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Life Income Gifts: Comparing Charitable Gift Annuities and Charitable Remainder Trusts

Making choices is a part of everyday life. Do you drive or take the train? Do you skip lunch so you can leave work early enough to catch your child's school concert? Do you work this weekend to assure the bonus that would pay for the vacation to Tuscany you promised your family? From the important to the mundane, from personal preferences to overriding moral dilemmas, we are continually faced with choices that demand answers. Sometimes we are sure we are making wise decisions, other times we remain uncertain about a course of action.

We often find the same uncertainty in philanthropically minded clients. The client wants to make a charitable gift, but hesitates because of concerns about perceived or needed income for themselves or their beneficiaries. Uncertainty prevails because the client doesn't know how to accomplish both of these distinct and seemingly contradictory personal planning goals. Fortunately, clients faced with this dilemma have options that allow them to make a charitable gift and provide life income for themselves or a beneficiary. In this issue, we review alternatives that can solve this gifting problem, and present a comparison of two types of life income gifts—charitable gift annuities and charitable remainder trusts.

The term "life income gift" describes a charitable gift that includes an income component in the form of regular payments to a non-charitable beneficiary.[1] The purpose of a life income gift is twofold—to provide a gift to charity and to secure an annuity for the donor or someone else. Though not every donor will want or expect an income stream to be part of a planned gift, the availability of life income options makes certain charitable gifts possible and helps donors make good choices. When a prospective donor is considering a life income gift, highlighting points of comparison between a charitable gift annuity and a charitable remainder trust will help guide the conversation.

FORMATION

A charitable gift annuity (CGA) is a contractual agreement made between the donor and the charity under which the donor agrees to make a charitable gift, and the charity agrees to pay a fixed amount periodically to the person designated by the donor. The charity provides a standard CGA contract that offers the donor limited choices depending on the type of CGA and what is permitted under state law.[2]

Questions for the donor include:

- Is the annuity for a single life, successive lives, or joint and survivor?
- Do the annuity payments begin immediately or later (more than a year after the gift)?
- Will payments be made monthly, quarterly, semi-annually or annually?
- Which monthly applicable federal rate is best to use?[3]

A charitable remainder trust (CRT) is a legal entity created by the donor. As such, the donor's particular planning needs influence the terms of the trust.[4] The donor, or one or more individuals designated by the donor, receives income from the trust for life, joint lives, or for a period of up to 20 years, after which the trust terminates and the trust corpus is distributed to the charitable remainderman. In order to qualify as a split-interest trust that generates an income tax deduction for the donor, the CRT has to meet criteria described under Section 664(d) of the Internal Revenue Code.[5]

FUNDING THE GIFT

A donor may fund a CGA with cash or property. Though cash is the simplest option, a donor might prefer to use other property such as appreciated securities held for more than one year. By using this type of asset, the donor avoids incurring capital gain on the gift part of the CGA, and the long-term capital gain realized on the annuity part of the CGA can be evenly spread across each year of the donor's life expectancy.[6]

While cash or marketable securities are easy funding choices, property that cannot be easily valued or easily sold is not the best option to fund a CGA. Payments must begin within the year the gift is made, and the charity would be at a disadvantage if the funding asset cannot be quickly converted into an income producing asset. The reality of charitable giving is that most, if not all charities, will not accept a gift that cannot be quickly converted into a liquid asset.[7]

A charitable remainder annuity trust (CRAT) is much like a CGA in that illiquid assets may not be a good choice to fund the gift.[8] Annuity payments must be paid at least once a year so an illiquid asset that does not generate income is not the best choice for funding, unless sufficient cash was also part of the gift.[9]

However, a charitable remainder unitrust (CRUT) can be a different matter.[10] There are variations of the CRUT that permit flexibility in the annuity payout. For instance, a "flip" CRUT is a type of CRT that allows the trust to change its payout method when a triggering event occurs. The CRUT begins as a net-income CRUT holding an asset that does not produce any income so there is no need for the trust to make payments. When the asset sells, the trust "flips" into a straight CRUT. The trustee invests the proceeds from the sale into income producing assets that permit the regular annuity payout.

GIFT AMOUNT

The minimum amount necessary to establish a CGA can be relatively modest and is determined by the charity. A 2009 survey conducted by the American Council on Gift Annuities reported that $10,000 was the minimum amount for 62.1% of respondents.[11]

A CRT may be feasible only for larger gifts, at least $100,000 depending on the type of CRT, due to the cost of creating and maintaining the trust. Note that it is possible to make additional gifts to the corpus of a CRUT (but not an annuity trust).

PAYOUT – RATE

The charity sets the payout rates for the CGA based on the annuitant's age. The offered payout rate must pass the 10% residuum to charity rule set forth in IRC Sec. 514(c)(5).[12] The charity cannot offer enhanced annuity payments based on investment performance or any other index.

The donor sets the payout rate for the CRT, but must follow the requirements found in the Internal Revenue Code. The payout rate must be at least 5%, but no more than 50%, and the calculation for the proposed CRT at the given rate must provide at least a 10% remainder to charity.[13]

PAYOUT – DURATION

A CGA makes annuity payments for the life of one or two annuitants. The CGA agreement cannot specify that the annuitant will receive a certain number of payments. The duration of CRTs can be measured by a term of years up to 20, or by the life or lives of the beneficiaries.

PAYOUT – VARIABILITY

The amount of the CGA annuity payment is set at the time it is created and never varies.

The payout of a CRAT is similarly fixed at the time the trust is created (as a percentage of the trust assets valued at that time) and never varies. The payout rate of a CRUT can vary from year to year, because it is a percentage of the trust assets as revalued every year. Also, a net-income CRUT payout may vary depending on the income the trust has earned, because the payout is the lesser of the net income earned or a percentage of the trust assets.[14] In the case of a net-income CRUT with a make-up provision, the trustee can pay a percentage of the trust assets as valued for the year, plus any amount of trust income in excess of the percentage to the extent that the trust experienced income deficits in prior years.[15]

PAYOUT – INCOME TAXATION

At the outset, a CGA payout can be taxed as income in three ways:

- A tax-free return of principal. Part of the annuity payment is a tax-free return of principal until the assumed cost of the annuity determined by the IRS tables has been recovered.

- Long-term capital gain. If the donor is the annuitant and funds the CGA with long-term capital gain property, part of the annuity payment will be taxed as long-term capital gain.
- Ordinary income. After the tax-free and capital gain portions of an annuity payment have been determined, the balance of the payment represents ordinary income.

Once the annuitant attains life expectancy, all principal attributable to the sale portion will have been recovered income tax-free and all capital gain attributable to the sale portion will have been recognized. Thereafter, the entire annuity payment will be taxable as ordinary income.

A CRT payout is taxed as income according to a four-tier system that accounts for the nature of the income itself:

1. Ordinary income;
2. Capital gain income;[16]
3. Other income (i.e., tax-exempt interest);
4. Tax-free return of the trust principal.[17]

Distributions are made according to a "worst in-first out" system for each respective tier. The highest taxed income in the top tier, ordinary income, is distributed first. If there is both ordinary interest income and qualified dividend income, the ordinary interest income is distributed first, then qualified dividends. After all ordinary income has been distributed, capital gains are distributed. Within the capital gains tier, net short-term capital gains are distributed before the net long-term capital gains.

BENEFICIARIES

The donor may choose one or two living persons (not a trust, corporation, LLC or charity) as annuitants of a CGA. For a CRT, the donor may choose any number of beneficiaries so long as there is at least one that is not a charity. Any number of charitable remaindermen may receive the remaining trust assets once the term of the CRT has ended. The donor may choose to retain a power to change the charitable remainderman without compromising the tax-exempt nature of the CRT.

ONGOING ADMINISTRATION

Once the CGA is established, the charity places the donor's gift in its own reserve fund. The charity observes its own policies and state regulations for investment and maintenance of reserve funds. Every year, the charity sends payment to the annuitants. The charity subsequently issues a 1099-R form to the annuitants detailing the taxation of the CGA payout.

A CRT has several ongoing administrative issues that the trustee must oversee.[18] The trust assets require regular investment management. The trustee must file the trust tax returns and make an accounting of trust income. In the case of net income make-up unitrusts, the trustee must also track the make-up amount when the income is less than the payout rate. Perhaps most importantly, especially to the beneficiaries, the trustee must report and distribute income to the trust beneficiaries.

RETIREMENT PLANNING

For persons looking to boost their income in retirement, a deferred CGA is an option. A deferred CGA begins payment at least one year after the date the CGA is created. Compared to regular CGAs, a deferred CGA has a higher payout rate and generates a larger charitable deduction. The donor enjoys the charitable deduction that year though the payments do not begin until some future date.

A CRUT naturally fits the retirement model because the payout reflects the investment performance of the trust assets, which can provide a hedge against inflation. More specifically, the assets in a net-income CRUT with a make-up provision can be invested, beginning payments at some future retirement date. The make-up provision units could provide an influx of cash to the beneficiary at that later date.

EASE OF EXPLANATION TO THE DONOR

A CGA is a relatively simple concept—part gift, part annuity—and the agreement document is short and straightforward. On the other hand, the CRT document is much more extensive and consists of titled paragraphs and what many refer to as "boilerplate" language. The language used to describe a CRT can be foreign even to a financially literate person—CRAT, CRUT, NICRUT, NIMCRUT, flip CRUT, remaindermen, etc.

ADVISING CHARITABLY-MINDED CLIENTS

Our discussion of CGAs and CRTs shows how each is similar to the other in some ways, yet different in many others. The predominant aspect that both life income gift options share is the donor's intention to make a gift. The payout rates of a CGA, even after considering the charitable gift deduction, will almost never compare favorably to commercial annuity rates, nor will the time and donor expense required

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to create and maintain a CRT justify the income it produces if a charitable gift is not personally important to the client.

Life income gifts are attractive to dedicated supporters because incorporating philanthropy into planning is essential for donors who want to give back to the charities they've spent a lifetime supporting. Advising clients how charitable giving compliments personal planning will be welcomed by philanthropically minded clients, and will help them as they undertake personal planning choices.

ENDNOTES

[1] It is important to keep in mind that the donor can be a beneficiary in the same manner as a third party, and, in fact, that the donor may be one of a number of beneficiaries.

[2] When so required by state law, the issuing charity must register with the state insurance departments 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 their potential obligations to annuitants under gift annuity agreements.

[3] The Internal Revenue Code ("IRC") allows the selection of the Applicable Federal Rate from the present month or one of the two prior months. IRC §7520. AFR rates can be found at: www.irs.gov/app/picklist/list/federalRates.html

[4] Charitable remainder trusts come in two forms: charitable remainder annuity trust (CRAT) and charitable remainder unitrust (CRUT). IRC §664(d); Treas. Reg. Sec. 1.664-1(a)(2).

[5] IRC §664(d).

[6] To qualify for this ratable recognition of long-term capital gain, the donor must be the only annuitant (or the donor and a designated survivor annuitant), and the annuity cannot be assignable to anyone but the charity itself.

[7] A key factor in the charity's acceptance of an illiquid gift is whether the state law of the charity's home state permits the charity to count certain illiquid assets towards the state's reserve requirements for charities. Additionally, most charities have adopted strict provisions in their gift acceptance policies which govern their acceptance of an illiquid gift. For example, a proposed real estate gift would likely be required to have appraisals, inspections, and a Phase I and Phase II environmental assessment.

[8] In 2003, the IRS issued model CRAT forms with preapproved trust language to conform to statutory and regulatory changes. Rev. Procs. 2003-53 through 2003-60, released in IRB 2003-31.

[9] The requirement that the annuity payment be paid once a year is a requirement that also includes the year the trust is created. This is a very important point in advising clients and planning.

[10] The CRUT comes in four sub-varieties: the straight or fixed-percentage unitrust; the net-income (without make-up) unitrust; the net-income with make-up unitrust (NIMCRUT); and the "flip" unitrust.

[11] The American Council on Gift Annuities (ACGA) presented its fourth national survey on charitable gift annuities in 2009. A report from the ACGA can be found at: www.acga-web.org/best_practices.html.

[12] IRC §514(c)(5).

[13] IRC §664(d).

[14] IRC §664(d)(3)(A).

[15] IRC §664(d)(3)(B).

[16] A fact to keep in mind is the differing treatment of types of capital gain, which does add another layer of complexity to the four tiered tax structure.

[17] IRC §664(b); Treas. Reg. Sec. 1.664-1(d)(1).

[18] The donor names the trustee, which may be the donor, the charitable remainderman, a third party (e.g., attorney, accountant, relative, etc.), or a financial institution with trust powers. The donor may retain the right to change the trustee.

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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