Giving IRA Funds to Charity

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A unique tax-saving strategy for retirees has been revived by the American Taxpayer Relief Act of 2012 (ATRA). The new law allows you to contribute to charities by transferring funds directly from your IRA. This provision had technically expired after 2011, but ATRA extends it through 2013, retroactive to the 2012 tax year.

Background: Generally, you can deduct the full amount of cash donations made to a qualified charitable organization, within generous limits. However, distributions from an IRA are taxed at ordinary income rates. Beginning in 2013, the top tax rate on ordinary income jumps from 35% to 39.6%. In addition, many itemized deductions—including deductions for charitable donations—are reduced for certain high-income taxpayers.

This combination of tax law changes provides a disincentive for wealthier individuals to withdraw funds from an IRA to give to charity. For instance, if you take an IRA distribution and turn around and donate the funds, you'll be taxed at a high tax rate, while your charitable deduction may be reduced.

However, under ATRA, if an individual age 70½ or older transfers funds directly from an IRA to charity, there is no tax on the distribution. The annual limit for tax-free withdrawals is $100,000 ($200,000 for a married couple). On the downside, you are not entitled to a charitable deduction. In effect, it is a "tax wash."

So what have you accomplished from a tax perspective? Consider the following:

- Because the charitable distribution is not realized as taxable income, your adjusted gross income (AGI) is reduced for other tax purposes. For instance, this may increase deductions for medical expenses, miscellaneous expenses or casualty losses.
- Deductions for charitable donations may be reduced by annual limits based on your AGI. The direct IRA-to-charity transfer is exempt from these limits.
- If you are carrying over a charitable deduction from the previous year due to one of the annual AGI limits, you can receive the full benefit of the deduction this year. Otherwise, the regular charitable limits are applied before the carryover is allowed.
- Normally, an IRA withdrawal will result in taxable income that could increase the tax on Social Security retirement benefits. The transfer does not boost taxable income for this tax computation.

- The distribution counts as a required minimum distribution (RMD). In other words, if you simply designate the RMD amount as a charitable contribution, you have complied with the law. There is no requirement to withdraw any other funds.

This tax-planning technique works with a Roth IRA as well as a traditional IRA, but it may not be as advantageous. Reason: Qualified distributions from a Roth in existence at least five years are already tax-free. In the usual situation, it makes more sense to use a traditional IRA for this purpose.

The IRS allowed retirees who made transfers in January 2013 to treat the contributions as having been made in either 2012 or 2013. Otherwise, transfers made at any other time this year are treated as having been made in 2013. Reminder: This provision is scheduled to expire again on December 31.

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