Should Charitable Taxpayers Donate Directly from an IRA or Donate Appreciated Securities?

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Executive Summary

- This paper analyzes and compares alternatives for a qualifying taxpayer making charitable contributions either through qualified charitable distributions from an IRA or by donating appreciated securities.
- Making a qualified charitable distribution from an IRA was generally found to be the tax-preferred method of contributing; however, donating appreciated securities may result in more tax savings in some cases.
- Specifically, for taxpayers who do not itemize deductions, qualified charitable distributions save more tax than donating appreciated securities.
- For taxpayers who do itemize deductions, a qualified charitable distribution can save more tax than donating appreciated securities if the taxpayer's long-term capital gain tax rate is 0 percent.
- For taxpayers who do itemize, donating appreciated securities generally saves more income tax than making qualified charitable distributions if the taxpayer's long-term capital gain tax rate is 15 percent or higher and the maximum Social Security benefits are included in income.

Individuals who wish to make charitable contributions—and who hold appreciated securities—have a few tax-attractive ways of doing so. One is to donate the appreciated securities directly to the charity. Another is to make contributions directly to the charity from the taxpayer's individual retirement account (IRA), called a "qualified charitable distribution" or QCD, which has specific requirements in order to be allowable.

This paper compares a QCD to donating the appreciated securities (referred to throughout this paper as DAS). A QCD can reduce required minimum distributions (RMDs) from IRAs for the year and, therefore, reduce taxable income compared to taking an IRA distribution. DAS, in contrast, results in the appreciation (gain) not being taxed. This saves income tax if the individual's taxable income is above the amount allowing the 0 percent long-term capital gain tax rate (in 2019 with single filing status and taxable income exceeds $39,375, or married filing jointly and taxable income exceeds $78,750). DAS also increases itemized deductions, saving tax if the individual's total amount exceeds their standard deduction. This occurs for 2019 if age 65 or over and single, and total itemized deductions exceed $13,850 (for married filing jointly, if both spouses are age 65 or over and total itemized deductions exceed $27,000).

Next is an overview of the changed "playing field" for charitable contributions after 2017. This is followed by the legal background and requirements for the two alternatives. After that is a discussion of the decision facing the taxpayer, a comparison of the alternatives, and finally a discussion of bequeathing appreciated securities to heirs.

Changes for Charitable Contributions after 2017

The landscape for tax savings from charitable contributions has changed significantly after the Tax Cuts and Jobs

Act of 2017.[1] Fewer individual taxpayers' donations are saving taxes at the same level as before 2018. The reasons include almost doubling the standard deduction, limiting taxes paid that are itemized deductions to $10,000 (regardless of filing status), and the elimination of "miscellaneous" itemized deductions in excess of 2 percent of adjusted gross income (AGI). As a result, far fewer individuals are itemizing deductions, which saves tax on donations to charity.

Gardner and Brannon (2018) suggested tax-saving strategies for clients given the changed landscape: DAS and/or make a QCD regardless of whether an individual itemizes deductions; and bunching cash donations to charity, possibly by using a donor advised fund, for individuals who itemize deductions only after giving to charity.[2] These suggestions warrant further investigation. The bunching strategy is tax-efficient for clients when it causes total itemized deductions to exceed the standard deduction. The more years that can be bunched together, the greater the effect.

The benefits of a QCD are well established (Kitces 2017; Gardner and Daff 2017; and Reichenstein, Cook, and Harelik 2016). QCDs always save income tax for a taxpayer with positive taxable income. In contrast, DAS sometimes results in no tax benefits (i.e., the taxpayer is not itemizing and faces the 0 percent long-term capital gain rate). Sometimes DAS results in one tax benefit (i.e., either excluding the long-term capital gain from income or causing itemized deductions to exceed the standard deduction). At other times, DAS results in two tax benefits (i.e., the long-term capital gain rate is 15 percent or higher and the taxpayer itemizes deductions). Whether a QCD or DAS saves more income tax is the subject of this analysis.[3]

Legal Background and Requirements

Qualified charitable distributions from an IRA. The general rule for QCDs provides that the QCD amount is excluded from income and the maximum is limited to $100,000 per tax year. QCDs are allowed from IRAs that are not SEP-IRAs or SIMPLE-IRAs.

The distribution must be made directly by the IRA trustee to the qualifying charity. The account owner must be at least 70½ years old and the amount would have been included in income were it not a QCD. Also, the whole QCD must have been allowable as a charitable deduction under the itemized deduction rules. To prevent a double benefit, the amount of the QCD is *not* also allowed as a charitable itemized deduction.[4] In contrast, donating appreciated securities to a qualifying charity can allow for a double tax benefit.

Donating appreciated securities. An individual holding appreciated securities outside of an IRA has two basic ways of contributing the stock. First, the taxpayer could sell the stock for cash, resulting in tax on the capital gain recognized, followed by a cash contribution to the charity, limited to 60 percent (through 2025) of the contribution base for that year. The remainder carries over for up to five years.[5]

Second, the taxpayer could donate appreciated securities held greater than one year directly to the charity. In this case, the gain is not taxed, and the maximum amount deductible is 30 percent of the contribution base for that year (20 percent for DAS to private foundations).

Figure 1: Individual Federal Income Tax Calculation

Gross Income
– "Above-the-Line" Deductions
= Adjusted Gross Income (AGI)
– Greater of Standard Deduction or Itemized Deductions
– Qualified Business Income Deduction*
= Taxable Income (TI)
× Tax Rate(s)
= **Federal Income Tax**

*Generally, only allowed for some taxpayers with qualifying business income (i.e., from an S corporation, partnership, and/or sole proprietorship).

In either of these cases, the result is an itemized deduction. An individual's contribution base is generally defined as his or her AGI.[6] If the taxpayer avoids any long-term capital gain tax, then they are better off by donating appreciated securities rather than selling the stock and donating the after-tax cash.

Decision Facing the Taxpayer

Assuming an individual making charitable contributions has both an IRA containing appreciated stock and appreciated stock held directly, the decision at hand is if he or she should contribute via a QCD or contribute the directly held stock. An important factor is whether the individual itemizes. Those taking the standard deduction will not receive any tax savings from the donation being an itemized deduction. Figure 1 reviews the basic income tax calculation for individual taxpayers.

According to Tax Policy Center analyses, the number of itemizers with any charitable contribution deduction has decreased from about 25 percent of 1040 filers before 2017 to about 10 percent after 2017.[7] Even if the taxpayer does itemize, itemizing increases "from AGI" deductions, which does not reduce AGI. In contrast, a QCD is excluded from gross income, which does reduce AGI. A major advantage of the latter is potentially less Social Security benefits (SSB) being taxed, because SSB taxability is based on the amount of provisional

income, which is defined as the sum of:

AGI (without SSB or the student loan interest deduction) + 50% of SSB + tax-exempt income

Additional advantages of lowering AGI include a lower threshold for the disallowance of the medical category of itemized deductions, and less—or possibly no—phase-out of the $25,000 maximum rental real estate loss deduction for active participants.

Those over age 70½ with a traditional IRA must take an RMD from their IRA annually. This amount is taxable at ordinary income tax rates. The QCD can count against this RMD amount, up to the $100,000 maximum allowable QCD (potentially $200,000 if married filing jointly, consisting of $100,000 from each spouse's IRA).

In the case of individuals desiring to leave wealth to loved ones through their estate, and who wish to make charitable gifts before death, the QCD offers an additional advantage.[8] Amounts left to heirs in an IRA are considered income in respect of a decedent and do not receive a basis step-up. Thus, distributions from the inherited IRA will be taxed as ordinary income to the heir.

When donating appreciated securities, the long-term capital gain element is excluded from income.

Appreciated securities held directly, however, will receive a step-up in basis when inherited.[9] When the inherited securities are ultimately sold, the heir will typically only pay tax at the long-term capital gain rate on any post-inheritance appreciation.

Comparison of the Alternatives

Assume the taxpayer has positive taxable income (> $0) both before and after the donation, is over age 70½, has an IRA balance, and owns appreciated securities (i.e., fair market value above tax basis) both inside the IRA and outside of tax-advantaged accounts.

Specifically, assume the taxpayer bought $2,000 of stock more than one year ago and simultaneously contributed $2,000 after-tax dollars to their deductible, traditional IRA, investing it in the same stock. To be actuarially equivalent, assume a 12 percent tax rate at the time of the IRA contribution, so $2,273 before-tax dollars were contributed to the IRA ($2,273 before-tax dollars contributed – [$2,273 × 12%] [i.e., tax savings] = $2,000 after-tax dollars).

Next, assume the stock doubled in value since its purchase, so stock held outside the IRA is $4,000 and inside the IRA is $4,546 ($2,273 + $2,273). The alternative is the taxpayer will either: (1) donate $4,546 in the form of a QCD from the IRA; or (2) donate appreciated securities of $4,000, which have been held long-term, and make a QCD of $546. Under either alternative, the charity receives $4,546.

When donating appreciated securities, the long-term capital gain element is excluded from income. The taxpayer will receive a charitable contribution itemized deduction of $4,000, which will save federal income tax, if itemizing. These are the potential "double tax benefits" of DAS. In contrast, the QCD counts toward the taxpayer's RMD and is excluded from income, but there is no itemized deduction created.

To compare tax savings and cash flows from the alternatives—if and when the taxpayer needs funds from one of the investment sources—assume in the case of the QCD that the taxpayer also sells the $4,000 of directly held stock. In the case of DAS, assume the taxpayer also takes a $4,000 distribution from the IRA. This allows a determination of which strategy creates the greater after-tax cash flow.

Exploring Five Case Studies

The five cases analyzed in this paper demonstrate all possible scenarios for an individual with positive taxable income. The four factors impacting tax savings are: (1) Does the taxpayer itemize deductions? (2) If the taxpayer does itemize, is it only because of DAS? (3) Is the taxpayer's long-term capital gain tax rate 0 percent or at least 15 percent? (4) Is the maximum percentage (85 percent) of SSBs included in gross income, or is the percentage less (i.e., inside the Social Security tax torpedo)?

These four factors represent 16 possible scenarios encompassed in the five cases presented here. This paper shows that while donating appreciated securities can have double tax benefits, a QCD is often the preferred alternative.

Case 1: Taxpayer does not itemize deductions, even if donating appreciated securities. Assume the taxpayer does not itemize deductions even after DAS of $4,000. Because the taxpayer uses the standard deduction, the donation itself does not save any income tax even though the exclusion of the gain on the stock can save some income tax.

Here, the QCD always saves more tax because the tax savings from excluding the entire QCD from income is always greater than the tax savings from excluding the long-term capital gain related to the DAS. When making a QCD of $4,546, the $4,000 of stock is sold, and $2,000 long-term capital gain income is recognized since the stock's basis is also $2,000.

In contrast, when donating appreciated securities of $4,000 and making a QCD of $546, a $4,000 distribution from the IRA is included in gross income. Table 1 presents these results.

The QCD saves more tax for three reasons. First, the long-term capital gain amount is always smaller than the amount

Table 1: Case 1 Comparison (Does Not Itemize Deductions, Even After Donating Appreciated Securities)

Donating Appreciated Securities (DAS)		Qualified Charitable Distribution (QCD)	
RMD excluded from AGI	($546)*	RMD excluded from AGI	($4,546)
Long-term capital gain included in AGI on stock sale	$0	Long-term capital gain included in AGI on stock sale	$2,000
Additional itemized deductions	$0	Additional itemized deductions	$0
Net tax savings**	($66)	Net tax savings***	($545)

Notes: The tax rates are at the time of DAS or a QCD.
*Necessary for actuarially equivalent contributions at beginning of investment.
**Assumes a regular tax rate of 12% and a long-term capital gain rate of 0%. (–$546 × 0.12) tax savings on RMD = ($66).
***Assumes a regular tax rate of 12% and a long-term capital gain rate of 0%. (–$4,546 × 0.12) tax savings on RMD + ($2,000 × 0%) tax cost of the stock sale = ($545) + $0 = ($545).

of the IRA distribution due to positive basis in the securities. Second, the long-term capital gain tax rate is lower than the ordinary tax rate on the IRA distribution. Third, the taxpayer's "below-the-line" deductions do not increase when donating appreciated securities.

Case 2: Itemized deductions exceed standard deduction *only if* donating appreciated securities. Specifically, the long-term capital gain tax rate > 0 percent (equals from 15 percent to 23.8 percent); and maximum (85 percent) Social Security benefits are included in AGI (i.e., the taxpayer is *not* in the Social Security tax torpedo range).

In this case, the tax savings from the increase in itemized deductions due to DAS depends on how much below the standard deduction total itemized deductions were before DAS and the tax savings from the exclusion of appreciation (gain). The latter depends on both the amount of such exclusion and the long-term capital gain tax rate. So, whether a QCD or DAS saves more income tax depends on the combination of these factors.

Assume the same single taxpayer faces a 22 percent tax rate both this year and more than one year ago when $2,000 of stock was purchased, and at that time, $2,564 before-tax dollars were actually contributed to the IRA (note the actuarially equivalent amount has changed since the tax rate at the time of the contribution to the IRA; it is now assumed to be 22 percent rather than 12 percent). Assume the stock value doubles, so now the stock is worth $4,000 and the IRA contains $5,128 ($2,564 + $2,564). The taxpayer will either donate $5,128 via a QCD or DAS worth $4,000 (held long-term) and make a QCD of $1,128. In either case, the charity receives $5,128. Also assume that itemized deductions absent this donation total $13,500, and after DAS of $4,000 equal $17,500. In 2019 the standard deduction for a single taxpayer age 65 or over is $13,850.

The taxpayer who chooses the QCD option will take the standard deduction ($13,850) and make a QCD of $5,128 and sell the stock for $4,000. Selling the stock increases after-tax cash flow by $3,700 (stock sale of $4,000 – ($2,000 long-term capital gain × 15 percent)).

In contrast, the taxpayer DAS of $4,000, makes a QCD of $1,128, and takes an IRA distribution of $4,000. This increases total itemized deductions to $17,500 and after-tax cash flow increases by $3,923. So, DAS is more tax-efficient than the QCD by $223 ($3,923 – $3,700) because increasing itemized deductions above the standard deduction saved tax. Note that the first $350 of the donation did not save tax. Table 2 presents these results under the DAS-A and QCD columns.

Note that DAS includes $4,000 of income from the RMD, whereas the QCD includes only $2,000 of long-term capital gain income from the stock sale. Thus, DAS results in relatively higher AGI than the QCD, and sometimes this could lead to higher Medicare insurance premiums. If that occurs, DAS might no longer be more tax-efficient than the QCD (this possibility is investigated after Case 5).

Now assume other itemized deductions are $10,500. Nothing changes in the case of a QCD. In contrast, if the taxpayer donates appreciated securities of $4,000, makes a QCD of $1,128, and takes an IRA distribution of $4,000, this increases total itemized deductions to only $14,500 and after-tax cash flow increases by only $3,263. Here the QCD is more tax-efficient because increasing itemized deductions above the standard deduction saves little tax. This is demonstrated in Table 2 under the DAS-B and QCD columns.

To summarize, Case 2 has itemized deductions below the standard deduction if a QCD, and above the standard deduction if DAS. The breakeven point for DAS compared to a QCD is where the long-term capital gain amount from the directly held stock sale multiplied by the long-term capital gain tax rate equals the amount by which itemized deductions are below the standard deduction before DAS (and taking the IRA distribution), multiplied by the ordinary tax rate.

In this example where the stock has doubled in value, the long-term capital gain tax rate is 15 percent, and the ordinary tax rate is 22 percent, the breakeven point is calculated in the following manner: rearrange both tax rates to the same side of the equation so the $2,000 (long-term capital gain amount) × 15 percent

Table 2: Case 2 Comparison (Itemized Deductions Exceed Standard Deduction Only if Donating Appreciated Securities)

Assumptions for DAS-A: Itemized deductions $350 below standard deduction before DAS of $4,000.			
Assumptions for DAS-B: Itemized deductions $3,350 below standard deduction before DAS of $4,000.			
	DAS-A	**DAS-B**	**QCD**
RMD excluded from AGI	($1,128)*	($1,128)*	($5,128)
Long-term capital gain included in AGI on stock sale	$0	$0	$2,000
Additional itemized deductions	($3,650)	($650)	$0
Net tax savings	($1,051)**	($391)***	($828)****

Further Proof:				
	DAS-A	**DAS-B**		**QCD**
Cash inflow: RMD	$4,000	$4,000	Cash inflow: stock sale	$4,000
Cash outflow: tax increase (↑)			Cash outflow: tax increase	
RMD income – ↑ below-the-line deductions (A) $4,000 – $3,650 = $350 (B) $4,000 – $650 = $3,350			Long-term capital gain income: $4,000 – $2,000 = $2,000	
Tax at 22% rate	–$77	–$737	Tax at 15% rate	–$300
After-tax cash flow	$3,923	$3,263	After-tax cash flow	$3,700

Differences: DAS-A versus QCD: after-tax cash flow is $223 more if DAS; DAS-B versus QCD: after-tax cash flow is $437 more if QCD.

Notes: The tax rates are at the time of DAS or a QCD.
*Necessary for actuarially equivalent contributions at beginning of investment.
**Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$1,128 × 0.22) tax savings on RMD + (–$3,650 × 0.22) savings due to additional deductions = ($248) + ($803) = ($1,051).
***Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$1,128 × 0.22) tax savings on RMD + (–$650 × 0.22) savings due to additional deductions = ($248) + ($143) = ($391).
****Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$5,128×0.22) tax savings on RMD + ($2,000 × 0.15) tax cost of the stock sale = ($1,128) + $300 = ($828).

(long-term capital gain tax rate) / 22 percent ordinary rate = breakeven itemized deductions below the standard deduction.

In this case, the breakeven itemized deductions are $1,364 below the standard deduction before DAS (because $1,364 more taxable income multiplied by 22 percent increases tax by $300). Thus, if itemized deductions had been $12,486, then DAS (increasing itemized deductions by $4,000 to $16,486) and making a $1,128 QCD and taking a $4,000 IRA distribution would have increased after-tax cash flow by $3,700—as does the QCD.

Case 3: Itemized deductions exceed standard deduction with 0 percent long-term capital gain rate and in tax torpedo range. Specifically, the long-term capital gains tax rate = 0 percent, and the taxpayer is *in* the Social Security tax torpedo range (less than maximum [85 percent] SSBs are included in gross income).[10]

Because the taxpayers are over age 70½, assume they receive Social Security benefits. Approximately 10 million taxpayers have some (> 0 percent) but less than the maximum (< 85 percent) of their SSBs included in income (Geisler 2017). In such cases, strategies that reduce adjusted gross income, such as a QCD, can lead to an even lower amount of SSBs being taxed.

Assume the taxpayers' income places them in either the 10 percent, 12 percent, or the bottom portion of the 22 percent ordinary tax rate bracket (where SSBs being included in gross income is phasing in). The effective marginal federal tax rate on additional (non-SSB) ordinary income is either 15 percent (10 percent × 150 percent), 18 percent (12 percent × 150 percent), 22.2 percent (12 percent × 185 percent), or 40.7 percent (22 percent × 185 percent), because more non-SSB income causes more SSBs to be taxed.

This range of higher marginal tax rates is the Social Security tax torpedo. The 150 percent and 185 percent amounts come from more SSBs becoming income as non-SSB income increases, first at a 50 percent rate and later at an 85 percent rate. For a taxpayer in the SSB phase-in range, choosing a QCD will save more tax than DAS. Specifically, if taxable income in 2019 is less than $78,750 for those married filing jointly ($39,375 single), the net long-term capital gain amount included in taxable income is taxed at 0 percent. So, excluding the appreciation when donating appreciated securities saves no tax. The only potential tax savings from DAS is through increasing itemized deductions.

For a single taxpayer, assume ordinary income without considering SSBs is $22,000. Social Security benefits are $30,000, of which $7,050 are included in income; and itemized deductions are $15,000 before engaging in either DAS or making a QCD. The ordinary tax rate bracket is 12 percent (since taxable income is above $9,700, but not above $39,475). For simplicity, assume that more than one year ago when buying

Table 3: Case 3 Comparison (Itemized Deductions Exceed Standard Deduction; 0 Percent Long-Term Capital Gain Rate)

Assumptions: Entire $4,000 donated appreciated securities saves tax, long-term capital gain tax rate is 0 percent, and non-Social Security benefit income increases Social Security benefit income.

	DAS		QCD
RMD excluded from AGI	($546)*	RMD excluded from AGI	($4,546)
Long-term capital gain included in AGI on stock sale	$0	Long-term capital gain included in AGI on stock sale	$2,000
Social Security benefits added to income	$3,400	Social Security benefits added to income	$1,700
Additional itemized deductions	($4,000)	Additional itemized deductions	$0
Net tax savings	($138)**	Net tax savings	($342)***
Further Proof:			
	DAS		**QCD**
Cash inflow: RMD	$4,000	Cash inflow: stock sale	$4,000
Cash outflow: tax increase (↑)		Cash outflow: tax increase	
RMD income – ↑below-the-line deductions $4,000 – $4,000 = $0		Long-term capital gain income: $4,000 – $2,000 = $2,000 × 0% = $0	
Additional SSB income = $3,400		Additional SSB income = $1,700	
Tax at 12% rate	–$408	Tax at 12% rate	–$204
After-tax cash flow	$3,592	After-tax cash flow	$3,796
Difference: After-tax cash flow is $204 more if QCD.			

Notes: The tax rates are at the time of DAS or a QCD.
*Necessary for actuarially equivalent contributions at beginning of investment.
**Assumes a regular tax rate of 12% and a long-term capital gain rate of 0%. (–$546 × 0.12) tax savings on RMD + ($3,400 × 0.12) tax cost on SSBs + (–$4,000 × 0.12) due to the deductions = ($66) + $408 + ($480) = ($138).
***Assumes a regular tax rate of 12% and a long-term capital gain rate of 0%. (–$4,546 × 0.12) tax savings on RMD + ($2,000 × 0.0) tax cost of the stock sale + ($1,700 × 0.12) tax cost on SSBs = ($546) + $0 + $204 = ($342).

the stock and making the traditional IRA contribution, the taxpayer's tax rate was also 12 percent.

Recall that when making a QCD of $4,546, the $4,000 of stock is sold, and $2,000 long-term capital gain income is recognized. This long-term capital gain is taxed at a 0 percent rate, but it causes $1,700 more SSBs to be income. This results in $204 ($1,700 × 12 percent) more tax, so after-tax cash flow increases by $3,796 rather than the full $4,000.

In contrast, now assume DAS of $4,000, making a $546 QCD, and distributing $4,000 from the IRA. The QCD has no impact on income, and the IRA distribution income of $4,000 is offset by the increase in itemized deductions of the same amount. However, the additional $4,000 of income causes $3,400 more SSBs to be income, which results in $408 ($3,400 × 12 percent) more tax. After-tax cash flow increases by only $3,592. So, the QCD results in $204 ($3,796 – $3,592) more tax savings. This is demonstrated in Table 3.

While giving equal amounts to charity, the QCD makes the taxpayer wealthier than donating appreciated securities for a taxpayer over age 70½ whose taxable income is low enough that the long-term capital gain tax rate is 0 percent, and for whom any additional income triggers a higher percentage of SSBs subject to income tax. The QCD always "wins" in this case; however, the QCD will also always "win" in a different case—where itemized deductions exceed the standard deduction *only after* DAS, the long-term capital gain tax rate = 0 percent, and less than the maximum SSBs are included in income. Here, DAS will save even less tax, because tax benefits are absent until DAS brings itemized deductions above the standard deduction.

Case 4: Itemized deductions exceed standard deduction with 15 percent long-term capital gain rate and in tax torpedo range. Specifically, long-term capital gain tax rate = 15 percent; and the taxpayer is *in* the Social Security tax torpedo range.[11]

In this case, whether a QCD or DAS saves more income tax depends on the donated stock's tax basis. The higher the stock's basis, the lower the long-term capital gains on the directly held stock sale when the charitable donation is made only by a QCD. This lower income means that less SSBs are included in gross income.

Assume a single taxpayer whose ordinary income is $36,000 without considering SSBs; SSBs are $30,000, of which $18,950 (less than maximum of 85 percent) are included in income; and itemized deductions are $15,000 before engaging in either DAS or making a QCD. The ordinary tax rate bracket is 22 percent (because taxable income is above $39,475). For simplicity, also assume that it was more than one year ago when buying the stock and making the traditional IRA contribution that the taxpayer's tax rate was also 22 percent.

When making a QCD of $5,128, the $4,000 of stock is sold and $2,000 long-term capital gain is recognized.

Table 4: Case 4 Comparisons (Itemized Deductions Exceed Standard Deduction; 15 Percent Long-Term Capital Gain Rate)

Assumptions for QCD-A: Entire $4,000 DAS saves tax, long-term capital gain tax rate is 15%, and more non-SSB income increases SSB income.			
Assumptions for QCD-B: Same as QCD-A, except long-term capital gain on stock sale is $1,000 higher.			
	DAS	**QCD-A**	**QCD-B**
RMD excluded from AGI	($1,128)*	($5,128)	($5,128)
Long-term capital gain included in AGI on stock sale	$0	$2,000	$3,000
Social Security benefits added to income	$3,400	$1,700	$2,550
Additional itemized deductions	($4,000)	$0	$0
Net tax savings:	($380)**	($454)***	($117)****

Further Proof:				
	DAS		**QCD-A**	**QCD-B**
Cash inflow: RMD	$4,000	Cash inflow: stock sale	$4,000	$4,000
Cash outflow: tax increase		Cash outflow: tax increase		
RMD income – increase in below-the-line deductions:		Long-term capital gain income:		
$4K – $4K = $0 (K = ,000)		(A) $4K – $2K = $2K × 15%; (B) $4K – $1K = $3K × 15%	–$300	–$450
Additional SSB income = $3,400		Additional SSB income = (A) $1,700; (B) $2,550		
Tax at 22% rate	–$748	Tax at 22% rate	–$374	–$561
After-tax cash flow	$3,252	After-tax cash flow	$3,326	$2,989

Differences: DAS versus QCD-A: after-tax cash flow is $74 more if QCD-A; DAS versus QCD-B: after-tax cash flow is $263 more if DAS.

Notes: The tax rates are at the time of DAS or a QCD.
*Necessary for actuarially equivalent contributions at beginning of investment.
**Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$1,128 × 0.22) tax savings on RMD + ($3,400 × 0.22) tax cost on SSBs + (–$4,000 × 0.22) savings due to additional deductions = ($248) + $748 + ($880) = ($380).
***Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$5,128 × 0.22) tax savings on RMD + ($2,000 × 0.15) tax cost of the stock sale + ($1,700 × 0.22) tax cost on SSBs = ($1,128) + $300 + $374 = ($454).
****Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$5,128 × 0.22) tax savings on RMD + ($3,000 × 0.15) tax cost of the stock sale + ($2,550 × 0.22) tax cost on SSBs = ($1,128) + $450 + $561 = ($117).

This long-term capital gain is taxed at a 15 percent rate, and it causes $1,700 (85 percent of $2,000) more SSBs to be income. This results in $674 [($1,700 × 22 percent) + ($2,000 × 15 percent)] more federal income tax, so after-tax cash flow increases by $3,326 ($4,000 − $674).

In contrast, if donating appreciated securities of $4,000, making a $1,128 QCD, and distributing $4,000 from the IRA, the QCD has no impact on tax, and the IRA distribution is offset by the increase in total itemized deductions. However, the additional $4,000 of income causes $3,400 more SSBs to be taxed, which results in $748 ($3,400 × 22 percent) more income tax. So, after-tax cash flow increases by only $3,252. The QCD of $5,128 makes the taxpayer wealthier than DAS by $74 ($3,326 − $3,252). This is demonstrated in Table 4 under the DAS and QCD-A columns.

In contrast, a lower stock basis results in the DAS making the taxpayer wealthier. This occurs because in the QCD-only case, the lower basis means more long-term capital gain income from the stock sale and thus more SSBs are included in income.

Assume the previous facts except that the directly held stock's basis is $1,000, so the long-term capital gain on its sale is $3,000 when making a QCD. This long-term capital gain is taxed at a 15 percent rate and it also causes $2,550 (85 percent of $3,000) more SSBs to be income. This results in $1,011 [($2,550 × 22 percent) + ($3,000 × 15 percent)] federal income tax, so after-tax cash flow increases by only $2,989 ($4,000 − $1,011).

In contrast, if DAS of $4,000, making a $1,128 QCD, and distributing $4,000 from the IRA, the increase in after-tax cash flow is the same as in the prior example: $3,252. Donating appreciated securities, thus, makes the taxpayer wealthier by $263 ($3,252 − $2,989). This is also demonstrated in Table 4 under the DAS and QCD-B columns.

The breakeven point is when 85 percent of the additional IRA distribution (I) multiplied by the ordinary tax rate (22 percent) equals the combination of the long-term capital gain income (L) multiplied by the long-term capital gain tax rate (15 percent) plus 85 percent of L (which represents the increase in SSBs being taxed) multiplied by the ordinary tax rate (22 percent). In simplified form:

$$85\% \times I \times 22\% = (L \times 15\%) + (85\% \times L \times 22\%)$$
$$18.7\% \times I = 33.7\% \times L$$
$$(0.187/0.337) \times I = L$$

Table 5: Case 5 Comparison (Itemized Deductions Exceed Standard Deduction; Above Tax Torpedo)

Assumptions: Entire $4,000 DAS saves tax, long-term capital gain tax rate is 15%, and more non-SSB income does not increase SSB income.

	DAS	QCD
RMD excluded from AGI	($1,128)*	($5,128)
Long-term capital gain included in AGI on stock sale	$0	$2,000
Social Security benefits added to income	$0	$0
Additional itemized deductions	($4,000)	$0
Net tax savings	($1,128)**	($828)***

Further Proof:

	DAS		QCD
Cash inflow: RMD	$4,000	Cash inflow: stock sale	$4,000
Cash outflow: tax increase (↑)		Cash outflow: tax increase (↑)	
RMD income – ↑ below-the-line deductions: $4,000 – $4,000 = $0		Long-term capital gain income: $4,000 – $2,000 = $2,000	
Tax at 22% rate =	–$0	Tax at 15% rate =	–$300
After-tax cash flow	$4,000	After-tax cash flow	$3,700

Difference: After-tax cash flow is $300 more if DAS.

Notes: The tax rates are at the time of DAS or a QCD.
*Necessary for actuarially equivalent contributions at beginning of investment.
**Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$1,128 × 0.22) tax savings on the RMD + (–$4,000 × 0.22) savings due to additional deductions = ($248) + ($880) = ($1,128).
***Assumes a regular tax rate of 22% and a long-term capital gain rate of 15%. (–$5,128 × 0.22) tax savings on RMD + ($2,000 × 0.15) tax cost of the stock sale = ($1,128) + $300 = ($828).

Assuming the additional IRA distribution (I) is $4,000, long-term capital gain income (L) equals $2,220 ((0.187/0.337) × $4,000), according to this simplified formula. The breakeven point between a QCD and DAS is a tax basis of $1,780 ($4,000 − $2,220) in the stock. To prove this is correct, if long-term capital gain income is $2,220, it triggers additional federal income tax (at a 15 percent rate) of $333, and triggers $1,887 ($2,220 × 85 percent) of SSBs to be included in income, which triggers additional tax ($1,887 × 22 percent rate) of $415.

The total additional federal income tax equals $748 ($333 + $415), so after-tax cash flow increases by $3,252 ($4,000 − $748) in the case of the QCD of $5,128; the same as DAS. Therefore, whether a QCD or DAS saves more income tax depends on the tax basis of the stock donated when itemized deductions are already above the standard deduction, the long-term capital gain rate is 15 percent, and SSBs are still being phased into gross income.

Next, consider the same case with one difference: that itemized deductions exceed the standard deduction *only after* DAS (all other factors are the same). Now DAS will save less tax because until the donation increases itemized deductions above the standard deduction, no tax is saved. It is still possible that DAS will save more income tax overall—it depends on both the stock's tax basis relative to current value and how far itemized deductions are below the standard deduction before DAS.

Assume the same facts as in Table 4 except itemized deductions are slightly below the standard deduction before DAS. Donating appreciated securities will still save more income tax, although less than the $263 savings when compared to QCD-B. However, if instead itemized deductions are well below the standard deduction before DAS, DAS will not save more income tax than a QCD.

The specific facts must be compared doing after-tax cash flow analysis. Such analysis for QCD-A and QCD-B are demonstrated in Table 4. For DAS, the analysis is similar to the bottom of Table 4 but must also include the tax increase (subtract the additional cash outflow) due to the below-the-line deductions not fully offsetting the RMD income.

Case 5: Itemized deductions exceed standard deduction with 15 percent to 23.8 percent long-term capital gain rate. Specifically, long-term capital gain rate > 0 percent (from 15 percent to 23.8 percent); and taxpayer has income above the Social Security tax torpedo range.

This is the case where DAS generally saves more tax than the QCD. Assuming that no other tax break is impacted by the QCD lowering AGI, the QCD saves tax at the ordinary rate(s) from 22 percent to 37 percent (2019 rates) while the additional itemized deduction for DAS saves tax at the same rate(s) and results in the exclusion of the appreciation—saving tax at the long-term capital gain tax rate.

The taxpayer is wealthier by an amount equal to the avoided long-term capital gain tax rate on the appreciation

when DAS (compared to making a QCD). Assume Case 2's facts, except that itemized deductions exceed the standard deduction *before* DAS. The QCD has the same result as in Case 2: after-tax cash flow increases by $3,700. In contrast, DAS is more tax-efficient because increasing itemized deductions by $4,000 offsets the RMD of $4,000, and after-tax cash flow increases by $4,000. DAS results in $300 ($4,000 – $3,700) more tax savings.

The advantage of DAS might not always be as large as the avoided appreciation multiplied by the long-term capital gain tax rate, though. Sometimes DAS could be less tax-efficient than the QCD. Both reasons why involve the QCD, combined with sale of the appreciated stock, resulting in lower AGI compared to DAS with its increase in IRA distributions.

First, DAS results in relatively higher AGI than a QCD, and this could lead to higher Medicare insurance premiums two years later since 2021's Medicare insurance premiums are based on 2019's modified AGI, or MAGI (for Medicare insurance premiums purposes, MAGI is defined as AGI plus tax-exempt income).

For example, 2021's Medicare insurance premiums will increase significantly if 2019's MAGI is only $1 over $85,000 if single (or only $1 over $170,000 if married filing jointly). The premiums continue to rise in steps as higher thresholds of MAGI for 2019 are reached. For a single taxpayer, such steps are when MAGI is $1 over the following: $107,000, $133,500, $160,000, and $500,000.

Assume in Case 5 that MAGI is $85,000 if donating appreciated securities. Now, compare DAS with making a QCD near the top of Table 5. Note that the effect of DAS was to reduce MAGI by $1,128. In contrast, the effect of the QCD was to reduce MAGI by $3,128 ($2,000 – $5,128), so AGI is $83,000.

Now assume MAGI is $1 higher in both cases. Because MAGI exceeds $85,000 if DAS, the increase in 2021's Medicare premiums—making the simplifying assumption that such premiums stay the same as 2019 and ignoring the time value of money—is about $650 ($54.10 higher per month). Instead of DAS saving $300 more than QCD, the QCD saves $350 more than DAS because MAGI is $83,001 (less than $85,000) in the QCD scenario.

This shows it is possible for the net tax savings from the QCD added to the lower Medicare insurance premiums to exceed the net tax savings from DAS. To summarize, DAS always results in higher

MAGI (than a QCD), which can trigger a higher Medicare premiums threshold and such additional cash outflow must be incorporated into the analysis to determine the optimal alternative.

Second, since DAS always results in higher MAGI than a QCD, a higher-income taxpayer making a QCD can reduce the 3.8 percent surtax on net investment income (compared to DAS). This surtax kicks in when the taxpayer has any net investment income and AGI exceeds $200,000 for single taxpayers ($250,000 married filing jointly). If the surtax is lower when making a QCD compared to DAS, the reduction must also be included along with any reduction in Medicare premiums to determine the total savings due to the QCD and thus determine the optimal alternative.[12]

Summary of Case Scenarios

Recall there are 16 possible scenarios with four binary factors impacting tax savings. Case 1 covers scenarios in which the taxpayer does not itemize deductions (eight of 16 scenarios). For these, a QCD always saves more tax.

Case 2 covers one scenario in which the taxpayer itemizes only when donating appreciated securities, the long-term capital gain tax rate is ≥ 15 percent, and 85 percent of Social Security benefits are included in taxable income. In this case, which method—DAS or a QCD—saves more tax depends on the specific facts.

Case 3 covers two scenarios where the long-term capital gain tax rate is 0 percent and < 85 percent of Social Security benefits are included in income, and the taxpayer itemizes deductions either before DAS or only because of DAS. A QCD saves more tax in both these scenarios.

Case 4 covers two scenarios: those in which the long-term capital gain tax rate equals 15 percent and < 85 percent of Social Security benefits are included in taxable income, and the taxpayer itemizes deductions either before DAS or only because of DAS. Which method—DAS or a QCD—saves more tax depends on the specific facts.

Case 5 covers one scenario in which the taxpayer itemizes deductions regardless of DAS or not, the long-term capital gain tax rate is ≥ 15 percent, and 85 percent of Social Security benefits are included in taxable income. In this case, DAS, both because of its "double" tax benefits and because the QCD does not reduce Social Security benefits subject to tax, generally saves more tax (absent the Medicare premium and investment income surtax effects).

Two additional possible scenarios, those involving a 0 percent long-term capital gain tax rate and 85 percent of Social Security benefits are included in taxable income, along with whether the taxpayer itemizes deductions before or only after DAS, are not possible because the 0 percent long-term capital gain tax rate requires low taxable income and 85 percent of Social Security benefits being income requires higher taxable income.

Additional Consideration: Taxpayer to Bequest Appreciated Stock to Heirs

The taxpayer sold the appreciated stock while he or she was still alive in the preceding cases of QCDs considered here. If the taxpayer intends to make a bequest to an heir of the appreciated stock, rather than use the funds personally, the analysis must fundamentally change.

Appreciated securities inside the IRA left to the heir will be taxed as ordinary income when distributed. There is no step-up in basis inside the IRA. In contrast, inherited appreciated securities held directly (or through a grantor trust) will step-up in basis. This removes from income taxation the appreciation on the securities prior to the taxpayer's death. The heir will only pay the long-term capital gain tax on any appreciation after the date of death. Thus, the heir prefers the taxpayer to make QCDs during life and pass the directly held securities to the heir.

Assume the taxpayer does not need additional spending money and has already taken the RMD from IRAs for the year. From the heir's perspective, the question is whether the heir is better off with the taxpayer: (1) making a QCD of $4,000 and leaving the heir both $4,000 of appreciated securities, which will step-up in basis to $4,000, plus $1,128 in an IRA; or (2) donating appreciated securities and leaving $5,128 in an IRA to the heir.[13]

If the heir's tax rate is 0 percent, he or she is indifferent between the two options because both increase the heir's after-tax cash flow by $5,128. If the heir has a greater than 0 percent income tax rate, then the heir would prefer receiving the $4,000 of appreciated securities and the $1,128 in the IRA instead of receiving $5,128 in an IRA. In the former case, the heir pays no tax on the $4,000 date-of-death value but does pay tax at the ordinary rate on the $1,128 of inherited IRA when distributed. In the latter case, the heir pays tax at the ordinary rate on the full $5,128 when distributed. So, a QCD by the taxpayer is always preferred by the eventual income-taxpaying heir of the appreciated stock.

In the previous cases in which the QCD was preferred, the choice was not affected by the desire to leave wealth to the heir. The QCD was preferred by both the taxpayer and the eventual heir. In the cases in which DAS was preferred at the taxpayer level, the tax savings differential at the taxpayer level must be compared with the present value of the heir's anticipated tax cost.

Conclusion

Financial planning professionals have the opportunity to provide tax-efficient planning strategies to charitably inclined clients. This opportunity is even more important for clients over age 70½ because of the opportunity to make a qualified charitable distribution.

Given a set amount donated to charity, this paper compared a taxpayer making a qualified charitable distribution or donating appreciated securities in all possible cases. The analysis presented here helps financial planners determine whether donating appreciated securities or a qualified charitable distribution from an IRA is more tax-efficient for a client. ■

Endnotes

1. See the Tax Cuts and Jobs Act (P.L. 115-97). Full text available at congress.gov/115/plaws/publ97/PLAW-115publ97.htm.
2. For an example of "bunching," assume a two-year window, the taxpayers are married filing jointly and have $20,000 in other itemized deductions (not including charitable contributions), and the standard deduction is $27,000 both years. The taxpayers' preference prior to 2018 was to make $10,000 in charitable contributions annually, because the standard deduction was far below $20,000 the entire amount donated to charity saved tax. If the couple continues to give $10,000 annually, they effectively only receive a tax benefit from $3,000 of the contribution (the excess of the total itemized deductions of $30,000 less the standard deduction of $27,000). However, if the couple bunches the contribution and gives $20,000 in one year and none in the other year, then in the itemizing year the couple will have itemized deductions of $40,000, which are $13,000 greater than the standard deduction, and in the second year will still have the $27,000 standard deduction. Effectively the taxpayers have increased deductions over the two years from $60,000 in total to $67,000 while still giving the same amount to the charity over the two-year window.
3. See Kitces (2016) for an analysis of comparing qualified charitable distributions with donating appreciated securities before the 2017 Tax Cuts and Jobs Act.
4. See IRC 408(d)(8)(E) (2019). Note that contributions to certain private foundations and donor advised entities are not eligible. In addition, in the case of multiple IRAs and IRAs with some basis, there are modifications to the basic rules. Financial planners should refer to the relevant tax laws if they are dealing with these less common cases.
5. See IRC 170(b) (2019).
6. Note that any net operating loss amounts carrying forward into the tax year would be taken into account to determine the contribution base.
7. See taxpolicycenter.org/statistics/charitable-deduction-state-and-agi and taxpolicycenter.org/model-estimates/individual-income-tax-expenditures-october-2018/t18-0178-tax-benefit-itemized.
8. This discussion assumes the taxpayer's total estate is under the lifetime exclusion (unified credit) amount so that additional estate tax planning considerations, such as tax-avoidance trust mechanisms, are not considered.
9. This includes securities held in a grantor trust. As a result, individuals can still achieve goals such as probate avoidance while obtaining the step-up in tax basis.
10. It is not possible for this case, where itemized deductions exceed the standard deduction before the charitable donation and long-term capital gain tax rate = 0 percent, that a taxpayer is below the Social Security tax torpedo range, since the level of SSBs used in this article is relatively high ($30,000 for the year). Taxable income does not exceed the standard deduction for a single taxpayer age 65 or over until gross income exceeds $13,850. In contrast, some SSBs are includible when income exceeds $10,000 because after that, provisional income (which is generally AGI before SSBs ($10,000) + tax-exempt income ($0) + ½ of SSBs ($15,000)) exceeds $25,000 for a single taxpayer. In other words, as soon as the single taxpayer has gross income greater than $13,850, he or she is already in the Social Security tax torpedo range, because this range kicks in when income other than includible SSBs exceeds $10,000 despite not having positive taxable income and federal income tax being $0 at that point.
11. The reason why the long-term capital gain tax rate equals 15 percent, instead of possibly being above 15 percent (for example, 18.8 percent or 23.8 percent as in Case 2 due to the net investment income tax), is it is not possible to have such a high long-term capital gain tax rate and the taxpayer still be in the Social Security tax torpedo range. Specifically, for a single taxpayer, if the effective long-term capital gain tax rate is 18.8 percent, then AGI must be above $200,000. And in such a situation, the maximum SSBs (85 percent) are already included in gross income. It follows that the maximum SSB situation must occur if the long-term capital gain tax rate is 23.8 percent.
12. Note also that state taxes may affect the analysis. This is particularly true if the state bases taxes on federal AGI rather than taxable income. A discussion of state taxes is beyond the scope of this paper.
13. Recall that this is necessary to have actuarially equivalent comparison of the alternatives.

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