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COROMANDEL WEALTH MANAGEMENT

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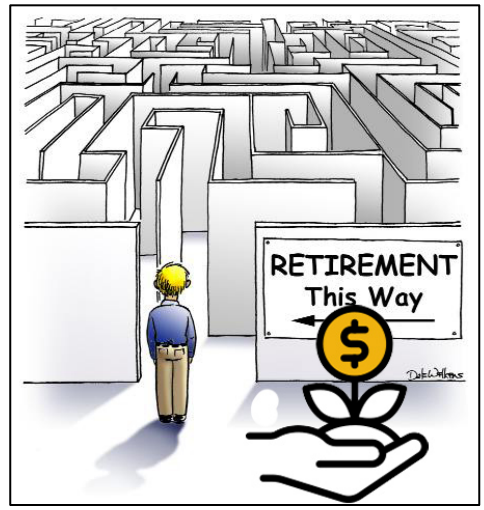
Feeling charitable? Use QCDs ASAP

Navigating the Retirement Maze



"Service to others is the rent you pay for your room here on earth."

- *Muhammad Ali, American professional boxer, activist, and philanthropist (1942 – 2016)*

When we were young, we learned that we should help others who were less fortunate than us. As adults, we have grown accustomed to gifting to charitable organizations and then receiving a tax benefit. The Tax Cuts and Jobs Act changed that, making it more difficult to take charitable deductions. I counsel my clients on the best ways to be tax-efficient in their giving, usually at the end of the year. But there is one charitable giving strategy that is best done early in the year rather than later. Qualified Charitable Distributions, or QCDs, are one of the best ways to be charitable and maximize your tax benefit. However, QCDs need to be executed correctly to get this tax advantage, which requires some explanation.

TCJA's impact on giving

The Tax Cuts and Jobs Act of 2017 (TCJA) includes provisions that constrain the ability to claim itemized tax deductions on Schedule A of the Federal tax return. First, it nearly doubled the standard deduction. That increases the threshold for itemizing, as the higher of either the standard or itemized deduction is taken. Second, it eliminated Miscellaneous Deductions and put a cap of $10,000 on the State and Local Taxes (SALT) deduction. It left intact charitable donations, mortgage interest, and medical expenses above 7.5 percent of adjusted gross income (AGI). For those who have already paid off their home mortgages and do not have high out-of-pocket medical expenses, deducting charitable donations can be a challenge.

For example, retired couples over the age of 65 have a standard deduction of $27,800 in 2021. If they have no mortgage and low out-of-pocket medical expenses and take the maximum $10,000 in property tax (SALT) deductions, the only remaining itemized deduction is Gifts to Charity. In this situation, the first $17,800 of charitable donations is not deductible. If they are in the 22 percent marginal tax bracket, that amounts to losing a $3,916 tax reduction. No wonder charities were not happy with the TCJA. (Note: The CARES Act of 2020 does allow deductions of up to $300 even if you take the standard deduction, but that goes away in 2021.)

QCDs to the rescue

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 provided a method for many to get around the charitable donation restrictions of the TCJA. It created Qualified Charitable Distributions, where those 70½ and older can gift to charities directly from their IRAs. Although there is no direct tax deduction for a QCD, it uses financial assets that will eventually be taxed at the Ordinary Income rate when withdrawn. Effectively, it avoids a future tax bill by gifting tax-deferred assets instead of taxable ones that may not be deductible.

There is a bonus with QCDs for those who must take required minimum distributions (RMDs) from their retirement accounts. Each dollar gifted with a QCD is one less RMD taxable dollar that must come out of IRAs. Provided you do not need RMD withdrawals for living expenses, you can gift up to the amount of your annual RMD and eliminate that much taxable income. But you need to adhere to the guidelines for QCDs to use them to your advantage.

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Caveat donor

A key provision governing the use of QCDs – and the reason that they are best taken early in the year – is the RMD "First dollars out" rule. It states that the first withdrawals from an IRA each year count towards satisfying the annual RMD requirement. If those dollars are used for a QCD, they reduce the remaining RMD balance. If the first withdrawals are in cash, that is taxable income and subsequent QCDs cannot be used to offset them. Thus, QCDs should be taken out each year before withdrawing any cash to satisfy RMDs.

A few other important QCD rules to follow:

- Payments must be made directly from the IRA to charities. If it comes out in cash, it is taxable income.
- Only domestic 501(c)(3) organizations and religious institutions qualify. You cannot use QCDs for Donor Advised Fund (DAFs) such as Fidelity Charitable or Vanguard Charitable, or with private foundations.
- There is a maximum of $100,000 per person per year. Spouses can each gift $100,000 per year.
- QCDs can only be made from IRAs. They cannot be used with employer plans such as 401(k)s or 403(b)s.
- Do not use Roth IRAs for QCDs. This might seem obvious, but it is "tax-inefficient" to use tax-free assets when you have tax-deferred ones available.
- QCDs above the RMD do not carry over to subsequent years to reduce future RMDs.

One last caution. Although IRA contributions can now be made at any age if you have qualified income, any tax-deferred IRA contributions after age 70½ will reduce the amount of QCDs excludable from taxation, effectively making part of the QCD taxable. This applies both forward and backward in time. Thus, do not make any IRA contributions after age 70½ if you intend to eventually make QCDs. Instead, contribute to Roth IRAs.

Tax-efficient giving

For those who can use QCDs, particularly those with RMDs, they are clearly superior to cash donations itemized on Schedule A. Is a QCD better than donating appreciated securities, another tax-efficient approach to charitable giving? Donated securities avoid long-term capital gain taxes, though you still need to exceed the standard deduction threshold to deduct them, which is not an issue for QCDs. Also, appreciated securities are best bequeathed to heirs because of the inheritance step-up in basis, thus going to your heirs free of capital gains tax. As inherited IRAs now must be emptied within 10 years of the donor's death, it is better to have your heirs receive appreciated securities rather than tax-deferred IRAs.

QCDs can reduce taxable RMD income, and thus lower adjusted gross income (AGI) and modified adjusted gross income (MAGI), two figures that affect various tax deductions, credits, and surcharges. Potential benefits of reducing MAGI/AGI include decreasing or eliminating the Medicare surtax (IRMAA) and investment surtax (NIIT), the ability to take medical deductions, reducing the marginal tax rate, and the deductibility of rental real estate losses. All good, tax-wise.

So, when being charitable, use the tax laws to your best advantage. Give generously, but do so tax-efficiently.

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