



## United Way of Santa Barbara County

### COMPARING LIFE INCOME PLANS

Life income plans have become increasingly popular with major donors. And for good reason: they pay a post-gift income to the donor and/or other beneficiary(ies), and they qualify for an immediate charitable deduction for the present value of the charity's interest. Life income plans include charitable remainder annuity trusts and unitrusts, charitable gift annuities (immediate and deferred), and pooled income funds.

Typically, a life income donor is looking for some or all of the following benefits:

- Increase cash flow
- Reduce current income tax
- Avoid capital gains tax on highly appreciated assets
- Fulfill philanthropic intentions.

This issue examines life income plans and provides some general guidelines for matching these giving techniques with the needs and objectives of clients. We hope this information will help you assist your clients in choosing the best life income plan that suits both their financial planning and philanthropic intent.

#### I. CHARITABLE GIFT ANNUITY

Gift annuities are straightforward and uncomplicated. With a gift annuity, the donor irrevocably transfers cash or property outright to a charity in exchange for the charity's promise to pay a specified dollar amount to the donor or other annuitant for life (two annuitants maximum). A gift annuity is set up by written agreement with the charity, and, unlike a trust arrangement, the responsibility to pay is considered a general obligation of the charity.

##### The Gift Annuity Payout

The annuity amount is fixed at the outset based on the age(s) of the annuitant(s). The payout rates are established by each issuing charity, but many charities follow the rates

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## TECHNIQUES

FIRST QUARTER, 2007

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of the American Council on Gift Annuities, or use such rates as a benchmark in setting their own rates. The ACGA rates are lower for younger annuitants and climb to a much higher rate at higher ages.

#### The Charitable Deduction

Generally the donor's immediate federal income tax deduction is approximately 50% of the amount transferred to charity. The balance represents the present value of the annuity. Thus, the gift annuity is a form of bargain sale, and the transfer to the charity is treated as part-gift and part-sale for tax purposes.

#### Transfer of Cash or Appreciated Property

When cash is transferred for the gift annuity, part of each annuity payment is typically federal income tax free to the donor or other annuitant as a return of principal. This tax-free treatment extends until the date the annuitant(s) reaches life expectancy. Based on the age of the annuitant, the tax free portion may be in excess of 70%. When appreciated property is transferred in exchange for a gift annuity, its basis must be allocated between the gift and sale portions and any long-term capital gain must be recognized by the donor. However, the gain on the sale portion may be

recognized ratably over the life expectancy of the annuitant(s) rather than all at once in the year of transfer provided that:

- The donor and any designated survivor beneficiary is/are the only annuitant(s); and
- The annuitant cannot assign the gift annuity payments to anyone other than the issuing charity [Reg. Sec. 1.1011-2(a)(4)(ii)].

Unless **both** of these conditions are met, the donor must recognize all of the gain in the year of transfer. Note that any gain spread over life expectancy reduces the tax-free portion of the annuity payments until all of the taxable gain has been recognized.

## II. CHARITABLE REMAINDER ANNUITY TRUST

A donor who establishes a charitable remainder trust (CRT) of any type is usually looking for some or all of the benefits typical of life income plans — increased cash flow, income tax savings, capital gains and estate tax relief. All properly drawn CRTs allow donors to reap these benefits to a greater or lesser degree, depending on donor choices with respect to trust design, funding, payout rate, applicable federal rate, etc.

### The Payout from a CRAT

The income interest in a charitable remainder annuity trust (CRAT) must be a sum certain — an unchanging dollar amount, fixed at trust inception, and paid at least annually. The payout amount cannot be less than 5% nor more than 50% of the initial fair market value of the assets transferred into the CRAT [IRC Sec. 664(d)(1)(A)]. Any change in the value of trust assets has no effect on the payout.

### Four-Tier System of Taxing Payouts

The annuity amount (and the unitrust amount in a charitable remainder unitrust, or CRUT) received each year by the income beneficiary is characterized under the four-tier system for taxing CRT distributions. Amounts distributed by a CRAT (or CRUT) are treated as having been made in the following order:

1. Ordinary income to the extent of trust income for the current year and any undistributed trust income from prior years.
2. Capital gain (short-term first, then long-term) to the extent the trust has net capital gain for the current year and any undistributed net capital gain of the trust from prior years.

3. Other income (such as tax-exempt income) to the extent the trust has other income for the current year and any undistributed other income from prior years.
4. Return of corpus.

## III. CHARITABLE REMAINDER UNITRUST

A CRUT has three major distinctions from a CRAT:

- The CRUT comes in several varieties rather than one-size-fits-all;
- Additions to the corpus are possible with a CRUT but not a CRAT (each CRUT addition must satisfy the 10% minimum charitable remainder test); and
- The fixed payout percentage (5% minimum, 50% maximum) in a CRUT applies to the annually revalued trust corpus rather than to the initial fair market value of the trust corpus. Thus, the income beneficiary(ies) of a CRUT participate(s) in the growth and earnings (or lack thereof!) of the trust.

### CRUT Design Options

The CRUT was introduced in 1969 as an answer to inflation. In an era of rising prices, the income beneficiary would not be stuck with a fixed dollar payout as in a CRAT. Even though inflation has been low in recent years, the CRUT has still been the more popular form of CRT. The flexibility in trust design and funding and the prospect of increasing income have made the unitrust attractive to many donors, especially those who have yet to retire.

The four types of unitrust are:

1. The straight or fixed-percentage-payout CRUT;
2. The net income unitrust, in which the payout amount is defined as the lesser of the fixed percentage payout or the net income of the trust;
3. The net income/makeup unitrust (NIMCRUT), in which the income shortfalls (from years in which the payout was limited to trust income) may be made up in the later years of the trust if income exceeds the payout required in those years; and
4. The flip unitrust, which starts out as a net income unitrust, and then switches to a straight unitrust upon the occurrence of some prescribed event.

### More on the Flip Unitrust

The IRS has ratified the flip unitrust and provided regulatory guidelines for tax qualification [see Reg. Sec. 1.664-3]. Because of its extraordinary flexibility, the flip unitrust may become the unitrust of choice in many donor situations.

The major drawback: any makeup amounts are forfeited when a NIMCRUT flips to a straight unitrust.

The flip unitrust may be particularly appropriate when the donor wants to transfer real estate or other hard-to-market property to the trust. The trustee can hold the real estate since it does not have to make the trust property productive in order to meet payout obligations. The eventual sale of the property can be the trigger for the trust to switch to a straight CRUT.

### Some General Conclusions about CRTs

The view has been expressed in planned giving circles that too many donors have used CRTs when gift annuities could have accomplished the same results with less expense and complexity. Some disadvantages associated with CRTs include:

- Attorneys' fees to research any tax issues and prepare the CRT instrument;
- Trust administration hassles and fees, including accounting for trust income, filing tax returns, and reporting income to beneficiaries;
- Possible management fees for CRT investments; and
- Practically speaking, the asset value needed to establish a CRT must be at least \$300,000 for it to be economical.

However, certain donor objectives are not possible with a gift annuity but are possible with a CRT. For example, a CRT may be preferred when the donor wants:

- To designate more than one charitable remainderman.
- The payout period to be measured by a term of years (up to 20), rather than by the income beneficiary's life expectancy.
- To fund the gift with real estate, closely held stock or other illiquid asset that may not be permissible or suitable for a gift annuity.
- The payout to grow with the value of trust assets, which is possible only in a unitrust.
- A flexible payout schedule possible with a NIMCRUT or flip unitrust.
- To be trustee of the CRT.

## IV. IMPORTANT DONOR CONSIDERATIONS WHEN SELECTING A LIFE INCOME GIFT

### Income Security

A charitable gift annuity provides income security for a donor or other income beneficiary in the sense that a charity's entire general assets stand behind its promise to pay

the annuity. By contrast, with a CRT, the trust assets alone stand behind payment of the annuity or unitrust amount. Furthermore, with a unitrust, the payouts vary with investment performance.

### Duration of Payments

On the other hand, a typical gift annuity must make payouts measured by the life of one or two annuitants, whereas the duration of CRTs can be measured by a term of years (up to 20), as well as by the life or lives of the non-charitable beneficiaries. Moreover, CRTs can be arranged to last for more than two lives if the 10% minimum charitable remainder test is satisfied.

### Complexity

Donors may feel less intimidated by the relatively simple gift annuity than a lengthy, complicated CRT document with strange new vocabulary such as unitrust amount and remainderman. Implementation of a CRT requires the assistance and expense of an attorney. Likewise, the administration of a CRT may require additional expertise.

### Flexibility

CRTs, however, offer the donor greater flexibility in gift design (especially in payout alternatives) than is available with a gift annuity. The unitrust, in particular, offers several planning options that can be adapted to the donor's individual circumstances and philanthropic goals.

Similarly, a CRUT of the net income, NIMCRUT or flip variety can receive assets that would not be suitable for a gift annuity. For example, some charities may not accept a gift of real estate in exchange for a gift annuity. But real estate might be appropriate for funding one of the CRUT options.

### Minimum Size of Gift

In most cases, a charitable remainder trust is feasible only for larger gifts. A minimum funding level of \$300,000 is generally recommended. A gift annuity can be funded with smaller amounts. Additions to the corpus are possible with unitrusts but not annuity trusts.

### Taxation of Payouts

There may be more favorable taxation of payouts from gift annuities since a portion of each payment is tax exempt as it consists of a return of the donor's cost basis until the donor reaches his or her age of life expectancy as set at the time the annuity is created. The four-tier system for taxing CRT distributions does not provide for any tax-exempt distributions until all levels of taxable income have been distributed.

## NEW TAX DEVELOPMENTS

### Transitional guidance on appraiser and appraisal requirements for charitable contributions of property

Under IRC Sec. 170(f)(11), the donor must obtain an appraisal for noncash contributions greater than \$5,000. The IRS had previously published regulations to define both a qualified appraisal and qualified appraiser. The Pension Protection Act of 2006 (PPA) codified these particular regulations.

In a published notice, the IRS provides transitional guidance before issuing official regulations under IRC §170(f)(11) as it concerns valuation of noncash contributions. A qualified appraisal must meet the description under Reg. 1.170A-13(c) and the requirements outlined in IRC §170(f)(11)(E)(i)(II) – specifically the Uniform Standards of Professional Appraisal Practice. A qualified appraiser must retain an appraisal designation from a recognized appraisal organization based on demonstrated competency or have met the minimum education standards set forth in IRC Sec. 170(f)(11)(E)(ii)(I).

The minimum education standard for real estate appraisers is a license or certification for the type of property being appraised in the state in which the appraised real property is located. The minimum education standard for other appraisers is to have (A) successfully completed college or professional-level coursework that is relevant to the property being valued, (B) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and (C) fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued. The minimum standards of education and experience are effective as of

October 19, 2006 for real estate appraisers, and February 16, 2007 for appraisers of all other property. Plus, the appraiser must acknowledge the penalties for substantial or gross valuation misstatement resulting from the appraisal will subject the appraiser to civil penalties (recently expanded and increased under the PPA; see IRC Sec. 6662 and 6695).

*Source: Notice 2006-96; 2006-46 IRB 1*

### Taxation of UBTI for a charitable remainder trust modified under new law

Unrelated business taxable income (UBTI) is defined as gross income derived from any unrelated trade or business less the deductions directly connected with the carrying on of such trade or business. In the case of a charitable remainder trust (CRT), UBTI usually refers to debt-financed income. Previously, the existence of any UBTI would leave the CRT subject to income tax for its entire net income for that particular tax year – a rather severe penalty since planning featuring CRTs usually depends on the tax exempt nature of the trust.

Under the Tax Relief and Health Care Act of 2006 signed into law on December 20, 2006, if a CRT has UBTI, an excise tax will be imposed on the trust equal to the amount of the UBTI. The excise tax should be paid from the trust corpus. And, the UBTI is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary. This change in the law is effective for tax years beginning after December 31, 2006.

*Source: IRC §664(c) as amended by the 2006 Tax Relief and Health Care Act §424(a)*

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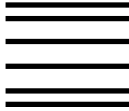
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