DECISION SCIENCES INSTITUTE

Directing Required Minimum Distributions, and Voluntary Distributions, to Charity Can Significantly Reduce Federal Income Taxes

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ABSTRACT

The tax code allows certain taxpayers to make direct charitable contributions from their individual retirement accounts (IRAs) without including the transferred amount as income. This paper explores this law and the possible benefits, especially as it affects the tax on social security benefits. Potential tax reform is also addressed.

KEYWORDS: Required Minimum Distribution, Qualified Charitable Distribution (QCD), Charitable Contributions, Individual Retirement Accounts, Adjusted Gross Income

INTRODUCTION

Internal Revenue Code (IRC) Section 408(d)(8) allows direct charitable contributions to be made from individual retirement accounts (IRAs) without the donor being required to include the amount in gross income (U.S. Code, Section 408). Of course, amounts excluded from income under this provision are also ineligible to be claimed as charitable contributions for taxpayers who itemize their deductions. This code section was created by Public Law 109-280 (2006), passed in 2006. The law was originally passed as a temporary law but was extended multiple times. Near the end of 2015, this tax law was made permanent by Public Law 114-113 (2015). While no law is necessarily permanent, Public Law 114-113 removed the termination date from IRC Section 408(d)(8), so without further legislation, this tax code section will remain rather than expire.

While this section of the tax code will not benefit everyone, it can be important to a specific set of taxpayers who meet the requirements and who desire to make contributions to charities. Of course, charities will want to approach potential donors who may benefit from this tax law, as it might increase the amount of contributions received. Because this tax provision is now permanent, donors and charities can better plan how to use this tax law without having to worry about its expiration. This paper explores this law, including the provisions of the law, the requirements for those using the law, and the possible benefits that can accrue to the taxpayer by using this method to make charitable contributions.

TAX BENEFITS OF CHARITABLE CONTRIBUTIONS

The Joint Committee on Taxation (2013) provided some history, background, and philosophical and economic arguments for tax benefits relating to charitable contributions. Some argue that tax preferences for charitable contributions increase the amount that individuals may be willing to donate to charitable entities. Others argue that giving tax advantages for contributions, especially those that would be made anyway, is an unnecessary government subsidy. Some will argue that services provided by charities might displace the demand on governments for similar services, thus making it worthwhile for the government to have tax benefits which encourage charitable giving.

The Joint Committee on Taxation (2013) also provided information about the present law on the federal tax treatment of charitable contributions. In recent history, charitable contributions only provide a specific, additional federal tax benefit for taxpayers who itemize their deductions. Since taxpayers may already take a standard deduction on their tax returns, regardless of whether or not they make any charitable contributions, taxpayers whose itemized deductions, including charitable contributions, are less than the standard deduction will just take the standard deduction and get no additional tax benefit for the charitable contributions as a separate item.

Other federal tax laws also affect the potential tax benefit of a charitable contribution. Taxpayers may lose a portion of their itemized deduction benefit if their income is high enough such that their itemized deductions are partially phased out. For example, for a joint return for 2017, itemized deductions will begin to phase out when AGI reaches $313,800 (IRS, 2016c). Also, annual charitable contribution deductions are limited to a percentage of a taxpayer’s contribution base. For an individual taxpayer, the contribution base is usually the adjusted gross income (AGI). The percentage limitation is dependent on the type of charitable entity to which contributions are made and the type of property contributed. For an individual donating cash or ordinary income property to a public charity (and some foundations), the charitable contribution deduction is limited to 50 percent of the contribution base for a given tax year, although excess contributions can be carried forward up to five years (IRS, 2016a). For contributions to some other entities and for distributions of capital gain property, the percentage limitation may be 30 percent or 20 percent (Joint Committee on Taxation, 2013).

State income tax benefits from charitable contributions would vary by state. Some states do not have an income tax and would therefore not provide any specific tax benefit to those who make charitable contributions. Other states which do have a state income tax have different ways of defining income, deductions, and taxable income. Therefore, this paper will focus on the federal income tax benefits from IRC Section 408(d)(8), but depending on each specific state’s laws relating to income taxes, additional tax benefits may accrue to a taxpayer at the state level by taking advantage of this federal tax provision.

QUALIFIED CHARITABLE DISTRIBUTIONS

IRC Section 408(d)(8) allows distributions to be made directly from an individual retirement account (IRA) to a charity without having to be included in the taxpayer’s income and then claimed as a charitable contribution deduction. Since it would be extremely rare for distributions from a Roth IRA that would otherwise meet the requirements from this exclusion to be taxable, this paper will focus only on distributions from a traditional IRA. Kitces (2016) shows a timeline of the legislative history of the qualified charitable distribution (QCD).

Although this tax benefit was originally passed in 2006 by Public Law 109-280, the tax benefit had a termination date. This termination date was extended four times before the law was finally made permanent in 2015. However, all of the legislative extensions were made near the end of a year after the provision had already lapsed. Thus, for large portions of 2008, 2010, 2012, 2014, and 2015, taxpayers were unsure if the law would be extended. By the time the extensions were legislated, it is quite possible that taxpayers had either already made their charitable contributions for the year in other ways and/or that taxpayers had already taken their required IRA distribution, thus discouraging the use of the QCD for that year even though the possibility technically existed before the end of the year.

QCDs have several limitations or qualifications. The contribution must be made directly from the IRA to the charitable entity. It cannot be withdrawn from the IRA by the account holder and then contributed to the charity. Thus, a QCD would require cooperation between the IRA manager and the charity so an appropriate transfer could be made. Contributions from simplified employee pensions (SEPs) or simple retirement accounts are not QCDs. Most entities that qualify for charitable contribution status can receive these contributions, but some are excluded —private foundations and donor advised funds. The account holder must be at least 70½ at the time of the transfer. The annual limit for a QCD is $100,000, so the ability to take advantage of this tax provision is not unlimited (U.S. Code, Section 408).

If a donor receives something of value from the charity for making a charitable contribution, the value received must be subtracted from the amount eligible for the charitable contribution deduction. For example, if a radio station sponsors a fund drive for a specific charity and gets other sponsors (either sponsors of the radio station or sponsors of the charity) to offer incentives to be given to donors to encourage more or larger donations, the value of the incentives received by any donor must be deducted from the amount contributed to determine the amount that can be deducted as an itemized deduction on the federal tax return. However, for QCDs made from an IRA, the entire amount of the donation must otherwise have been deductible; nothing of value can be transferred to the donor (U.S. Code, Section 408).

While taxpayers who itemize can take a deduction for charitable contributions, this is not true for QCDs (U.S. Code, Section 408). Because the taxpayer already gets a tax advantage by not claiming the IRA distribution as income, no further tax advantage is available. Tax laws are carefully written and coordinated so that a taxpayer cannot get two tax benefits for the same item.

When charitable contributions are made, certain documentation requirements must be met for the taxpayer to claim the charitable contribution deduction. These are outlined in IRS Publication 526 (IRS, 2016a). The general requirement for cash contributions could be met by a receipt, letter, or other written communication from the charitable entity which includes the name of the organization and the date and amount of the contribution. If the contribution exceeds $250 and is not made by payroll deduction, a written acknowledgement is required. This acknowledgement would need the details described above but would also need an indication of whether any goods or services were received for the donation. If so, the value of the goods or services would also need to be given. If a contribution is made through a QCD from an IRA, no goods or services can be received by the donor, but the donor would still need to obtain the same type of acknowledgement from the charitable entity verifying the contribution (IRS, 2016b).

ADVANTAGES OF QUALIFIED CHARITABLE DISTRIBUTIONS

Several possible advantages can result from the ability to make charitable contributions directly from an IRA. These advantages may encourage more charitable giving. As mentioned earlier, the charitable contribution deduction is limited, generally to 50 percent of the contribution base. If a taxpayer wants to give more than is allowed under this limitation, the excess can be carried forward to the future and provide a potential future tax benefit, but it will not provide an immediate tax advantage. However, if a QCD is made from an IRA, this amount is excluded from income and never affects the contribution base. Therefore, a taxpayer can give up to an additional $100,000 directly from an IRA without worrying about this amount affecting the contribution base or being limited by it (Smucker, 2016).

Taxpayers, especially older taxpayers who may no longer be paying interest on a mortgage, might not have enough total deductions to itemize rather than claim the standard deduction. If they desire to make charitable contributions and can do so from an IRA through a QCD, they can avoid having to claim the income and use the charitable contribution deduction, which might increase their taxable income (Independent Sector, 2016).

As an example, the standard deduction on a joint return for 2017 is $12,700. If a couple had only $2,000 of deductions, they would choose not to itemize but instead take the standard deduction. However, if this couple also wanted to donate $20,000 to a charity at the end of the year and did it by withdrawing $20,000 from an IRA (with only pre-tax amounts) and then contributing it to the charity, the entire $20,000 would need to be included in income. The $20,000 donation would be added to their deductions, bringing them up to $22,000, so now they would prefer to itemize their deductions. But since they could have claimed the standard deduction without this contribution, their deductions will only increase by $9,300 from the standard deduction of $12,700 up to their itemized deductions of $22,000. Since their income increased by $20,000 but their deductions only increased by $9,300, their taxable income will actually increase by $10,700. If this same couple were able to make the $20,000 charitable contribution through a QCD, neither their income nor their deductions would change. So the QCD would help them make a charitable contribution without increasing their taxable income and the subsequent tax liability.

The benefit of itemized deductions can be partially phased out for taxpayers with adjusted gross income in excess of a certain threshold ($313,800 for a joint return in 2017). Although the phase out for personal exemptions is calculated differently, the phase out begins at the same threshold amounts as for the itemized deductions. If amounts were withdrawn from an IRA and became taxable, even if contributed to charity, they could possibly move some taxpayers into or further into this phase out range, causing them to lose some of the possible benefit of their itemized deductions and their personal exemptions. By contributing directly from the IRA and using a QCD, these amounts contributed to charity would not cause or increase the phase out of these other tax benefits (Smucker, 2016).

Medical expenses can be included in itemized deductions but only the portion that exceeds 10 percent of AGI (7.5 percent for taxpayers over 65 through 2016). Most miscellaneous itemized deductions also have a floor, typically 2 percent of AGI, meaning they cannot be included in itemized deductions except to the extent they exceed 2 percent of AGI. If amounts can be contributed to charity directly from an IRA without being included in income, the amounts donated in this manner will not further limit potential medical or miscellaneous itemized deductions by increasing the taxpayer's AGI (Smucker, 2013).

Up to 85 percent of a taxpayer's Social Security income can become taxable on a federal tax return, depending on the level of income. So, if charitable contributions are made directly from an IRA without having to be included in income, the amount will not increase the taxability of any Social Security benefits included on the tax return (American Endowment Foundation, 2016).

Some states do not provide a state income tax benefit for contributions to charity—Ohio, Indiana, Michigan, New Jersey, Massachusetts, and West Virginia. By using a QCD, taxpayers in these states could avoid having to claim the income and would, in essence, receive a state tax benefit for the charitable contribution, even though their state does not provide for income tax benefits from charitable donations (American Endowment Foundation, 2016).

A traditional IRA can include amounts that were contributed both on a pre-tax or an after-tax basis, either directly into the account over a period of years, or rolled over to an IRA from an employer-sponsored retirement plan. The contributions that went into the IRA on a pretax basis will be taxed as they are distributed. The contributions that went into the IRA on an after-tax basis will not be taxable when they are distributed. However, the earnings from both pre-tax and after tax contributions in an IRA are deferred from taxation until distributions are made. For regular distributions from an IRA with both pre-tax and after-tax amounts, the amount of the annual distribution is split between taxable and nontaxable portions, at least until all the after-tax contributions have been withdrawn (IRS, 2016b). If an individual has multiple IRA accounts, they are all treated as one account and all distributions for the year are treated as one distribution in calculating the taxable and nontaxable portions of the distribution (U.S. Code, Section 408).

However, a special rule exists for QCDs. Since only the taxable portion of an IRA distribution can become a QCD, the law allows the entire distribution to come from the taxable portion of the IRA (up to the amount of taxable amount in the IRA) first, thus increasing the benefit of the QCD to the taxpayer (U.S. Code, Section 408). If a taxpayer has multiple IRAs, they are again combined in determining the taxable portion that can meet the definition of a QCD. Of course, once a QCD is made from the IRA(s), a recalculation would need to take place as to the taxable and nontaxable amounts for future IRA distributions.

For a traditional IRA, once the account holder reaches the age of 70½, annual distributions from the IRA are required. This is called a required minimum distribution (RMD). The RMD each year would be recalculated based on the value in the account and the expected lifespan for the account holder. The taxpayer can choose to withdraw more than the RMD from the IRA in a given year, but taxes will be due on all portions (both contributions and earnings) not previously taxed.

Although the government allows tax deferrals for certain IRA contributions and for the increase in value during a normal working period for the taxpayer, the account cannot grow tax free in perpetuity. The government wants to get taxes on the money at some point in time, so the RMD is set so a portion of the pre-tax account balance becomes taxable each year. However, if a QCD is made from the IRA, the amount of that distribution helps to meet the RMD for the year, but the qualifying distribution would not be taxable (Smucker, 2016). Besides the amount of the distribution itself not being taxable, the exclusion might keep the taxpayer in a lower tax bracket than if the RMD all had to be claimed as income for the year. If more than the RMD is distributed from an IRA in a given year, either for a withdrawal or for a QCD, the excess withdrawn or transferred would not count toward future years' RMDs.

The $100,000 limit on QCDs is an individual, annual limit. Therefore, up to $100,000 can be transferred in this manner each year. In addition, if a spouse also has an IRA, joint filers could actually exclude up to $200,000 per year from QCDs (Smucker, 2016). IRAs left in an estate could be subject to both income and estate taxes. Any amounts distributed before death through QCDs would reduce the estate and subsequent estate taxes (American Endowment Foundation, 2016).

Through cooperation between the donor and the charity, the actual benefit to the charity could possibly be larger than $100,000 from a QCD. If the charity uses the donation to buy a single premium life insurance policy on the donor, it could generate an even larger amount for the charity upon the death of the donor (Smucker, 2016). Of course, this would postpone when the charity could use the contribution for its charitable purposes.

SOME ILLUSTRATIONS WITH TAX ON SOCIAL SECURITY

Two real benefits of QCDs are that removing charitable contributions from adjusted gross income and itemized deductions might allow the taxpayer to claim the standard deduction, rather than itemize, and that the resulting reduction in adjusted gross income might make less of one's social security benefit taxable.

Vast differences exist depending on the situation, from no tax difference for some to thousands of dollars in savings, when QCDs are used. In addition to the ability of some to use the standard deduction if they do not itemize the charitable deduction, the reduction in AGI can substantially affect the taxable amount of social security benefits. Several examples have been developed as illustrations of how significant the differences can be, but generalization is difficult because of the multiple variables.

The first few illustrations are for married couples with varying amounts of income and deductions.

Illustration 1

Exhibit 1 involves a married couple with a pension of $20,367 and social security benefits of $25,000 who make a, perhaps one time, QCD of $15,000. Note that it is assumed that the QCD is the amount of the RMD, but taxpayers can contribute more than the RMD.

EXHIBIT 1

Pension	$ 20,367	$ 20,367
RMDs	$ 15,000	
Social Security of $25,000	$ 9,287	$ 433
AGI	$ 44,654	$ 20,800
Standard deduction		$ 12,700
Itemized:		
Charitable contributions	$ 15,000	
Other	$ 3,000	
Exemptions	$ 8,100	$ 8,100
TI	$ 18,554	$ 0
FIT	$ 1,856	$ 0

This couple would pay $1,856 in gross income tax if they receive the RMD in cash and contribute it to charity versus zero tax if they make the QCD. The savings evolve because less of their social security is taxed and they are able to enjoy the benefit of the standard deduction. One could argue that this is a 100% tax reduction, but it is also 12.4% of the QCD.

Illustration 2

The second illustration reveals how elastic the tax effects are. Increasing the pension amount by less than $10,000 has profound effect. One might ask how a married couple could have other itemized deductions of $3,000. In a state with no income tax, the only itemized deductions might be property tax, if any, and sales tax, or other modest amounts.

EXHIBIT 2

Pension	$ 30,000	$ 30,000
RMDs	$ 15,000	
Social Security of $25,000	$ 17,475	$ 5,250
AGI	$ 62,475	$ 35,250
Standard deduction		$ 12,700
Itemized:		
Charitable contributions	$ 15,000	
Other	$ 3,000	
Exemptions	$ 8,100	$ 8,100
TI	$ 36,375	$ 14,450
FIT	$ 4,524	$ 1,445

The couple at this level of income has 85% of much of their social security taxed when receiving the RMD in cash; but no more than 50%, when utilizing the QCD. The tax is reduced by 68.1%, which is 20.5% of the QCD.

Illustration 3

The third illustration involves a couple with a pension of $50,000. The extra income causes them to reach the 25% tax bracket when receiving the RMD in cash; but not, with the QCD.

EXHIBIT 3

Pension	$ 50,000	$ 50,000
RMDs	$ 15,000	
Social Security of $25,000	$ 21,250	$ 21,250
AGI	$ 86,250	$ 71,250
Standard deduction		$ 12,700
Itemized:		
Charitable contributions	$ 15,000	
Other	$ 3,000	
Exemptions	$ 8,100	$ 8,100
TI	$ 60,150	$ 50,450
FIT	$ 8,090	$ 6,635

For this couple 85% of the social security is taxed regardless, but the tax bracket effects and the standard deduction cause a significant difference. The tax is reduced by $1,455 or 18.0%, which is 9.7% of the QCD.

Illustration 4

The fourth illustration involves a couple who have substantial income. Their itemized deductions are increased and 85% of their social security is taxed. The QCD still has a modest effect.

EXHIBIT 4

Pension	$ 300,000	$ 300,000
RMDs	$ 30,000	
Social Security of $25,000	$ 21,250	$ 21,250
AGI	$ 351,250	$ 321,250
Standard deduction		$ 12,700
Itemized:		
Charitable contributions	$ 30,000	
Other	$ 12,700	
Itemized cutback (3% of AGI > $313,800)	- $ 1,124	n/a
Exemptions	$ 8,100	$ 8,100
Exemption cutback (2% per $2,500 > $313,800)	- $ 2,430	- $ 486
TI	$ 304,004	$ 300,936
FIT	$ 75,538	$ 74,526

There is no tax bracket difference and seemingly no standard deduction *because the itemized deductions equal the standard deduction, the Pease limitations/cutbacks reduce the benefit from the itemized deductions and exemptions. The $1,012 tax reduction due to the QCD simply is 3.4% of the QCD and 1.3% of the tax. This benefit would continue until the income reaches a level where the itemized deductions and exemptions are totally phased out.

Illustration 5

The fifth illustration involves a couple who would pay the 3.8% tax on investment income. Their itemized deductions are increased and 85% of their social security is taxed. The QCD has a modest effect.

EXHIBIT 5

Pension	$ 200,000	$ 200,000
Long-term capital gain (15% gain)	50,000	50,000
RMDs	$ 30,000	
Social Security of $25,000	$ 21,250	$ 21,250
AGI	$ 301,250	$ 271,250
Standard deduction		$ 12,700
Itemized:		
Charitable contributions	$ 30,000	
Other	$ 10,000	$10,000
Exemptions	$ 8,100	$ 8,100
TI	$ 253,150	$ 250,450
FIT on ordinary income (TI - $50,000)	$ 50,265	$ 49,590
15% capital gains tax	7,500	$ 7,500
Tax on investment income	1,900	808
Total	$ 59,665	$ 57,898

There is no tax bracket difference. The $1,768 tax reduction due to the QCD is 5.9% of the QCD and 3.0% of the tax.

TAX REFORM

President Trump and the 115th Congress of the United States have released a sketchy summary of tax reform. The details are not sufficient at this writing to predict effects of QCDs with accuracy. However, the proposals have consistently included increased standard deductions and repeal of personal and dependency exemptions. Most proposals also repeal the itemized deductions except for charitable deductions and residence interest. In addition, a reduced number of tax rates is proposed. Increasing the standard deduction to $24,000 to $30,000 for married couples and $12,000 - $15,000 for other taxpayers, would make the QCD more beneficial for many taxpayers.

Assuming that the standard deduction is $24,000, that itemized deductions for residence interest do not exceed the standard deduction, the benefit of the charitable deduction would be limited. The income would all fall within the 12% tax bracket under one proposal. The QCD option would provide full benefit within the annual limits.

Illustration 6

EXHIBIT 6

Pension	$ 30,000	$ 30,000
RMDs	$ 15,000	
Social Security of $25,000	$ 17,475	$ 5,250
AGI	$ 62,475	$ 35,250
Standard deduction	$ 24,000	$ 24,000
Itemized (do not exceed the standard):		
Charitable contributions		
Other		
Exemptions (repealed)		
TI	$ 38,475	$ 11,250
FIT	$ 4,617	$ 1,350

This situation accentuates the possible effects of tax reform if most itemized deductions are repealed, the standard deduction is increased, and tax rates are adjusted. This is an extreme example based on unspecified possible law changes. It assumes the tax on Social Security and the QCD are unchanged.

IMPLICATIONS AND DISCUSSION

While a QCD may have great advantages to taxpayers who qualify to use it, the requirements must be met, so not all taxpayers can benefit. A taxpayer must be at least 70ó years old and must have saved money in an IRA, either through direct contributions or through a rollover from some other retirement plan. The taxpayer would also need a desire to contribute to a qualified charity and get cooperation from the charity to process the direct contribution and provide appropriate acknowledgement. As mentioned above, those who qualify to use this exclusion of income from an IRA for charitable purposes can possibly have significant tax advantages.

For those who qualify to use this tax law, no specific tax disadvantages seem to exist. However, Kitces (2016) does point out that in a specific case, a taxpayer might get an even larger tax benefit by not using the QCD. If a taxpayer takes a taxable IRA distribution and then offsets the income by making a charitable donation of appreciated securities, the tax deduction could be claimed and the capital gains tax on the appreciated security could be permanently avoided. This could work if the taxpayer is already itemizing deductions, is not subject to the 50 percent limit on charitable contributions, and will not enter the phase-out range for itemized deductions and exemptions by recognizing this additional income.

The law allowing QCDs can provide significant advantages to taxpayers who have the ability and desire to support charitable causes and to qualifying charities which may now have an additional way of increasing the number of donors and the amounts of individual contributions. Permanence in this tax law aids the ability of individual taxpayers to plan longer-term donation/tax strategies. Taxpayers can work with their tax advisors to better maximize the benefit of whatever charitable contributions they want to make. Permanence in this tax law also allows charities to develop better planning tools to encourage and educate donors and potential donors of the advantages to this tax law.

MUST BE PART OF A COMPREHENSIVE FINANCIAL PLAN

Cash and qualified charitable distributions are not the only choices available for making charitable contributions. Gifting of highly appreciated property, for example, provides a very attractive result. Except for ordinary income property and certain tangible personalty not used in the exempt function of the charity, the donor is entitled to a deduction equal to fair market value and never incurs income tax on the appreciation. Charitable individuals could also designate the charity as the beneficiary on life insurance.

Under current law, the heir or estate gets a step-up in the basis of the appreciated property, but not in a traditional individual retirement account since the distributions are income in respect of a decedent. Under tax reform proposed by the current administration and Congress, this step-up may be repealed.

These are just a few examples of why, although QCDs may produce favorable benefits, other alternatives for funding charitable intentions must be considered if the contributor has varied means to contribute. The financial plan should consider all of the options available to achieve the optimal amount and timing of benefits to the donor and the charity.

CONCLUSION

QCDs can be made from an IRA without having to be included in income. For those who meet the requirements, this can be a way of contributing to a charity while gaining some possible tax advantages which might be better for the taxpayer than a specific distribution from the IRA which would be included in income, even if that amount is then donated to charity and subtracted as a charitable contribution deduction on the tax return. The implications for both taxpayers and charities can be significant. Because the law allowing this exclusion has now been made permanent, taxpayers and charities can work toward short-term and long-term planning strategies to take advantage of this tax provision. Multiple year tax planning might be rewarding, but is subject to uncertainty when tax laws are likely to change.

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