United Way
of Santa Barbara County

an income, estate and gift tax service for attorneys and other professional advisors

TECHNIQUES

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Gift Annuities Reconsidered

For many years, charitable gift annuities have generated great interest among donors. Several factors account for this interest:

- Low returns on CDs and other interest-bearing, fixed-income investments make gift annuity payouts more attractive to donors.
- Low monthly Applicable Federal Rates (AFRs) increase the tax-free income component of the charitable gift annuity payout.
- Donors may prefer gift annuities over charitable remainder trusts for certain situations (e.g., the donor wants to donate less than what is practical for a charitable remainder trust).
- Donors want a fixed, stable income as a hedge against uncertain financial markets.

Because of the continuing interest in charitable gift annuities, a fresh look at this time-tested planned giving technique is warranted.

A Quick Review of Gift Annuities

A gift annuity is a contractual agreement between a donor and a qualified charity. The donor makes an irrevocable transfer of cash or property (often long-term appreciated stock) to the charity. And the charity agrees to pay a specified amount each year for the lifetime of one or two annuitants.

The charity may choose to offer the recommended payout rates published by the American Council on Gift Annuities (ACGA) or payout rates of its own. With the recent low federal interest rates (AFRs), charities may need to reduce payout rates below the ACGA rates generally offered to younger donors in order to satisfy the 10% minimum charitable interest (as explained below).

The present value of the donor's annuity is always less than the value of the transferred property. For tax purposes, the transfer is considered part charitable gift and part the purchase of an annuity.

Gift annuities are an exception to the general rule that charities cannot issue commercial insurance contracts. To qualify for the exception, charities that issue gift annuities must comply with the "Clay-Brown" rules [IRC Sec. 501(m)(3)(E), 501(m)(5), 514(c)(5)]:

- The present value of the annuity must be less than 90% of the total value of the property transferred in exchange for the annuity. In other words, the charitable interest has to be at least 10%.
- The annuity cannot be payable over more than two lives, and the individual(s) must be alive at the time the gift annuity is set up.
- The gift annuity agreement between the donor and charity must not specify a guaranteed minimum, nor a maximum number of annuity payments.
- The actual income produced by the property transferred in exchange for the gift annuity must have no bearing on the amount of the annuity payments.

Only qualified charities may offer gift annuities. When required by state law, the issuing charity must register with the state insurance department in the states in which it solicits gift annuities. The solicitation process itself may also be subject to state regulations. State laws often require issuing charities to maintain segregated reserves to cover the potential obligations to annuitants under gift annuity agreements.

PROOF

Benefits for Your Clients

A charitable gift annuity offers several client benefits:

- It provides an immediate income tax charitable deduction to the donor for the gift portion. (Part of the deduction might be deferred because of the annual percentage of adjusted gross income (AGI) deduction limits.)
- It pays a lifetime income to one or two individuals, part of which is usually a return of principal and free from federal income tax.
- The income payout from the gift annuity can begin immediately or can be deferred.
- The charity's obligation to pay the annuity is backed by the general assets of the charity.
- When appreciated property is given and the donor is an annuitant, some of the capital gain is spread over the donor's life expectancy, and the rest is never recognized because it is attributed to the gift portion.
- A gift annuity is simple to execute.

Tax Considerations

Income Tax Charitable Deduction

A charitable gift annuity is considered part gift and part sale since the donor contributes the property in exchange for annuity payments from the charity. As noted above, the present value of the annuity is less than the value of the property transferred to the charity. The donor who itemizes may take an income tax charitable deduction for the gift portion (i.e., the value of the transferred property less the present value of the annuity).

This income tax charitable deduction is subject to the same limits as an outright gift of cash or property: If cash is transferred for the annuity, the limitation on the deduction is 50% of the donor's AGI; and, if long-term capital gain property is transferred, the limitation is generally 30% of AGI. Any deduction in excess of the applicable percentage limitation may be carried forward up to five tax years.

Taxation of Payouts

The annuity payments by the charity under a gift annuity are treated as follows for income tax purposes:

- A tax-free return of principal
- Long-term capital gain
- Ordinary income

Return of Principal Portion: A portion of each payment received by the donor or other annuitant is a tax-free return of principal until the assumed cost of the annuity is fully recovered when the annuitant reaches life expectancy.

The assumed cost of the annuity does not include the gift portion of the transaction. The donor's cost basis must be allocated between the gift and sale portions in accordance with their respective proportions of the value of the property transferred. For example, if the gift portion represents 60% of the total transfer, then 60% of the donor's basis must be allocated to the gift, and is not available to offset the gain on the sale portion.

Capital Gain Portion: If property held for more than one year is transferred for a gift annuity, a portion of each payment will be taxed as long-term capital gain. This will reduce the income tax-free return of principal portion of the annuity payments described above.

Capital gain is recognized only on the sale portion of the transaction and with the basis allocation previously described. Normally, under general tax rules, long-term capital gain is recognized in the year the property is sold. However, with a charitable gift annuity, the donor may spread the gain over life expectancy provided the donor is the sole annuitant, or the donor and another individual named as a survivor annuitant.

Furthermore, the annuity must be (1) non-assignable, or (2) assignable only to the charity that issued it. If this prohibition against assignment is not incorporated into the terms of the gift annuity agreement, the donor will recognize the entire gain immediately in the year of the contribution.

Ordinary Income Portion: After the capital gain and tax-free portions of the annuity payment have been determined, the balance of the payment is taxed as ordinary income. If and when the annuitant reaches life expectancy, all principal will have been distributed, and all capital gain attributable to the sale portion will have been recognized. Thereafter, the annuity payments will be fully taxable as ordinary income.

Gift and Estate Taxation

If the donor is the sole annuitant, there are no gift or estate tax issues because the annuity is her own and the annuity terminates at death. If the donor names anyone other than herself as an annuitant, gift and estate tax issues do arise.

If the donor names another person as an annuitant, the gift is the value of the annuity. An exception exists for a spouse under the gift tax marital deduction. Or, to avoid the gift tax, the donor could retain the right to revoke when the named annuitant has a survivor interest.

If the donor names another person as an annuitant, the remaining value in the annuity is considered part of the donor's estate. An exception exists for a joint annuity using the donor's life alone as the measuring life. And, of course, there is an estate tax martial deduction available if the surviving annuitant is a spouse.

Gift Annuity Planning Ideas

Applicable Federal Rate	4.2% (July)	4.0% (June)	3.6% (May)
Charitable deduction	$22,420	$21,720	$20,607
Exclusion ratio	66.4%	68.1%	70.8%
Tax-free amount	$2,224	$2,281	$2,372

Low Interest Rates Mean Higher Tax-Free Income

The Internal Revenue Code requires an "Applicable Federal Rate" (AFR) to be used in calculating the charitable deduction for gifts of partial interests in property, including gift annuities. Toward the end of each month, the Treasury Department issues a revenue ruling that provides a table of rates for the following month. The pertinent rate from this table is 120% of the applicable midterm rate, rounded to the nearest two-tenths of one percent.

The rate for the month of the transfer or the rate for either of the two preceding months may be used. The AFR selection decision is more complicated for gift annuities than for other split-interest gift vehicles because there's a tradeoff involved: A donor who wants to maximize his or her deduction will select the highest rate available. This reduces the value of the annuity and increases the amount of the charitable gift. But a donor who wants to maximize the income tax-free portion of the annuity payments will select the lowest available rate.

Refer to the chart above for an illustration: In July 2008, a 75 year-old donor sets up a charitable gift annuity that pays 6.7% with a cash gift of 50,000. The donor has the choice of three AFRs — July 2008, June 2008 or May 2008. Note the differences in the projected charitable deduction and tax-free amount. If the AFR were to increase to 7%, the charitable deduction would jump to $26,569, and the tax-free amount would drop to $1,889.

With the low AFRs now prevailing, your philanthropically minded clients have a unique opportunity to lock in a high tax-free income for life. Short-term CD rates are hovering around 3-4% (and interest is taxable). The opportunity for a 75-year-old donor to get a 6.7% payout, more than two-thirds of which is tax-free, could be very appealing.

Choose the Start Date of a Deferred Gift Annuity

In an immediate gift annuity arrangement, annuity payments begin no later than one year after the gift has been made. A deferred gift annuity allows donors to delay the start date of their annuity payments an entire year or more after the gift date. This delay will both increase the annuity amount when payments begin and result in a larger income tax charitable deduction which is available in the year of the contribution (subject to the AGI limitations). Thus, a deferred gift annuity can produce current tax savings during high-earning years while creating a supplemental retirement income.

Usually, the donor sets a date for the deferred gift annuity to begin. However, the IRS has approved a deferred gift annuity that did not specify a fixed starting date for the annuity payments [Ltr. Rul. 9743054]. The donor established the annuity at age 50, and could elect to have payments begin at any time after age 55 and before age 80. The gift annuity agreement between the donor and the charity specified a different payment amount (rising with the deferral of the start date) for each possible age at which payments might begin. The income tax charitable deduction allowed for the gift was based on the lowest possible deduction that would be available at the earliest annuity starting date (i.e., age 55 in this case).

Testamentary Gift Annuity

Carefully planned, it is possible to arrange a charitable gift annuity (CGA) through a will. The IRS has approved a testamentary gift annuity [Ltr. Rul. 8506089]. A decedent's will left the residue of his estate to a qualified charity on the condition that the charity pay a 7% annuity to two surviving relatives. The IRS allowed an estate tax charitable deduction in the amount of the value of the residuary bequest to charity, reduced by the present value of the two-life annuity. Charitable bequests that are unascertainable in amount can cause a loss of the estate tax charitable deduction [see Est. of Marine v. Comm'r, 97 T.C. 368 (1991), aff'd, 93-1 USTC ¶60,131 (4th Cir.)]. It is important that both the bequest amount and the annuity payout can be determined from the terms of the will. It is generally thought that the will may invoke the standard gift annuity payout rate used by the charity at the time of the testator's death.

When your clients set up testamentary gift annuities, they may want to address three important contingencies:

- First, the designated annuitant(s) may predecease the testator. Your client may want to specify a contingent annuitant, or, perhaps, provide for an outright bequest to the charity.
- Second, the charity may no longer be in existence at your client's death. Or, it may be unable or unwilling to accept the gift. Therefore, your client should consider naming a contingent charitable beneficiary.
- Third, your client should leave the charity some flexibility in the payout rate to assure that the 10% minimum charitable interest requirement can be met some time in the future.

New Tax Developments

IRS Issues New Sample Testamentary Charitable Lead Unitrust

The IRS has published a new sample form for a testamentary Charitable Lead Unitrust (CLUT). A CLUT provides for unitrust payments payable to one or more charitable beneficiaries for the unitrust period followed by the distribution of trust assets to one or more non-charitable remaindermen. Earlier this year, the IRS issued inter-vivos CLUT sample forms (both grantor and non-grantor) under Rev. Proc. 2008-45. The new testamentary CLUT sample form features annotations and alternate provisions. Charitable Lead Trusts are gaining more attention as applicable federal rates remain relatively low, so the newest sample CLUT is a timely resource.

Rev. Proc. 2008-46, 2008-30 IRB 1

IRS Issues Guidance on the Division of Charitable Remainder Trusts

The IRS has published a revenue ruling detailing how a charitable remainder trust can be divided into two or more distinct charitable remainder trusts. In sum:

- The pro rata division of a qualified CRT into two or more trusts does not cause any of the individual trusts to fail as a CRT.
- The division is not a sale, exchange or other disposition producing gain or loss.
- The basis of each separate trust's share of each asset is the same share of the basis of that asset in the hands of the trust immediately before the division of the trust (same for the holding period of the asset).
- The division of the CRT does not terminate the trust under private foundation rules that would require imposition of an excise tax.
- The division of the CRT does not constitute an act of self dealing.
- The division of the CRT does not constitute a taxable expenditure.

Rev. Rul. 2008-41; 2008-30-IRB 1

Final Regulations on Inclusion of GRAT, GRUT, CRAT or CRUT in the Gross Estate

The IRS has finalized regulations to provide guidance on what part of trust property should be included in a grantor's gross estate under IRC Sec. 2036 and 2039 if the grantor has retained a lifetime interest. The regulations generally cover the following trust types:

- Grantor Retained Annuity Trust
- Grantor Retained Unitrust
- Charitable Remainder Annuity Trust
- Charitable Remainder Unitrust

The portion of the trust included in the gross estate is that part necessary to yield that annual annuity or unitrust payment without reducing or invading principal. This calculation is made using the Section 7520 rate in effect on the decedent's date of death (or alternate valuation date).

Note that the final regulations do apply to pooled income funds (though they do not apply to a charitable gift of a remainder interest in a personal residence or farm).

T.D. 9414, Reg. Sec. 20.2036-1

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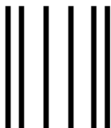

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