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Making Charitable Donations from Your IRA

For those 70-1/2 and older, how to take advantage of this tax deal

By BILL BISCHOFF


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If you've reached 70-1/2, you can make cash donations to Internal Revenue Service-approved charities directly out of your traditional IRA. This can be a tax-smart opportunity, but it will expire at the end of this year unless Congress acts. Here's what you need to know.

Qualified Charitable Distribution Basics

So-called qualified charitable distributions (QCDs) come out of your traditional IRA free of any federal income hit. In contrast, other IRA distributions are taxable. Unlike garden-variety cash donations to charities, you can't claim itemized deductions for QCDs. That's OK, because the tax-free treatment of QCDs equates to a 100% deduction (because you will never be taxed on those amounts) without having to worry about restrictions that apply to itemized charitable write-offs.

If you inherited an IRA from the original account owner, you too can do the QCD drill if you have reached 70-1/2.

A QCD must meet all of the following tax-law requirements.

1. It must be distributed from an IRA, and it cannot occur before you, as the IRA owner or beneficiary, are 70-1/2.

3. It must be distributed directly by the IRA trustee to an eligible IRS-approved charity. (The list of such organizations can be found here.) A distribution check issued by the trustee and made payable to an eligible charity meets the preceding requirement even if you handle the check on its way to the charity. However, when a distribution check is made out to you personally, it cannot be a QCD no matter how you handle it.

4. It must meet the normal tax-law requirements for a 100% deductible charitable donation. Beware of this rule: If you receive any benefits that would be subtracted from a donation under the normal charitable deduction rules, such as tickets to an event, the distribution cannot be a QCD.

5. It must be a distribution that would otherwise be taxable. A Roth IRA distribution can meet this requirement if it's not a qualified (meaning tax-free) distribution. However, making QCDs out of Roth IRAs is generally inadvisable for reasons I'll explain later.

$100,000 Limit Applies

There's a $100,000 limit on total QCDs for any one year. But if both you and your spouse have IRAs, each of you is entitled to a separate $100,000 limit, for a combined total of $200,000, even if you file jointly.

Income and Estate Tax Advantages

The QCD strategy has at least four potential tax-saving elements.

First: QCDs are not included in your adjusted gross income (AGI). This lowers the odds that you will be affected by various unfavorable AGI-based rules -- such as those that can cause more of your Social Security benefits to be taxed and less of your rental estate losses to be deductible. Also, QCDs are exempt from the rule that says your itemized charitable write-offs for the year cannot exceed 50% of AGI (any excess donations are carried forward for up to five years).

Second: A QCD from a traditional IRA counts as a distribution for purposes of the required minimum distribution rules. Therefore, you can arrange to donate all or part of your 2011 required minimum distribution amount (up to the $100,000 limit) that you would otherwise be forced to receive and pay taxes on.

Third: Say you own one or more traditional IRAs to which you have made nondeductible contributions over the years. Your IRA balances consist partly of a taxable layer (from deductible contributions and account earnings) and partly of a nontaxable layer (from those nondeductible contributions). Any QCDs are treated as coming straight from the taxable layer. Any nontaxable amounts are left behind in your IRA(s). Later on, those nontaxable amounts can be withdrawn tax-free by you or your heirs.

Fourth: QCDs reduce your taxable estate.

Are You a Good Candidate?

If you can afford to donate IRA money, you can benefit tax-wise if you match one or more of the following profiles.

1. You don't itemize deductions (under the normal rules only itemizers get any income tax benefit from charitable donations).

2. You itemize, but your charitable donation deductions would be delayed by the 50%-of-AGI restriction.

3. You want to avoid being taxed on the required minimum distribution amount that you must take from your IRA this year.

4. You are looking for a quick and easy estate tax-reduction strategy.

Should You Consider Making QCDs from a Roth IRA?

Generally, the answer is no. Why? Because you and/or your heirs can take federal-income-tax-free Roth IRA withdrawals after at least one Roth account owned by you has been open for at least five years. Also, for original account owners (as opposed to beneficiaries), Roth IRAs are not subject to the required minimum distribution rules until after you pass on. Because the tax rules for Roth IRAs are so favorable, it's generally best to leave Roth balances untouched for as long as possible rather than taking money out for QCDs.