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New Law Provides Certainty for Charitable Distributions from IRAs

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The Protecting Americans From Tax Hikes Act of 2015 (PATH) provides long-awaited certainty for taxpayers that make charitable contributions from IRAs. The new law became effective December 18, 2015. It made permanent the IRA charitable rollover provision that allows taxpayers to exclude up to $100,000 from gross income for "qualified charitable contributions" from an IRA.

Background

Taxpayers with IRAs must withdraw required minimum distributions (RMDs) annually. RMDs begin when the taxpayer reaches 70 ½ years of age or, if later, the year in which he or she retires. The taxpayer must withdraw the RMD—and pay the corresponding income tax—regardless of whether the taxpayer needs the RMD for financial support.

For taxpayers that do not need their IRAs for financial support, the mandatory RMDs create unneeded taxable income. To avoid recognizing this income, charitable taxpayers can make contributions to qualified charities and receive a charitable deduction. In theory, a charitable contribution in an amount equal to the RMD should create a charitable deduction to offset the income recognized because of the RMD. But in practice, the charitable deduction does not perfectly offset the taxable income.

There are several reasons why charitable contributions in amounts that equal a taxpayer's RMDs do not fully offset the income tax on the RMDs. The income from the RMDs is counted "above the line" and increases the taxpayer's adjusted gross income. This can have a ripple effect across many deductions and tax credits. In contrast, the charitable deduction is a "below the line" deduction that is only available for taxpayers that itemize deductions. The amount of the deduction may be also reduced by the charitable deduction limits. Taken together, these rules often result in a mismatch between the income from the RMD and the deduction from the charitable contribution.

The Pension Protection Act of 2006

The Pension Protection Act of 2006 introduced a new charitable rollover provision, codified at Internal Revenue Code Section 408(d)(8). Under Section 408(d)(8), individuals age 70½ or over may exclude up to $100,000 from gross income for donations paid directly from their IRA to a qualified charity. Because Section 408(d)(8) provides an exclusion—and not just a charitable deduction—it results in a dollar-for-dollar offset between the RMD distributed to charity and the income that the taxpayer must recognize.

Section 408(d)(8) allows "qualified charitable distributions" from IRAs to satisfy the required minimum distribution requirements. A "qualified charitable distribution" must meet these requirements:

1. **The Distribution Must be from an IRA.** The distribution must be made to a traditional or Roth IRA. Other types of retirement accounts—including ongoing SEPs, ongoing SIMPLE IRAs, and 401(k) and 403(b) plans—cannot make qualified charitable distributions. But taxpayers may take advantage of the IRA rollover rules to transfer funds from a non-qualifying retirement plan into an IRA, then make the distribution from the IRA.

2. **The Distribution Must be to Public Charity.** The distribution must be made to a "public charity" described in Section 170(b)(1)(A). This broad category includes churches, hospitals, museums, and educational institutions. But distributions to other types of organizations—such as donor-advised funds and supporting organizations—do not qualify, even if they are associated with public charities.

3. **The IRA Account Holder Must be at Least 70 1/2 Years Old.** If the donor has not reached age 70 1/2, the distribution is not a qualified charitable distribution.

4. **The Distribution Must Be Directly to the Charity.** The funds must flow directly from the IRA to the charity. If the funds are paid to the IRA account holder and endorsed to the charity, the distribution is not a qualified charitable distribution.

5. **The Distribution Must Be Deductible as a Charitable Contribution.** If the entire distribution would not qualify under the ordinary charitable deduction rules, it may not be excluded as a qualified charitable distribution. This could happen if the donor received a benefit for the contribution and the benefit is not disregarded under Section 170. In that scenario, no portion of the distribution is a qualified charitable distribution.

6. **The Distribution Must be Otherwise Includable in Gross Income.** If any portion of a distribution would not be taxable if it was received by the taxpayer, that portion will not be excluded from the taxpayer's income if it is transferred to a charity. This could happen if a distribution from a Roth IRA (which would generally not be taxable) is made directly to a charity. Only the taxable portion of a charitable distribution will qualify for exclusion.

When the IRA makes a qualified charitable distribution, it is meets the RMD requirement to the same extent it would if the distribution were made to the account holder. This allows the donor to contribute the entire RMD to charity with no recognition of taxable income. If the distribution does not qualify as a qualified charitable distribution, it is treated as though it were distributed to the owner, then donated to the charity under the ordinary charitable deduction rules.

The Protecting Americans From Tax Hikes Act of 2015

Section 408(d)(8) was originally enacted as a two-year temporary measure. Since its enactment in 2006, Congress has extended the charitable rollover provision in increments. But the extensions always came late in the year, after the provision had expired, and were applied retroactively to the prior expiration date. The most recent extension applied through December 31, 2014. Throughout most of 2015, taxpayers and planners were uncertain whether the charitable rollover would be available for 2015 and later years.

PATH was enacted on December 18, 2015. It indefinitely extended the charitable IRA rollover and made it retroactive to January 1, 2015. Taxpayers who want to use Section 408(d)(8) to make charitable contributions in 2015 must make charitable distributions from the IRA by December 31, 2015. This provides a very limited window for 2015 planning. But because Section 408(d)(8) is now permanent, taxpayers now have certainty about charitable distributions from IRAs in 2016 and beyond.