before the rollover contribution is made from the plan to the IRA.

5. QCDs must be made payable to the charity

A distribution made to the account owners is not eligible to be treated as a QCD. Instead, the distribution must be made payable to the charity. However, distributions made in the form of a check payable to the charity can be delivered to the IRA owner, who can then deliver the check to the charity. This must be the same check issued by the IRA custodian.

6. The charity must be 'eligible'

Only certain charities can receive QCDs. For this purpose, an eligible charity is one that meets the definition under Internal Revenue Code (IRC)170(b)(1)(A), other than an organization described in IRC 509(a)(3) or a donor-advised fund.

7. QCDs can be used to satisfy RMDs

A QCD can be used to satisfy the account owner's RMD that was not distributed before the QCD was processed. But any amount processed before the QCD is treated as an RMD up to the account owner's RMD due for the year, and is therefore not eligible for rollover.

Example 1: QCD is RMD

Jane's RMD for the year is $10,000. In the first week of December, Jane (age 74) submitted instructions to her IRA custodian to process a QCD for $20,000 from her IRA. At that time, Jane had not yet made any other distributions from her IRA for the year.

Even though the $20,000 is paid to the charity and not Jane, $10,000 of the $20,000 QCD is counted towards Jane's RMD for the year. As a result, Jane is not required to distribute any additional amount for the year for RMD purposes.

If Jane's QCD was for $8,000, she would need to distribute only $2,000 to satisfy her RMD ($8,000 QCD +$2,000 regular distribution= $10,000 RMD).

Example 2: QCD is not RMD, and RMD is not eligible for rollover

Tom's RMD for the year is $10,000. During the first week of December, Tom (age 75) instructed his IRA custodian to process a QCD for $20,000. He had already distributed $10,000 during the last week of November.

When Tom heard that a QCD can be used to satisfy an RMD, he wanted to roll over the $10,000 that he distributed in November. However, the amount was not eligible for rollover because the first distribution made during an RMD year goes toward satisfying the account owner's RMD until the RMD is satisfied, which means that the $10,000 distributed in November is Tom's RMD. Had Tom taken that $10,000 distribution after the QCD was processed, the amount would have been eligible for rollover.

8. QCDs are not subject to the pro-rata rule

Generally, an IRA distribution includes a prorated amount of pretax and after-tax funds, if the individual's IRA balance includes basis amounts. Basis amounts come from nondeductible contributions and rollovers of after-tax amounts from employer-sponsored retirement plans.

For example, assume that an individual has one traditional IRA with the balance of $100,000, and $20,000 of that represents basis. If that individual takes a distribution of $80,000 from the traditional IRA, the pro-rata rule would apply as follows: $64,000 of pretax assets would be taxable and $16,000 of after-tax assets which would be nontaxable, leaving a balance of $20,000. The pretax amount would be $16,000 and the basis would be $4,000.

One of the exceptions to this pro rata rule is a QCD. Under this exception, a QCD is deemed to come first from the taxable amount. Using the example above, if the $80,000 distribution is a QCD, then that entire amount would be attributed to the pretax balance, albeit nontaxable because it is a QCD. As a result, the remaining $20,000 would represent basis.

Note: All of an individual's traditional, SEP, and SIMPLE IRAs are aggregated and treated as one for this purpose.

9. They are not subject to tax withholding

Unless an exception applies, IRA distributions are subject to income tax withholding. Under the withholding requirements, an IRA owner can request to have 10% or more withheld for federal income taxes plus any state tax. If an individual fails to make a tax withholding election, the IRA custodian/trustee is required to withhold 10% for federal income taxes.

One of the exceptions to this withholding rule is a QCD. Therefore, whether or not the IRA owner makes a withholding election, the IRA custodian must not perform any tax withholding on a QCD.

10. QCDs are reported as regular distributions

IRA custodians/trustees are required to report QCDs as regular distributions. Despite the fact that a QCD is nontaxable, the IRA custodian must report a QCD from a traditional IRA as a taxable distribution on IRS Form 1099-R as follows:

- Report the entire amount in Box 1: Gross distribution
- Report the entire amount in Box 2a: Taxable amount
- Check Box 2b: Taxable amount not determined

The IRA owner's tax preparer is responsible for reporting the QCD as a nontaxable distribution on the IRA owner's return 1040, and must follow the instructions for reporting a QCD on Line 15a and Line 15b of Form 1040.

For example, assume that Jane has a traditional IRA with a balance of $100,000, which is entirely pretax. If Jane takes a distribution of $50,000 from her traditional IRA, the amount must be reported on Line 15a (IRA distributions) of Form 1040.

If the distribution is not a QCD and does not qualify for any other exception that allows the amount to be excluded from income, Jane's tax preparer must report the entire $50,000 on Line 15b (taxable amount). If the amount qualifies to be a QCD, Jane's tax preparer must input -0- on Line 15b, and enter 'QCD' next to line 15b.

An IRA owner who submits a distribution request that is intended to be a QCD should notify the IRA custodian of his or her intention. This will help the IRA custodian to ensure that the amount satisfies the QCD requirement, including that amount that is made payable to the charity.

However, it is the IRA owner's responsibility to ensure that the charity meets the requirement for being an eligible charity under the QCD rules. In addition, the IRA owner must ensure that the age 70½ requirement has been met before the QCD is processed.

A CPA should determine suitability

IRA owners who are considering a QCD should consult with a tax professional about whether or not it is the most suitable option for making a donation. A CPA should also be able to determine if it makes better tax sense to donate other assets.

Checks and balances are recommended

If a distribution is made from an IRA to a charity, and it is determined that the distribution does not satisfy all the requirements to be treated as a QCD, then the amount would be treated as a regular distribution to the IRA owner and included in the IRA owner's gross income.

Also, while an individual cannot claim a charitable contribution deduction for any QCD not included in income, an amount that does not meet the QCD requirements but is paid to a charity would be treated as a regular donation to which the general rules and percentage limits would apply.

To help ensure that clients' QCDs meet all the requirements, encourage them to contact you for assistance with their requests.

This article is written by Denise Appleby, APA, CISP, CRC, CRPS, CRSP, produced by Horsesmouth LLC, and provided to you as a courtesy by your representative. Horsesmouth, LLC is not an affiliate of Cetera Advisor Networks, LLC.

Clelan and Company, 210 Grandview Avenue, Suite 101, Camp Hill, PA 17011
(717) 761-4633, www.clelan.com, financialpro@clelan.com