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Charitable Gift Annuities: A Highway to Planning

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Charitable Gift Annuities: A Highway to Planning

Thor Heyerdahl was an adventurer. After serving as a WWII parachutist, he worked as an anthropologist in South America.[1] Discovering cultural, religious and oral history similarities between Polynesia and Peru led Heyerdahl to speculate on an ancestral connection between the two—an idea in direct opposition to the prevailing theory that the Polynesians were descended from people from other parts of Asia.

To prove that the ocean was a highway, not a barrier, Heyerdahl mounted an expedition to sail from Peru across the vast Pacific to the Polynesian Islands using a raft typical in material and construction to those used by the pre-Columbian Peruvians. He and five fellow adventurers loaded up Kon-Tiki (their 30 x 15 balsa-wood raft) and set off, reporting by radio on their status and scientific observations. Of course, this perilous 4,300-mile journey required extensive planning and courage, but the team proved the plausibility of Heyerdahl's theory by reaching Polynesia in 101 days.

Today, philanthropically inclined adventurers may, like Heyerdahl, need assurance that a charitable gift can be "a highway, not a barrier" to income security. Donors who want to make charitable gifts but also want to be assured of future income security may find that a charitable gift annuity lets them do both—create a positive steady stream of income (for themselves and/or another recipient of their choosing) and accomplish another important goal in their philanthropic journey.

Formation: Considering Options and Planning Ahead

Short trips require planning, but longer voyages necessitate a greater investment of time and energy as travelers contend with alternate GPS routes, roadwork, flight schedules, tight connections, security measures, packing restrictions, and inevitable delays. Donors may confront a similar level of alternatives and challenges when setting up a charitable gift annuity (CGA).

Charitable gift annuities are contractual agreements under which a donor agrees to make an irrevocable gift of cash or property (often, long-term appreciated stock) to a qualified charity, and in return, the charity agrees to pay a fixed amount for life to the donor and/or another person designated by the donor, with payments to be made quarterly, semiannually or annually. However, the transaction is not merely a "quid pro quo" between donor and charity. Since the present value of the donor's annuity is less than the value of the property transferred, the transfer is legally considered part charitable gift and part annuity purchase.

NOTE: Charitable gift annuities are regulated by state law, so advisors should review the applicable state requirements carefully. See the Regulation section for more detailed information.

Benefits of a CGA

Of course, the charity benefits from the gift, but there are a number of advantages to donors as well:

- **Simplicity.** Since a CGA is a contractual arrangement, it is often easier to create and explain than other charitable tools (consider charitable trusts, for example, which require additional legal work and expense to create and administer).
- **Immediate tax deduction.** The CGA provides an immediate income tax charitable deduction in the year the property is transferred to charity for donors who itemize.
- **Income stream.** The charity promises to provide annual payments over the lifetime(s) of one or two individuals, with part of each payment considered a tax-free return of principal—a promise backed by the charity's general assets.
- **Flexibility.** The donor can choose whether to begin income payouts immediately or defer income until some point in the future.
- **Appreciated property tax treatment.** When a donor transfers appreciated property in exchange for a gift annuity, the resulting capital gains tax liability (recognized because the transfer is, in part, a taxable exchange of property) can be spread over life expectancy if the donor is the annuitant.

- **Smaller gift threshold.** Often, the minimum gift amount required is low enough to make gift annuities accessible to a large part of the charity's donor base.

Types of CGA Agreements

There are typically three types of CGA agreements that fit the varying needs and wishes of the donor.

- **Single life**—an annuity that pays income to one person for that person's lifetime.
- **Two lives in succession**—an annuity that pays first to one person and then, upon that person's death, to a second person (assuming the second person survives the death of the first person).
- **Joint and survivor**—an annuity that pays two annuitants during their respective lives, but upon the death of one, pays the full amount of the payment to the surviving annuitant.

Usually, these agreements are fairly standard. They offer donors limited choices and are based on the type of CGA and what is permitted under state law.

Immediate vs. Deferred

While an immediate gift annuity begins payments within one year, a deferred gift annuity lets donors postpone the start date of income payments beyond the one-year mark. A deferred annuity significantly increases the annuity amount and the income tax charitable deduction (which is still available in the year of the contribution). Although many high-earning donors find the immediate income tax relief attractive, they neither want nor need additional current income, preferring instead that payments begin later when they can be used to supplement other retirement income.

The IRS has even approved a deferred gift annuity that did not specify a fixed starting date for the annuity payments.[2] In this Private Letter Ruling (PLR), the gift annuity agreement specified a different payment amount for each possible age at which payments might begin, rising with the deferral of the start date. 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. This letter ruling technically applies only to the donor involved therein, but it is generally believed that the IRS will look favorably on similar cases in which donors seek to preserve some flexibility in setting their annuity starting date—and who are willing to take a lower upfront deduction in return.

Funding the Gift

Each charity determines its own minimum amount necessary to establish a CGA. In many cases, this minimum is much lower than the threshold required for other charitable giving options.

A donor may fund a CGA with cash or property. Though cash is the simplest option, using appreciated property (say, securities held for more than one year) lets donors avoid capital gains tax on the gift part of the CGA. In addition, 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. 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.

Avoid funding a CGA with property that cannot be easily valued or sold. Payments for an immediate CGA must begin within a year, and the charity would be at a disadvantage if it could not quickly convert the funding asset into income-producing property. The reality of charitable giving is that most (if not all) charities refuse to accept gifts that cannot be quickly converted into a liquid asset.

Taxation: Avoiding Hazards

Long-haul truckers expect to face hazards—inclement weather, traffic jams, poor drivers, damaged roads. However, there are also unexpected hazards. For example, one trucker reported driving through the Arizona desert when it appeared that wind was blowing leaves across the road ahead. As she approached, however, she realized that what she thought were leaves were in reality thousands of tarantulas crossing the road during migration—so many that her wheels began slipping.[3] Undoubtedly, her mental list of potential hazards for her next trip through the desert included spiders.

While CGA transactions are pretty well guaranteed to be tarantula free, donors should be aware of potential hazards, such as the assessment of unwanted taxes that may result from poor planning. Donors who understand the CGA tax treatment can find the best ways to fund a gift annuity and avoid unexpected hazards.

Income Tax Charitable Deduction

As we mentioned earlier, a charitable gift annuity is part gift and part sale (i.e., a bargain sale).[4] The donor must intend for the donation of the property to be a charitable gift for the income tax charitable deduction to be allowed.[5] The donor receives this deduction in the year the gift is made, but only for the gift portion of the transfer—in other words, the value of the contributed cash or property less the present value of the annuity payments.[6]

The deduction for a cash gift is limited to 60% of adjusted gross income (AGI).[7] The deduction for a gift of long-term appreciated property is generally limited to 30% of AGI.[8] Any deduction in excess of the applicable percentage limitation may be taken in up to five following tax years. If the donor needs a large deduction in the current year or if the appreciation in the donated property is minimal, the donor may make a special election to take the 60% deduction on appreciated property and reduce the deduction to the basis of the property.[9] However, by taking the special election, the donor may lose some charitable carryover, since the carryover will be recomputed as if the election was also made in prior years.[10]

A gift annuity payable to two annuitants for their joint lives will result in a reduced income tax charitable deduction. Obviously, the payout period for two annuitants is expected to last longer than for a single annuitant, thus boosting the present value of the annuity.

Gift Tax Implications

If the donor names someone else as the sole annuitant, the donor has made a gift of the present value of the annuity for gift tax purposes. If the annuity is immediate, the donor may be entitled to use the annual gift tax exclusion.[11] If the annuity is deferred, the annual exclusion is generally not available since the annual gift tax exclusion is for present gifts.[12]

Estate Tax Implications

The estate tax implications depend on the type of CGA. If the donor was the sole annuitant, there are no federal estate tax implications upon the donor's death. However, there can be estate tax considerations for joint annuitants.[13]

CONSIDERATIONS: A donor who is considering a CGA should give thought to a number of questions, including:

- Is the annuity for a single life, successive lives, or joint and survivor?
- Will the annuity payments begin immediately or in the future (more than a year after the gift)?
- Will payments be made monthly, quarterly, semiannually, or annually?
- Will funding come from cash or property? If property, is it liquid enough for the charity? Is it long-term capital gain property? Does the donor need to consider the special election to take the 60% deduction?
- Does the donor have the requisite intent to make the gift?
- Will the donor retain any right to revoke the annuity for any other annuitant?
- Will the donor be the sole annuitant or will there be gift tax implications?

Administration: Optimizing Future Success

The NFL is big business, and the people who run football teams must continually evaluate players with an eye toward long-term success. Often, this presents a challenge. Consider teams who have a great young quarterback on the bench behind a successful older player. Both the San Francisco 49ers (hall-of-famer Joe Montana and his replacement, Steve Young) and the Indianapolis Colts (future hall-of-famer Peyton Manning and his replacement, Andrew Luck) faced this situation. Both football teams had to consider what was best for their future, and both ended up moving on from their legendary quarterbacks.

As donors near retirement, they also must consider what is best for their future. When evaluating sources of future income, donors may need to decide whether high-performing resources will continue to maintain returns, or whether it makes more sense to convert to an asset that will produce a guaranteed income stream later. This is an excellent use of a charitable gift annuity—however, it's vital for the donor to understand the process by which a CGA pays out and the implications of the payout.

Payout

The charity determines the payout rate for the CGA based on the annuitant's age—but keep in mind that the payout rate must meet the IRC's requirement of a minimum 10% residuum to the charity.[14] Most charities adopt a rate similar to the schedule of rates published by the American Council on Gift Annuities (ACGA)—a nonprofit that has long published suggested maximum charitable gift annuity rates recognized as actuarially sound by state insurance departments and the IRS. At its Board of Directors meetings, the ACGA reviews the assumptions that go into the suggested CGA rates and adjusts the rates if necessary. The ACGA's suggested rates are "generally…designed to produce a target gift for charity at the conclusion of the contract equal to 50% of the funds contributed for the annuity."[15]

It's important for donors to understand that the annuity payment amount set in the CGA contract cannot be changed and will not reflect investment performance or any other index. For most donors, this is a benefit, as the CGA provides dependable income that will never be impacted by a decline in the markets.

A CGA makes annuity payments for the life of one or two annuitants—it is not possible to specify that the annuitant will receive a certain number of payments. (Donors interested in setting a specific term for payments should consider the charitable remainder trust, which can be measured by a term of years up to 20, or by the life or lives of the beneficiaries.)

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 considered a tax-free return of principal until the assumed cost of the annuity (as determined by IRS tables) is recovered.
- **Long-term capital gain.** If the donor is the annuitant and funds the CGA with long-term capital gain property, part of each 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 taxed as ordinary income.

Beneficiaries

The donor may choose one or two living persons (not a trust, corporation, LLC, or charity) as annuitants to receive the payout from a charitable gift annuity.

Retirement Planning

As we mentioned earlier, a deferred CGA may be an excellent option for a donor who would like to provide an additional stream of income during retirement. The payout can be set to begin at retirement, or at some other date at least one year after the date of creation, which offers important planning flexibility. In addition, compared to an immediate CGA, a deferred CGA offers a higher payout rate on future payouts and a larger charitable deduction in the year of creation.

Ongoing Administration

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

Regulation: Adhering to National and State Rules

Let's take a quick look at some of the regulations that govern the operation of charitable gift annuities.

The Philanthropy Protection Act of 1995

Prior to December 1995, a number of charities and donors harbored concerns about the status of charitable gift annuities. Part of this concern was related to a class action case filed in Texas which alleged that charitable gift annuities were actually investment companies under the federal Investment Company Act and the plaintiffs were seeking a rescission of certain charitable donations (*Richie v. American Council on Gift Annuities, Inc.*, 943 F. Supp. 685 (N.D. Tex. 1996)). However, Congress stepped in, and with President Clinton's signature on December 8, 1995, the Philanthropy Protection Act of 1995 (PPA) was put into law.

The PPA clarified charitable gift annuities, providing both certainty and protection for the charities offering gift annuity contracts. According to the PPA:

> The Philanthropy Protection Act of 1995 "is to protect and facilitate donations to entities organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes (collectively referred to as "charitable organizations") by limiting the applicability of Federal and State securities laws to the activities of such organizations in connection with the maintenance of certain pooled funds (collectively referred to as "charitable income funds"). Charitable income funds include a variety of vehicles that permit donors to make contributions and retain a remainder interest, usually a lifetime income interest, in the donated property.[16]

The ACGA notes that the PPA "prohibits the payment of commissions or remuneration to anyone based on the value of a charitable gift annuity given to a public charity, and also requires the charity to provide a Disclosure Statement to the donor prior to the receipt of the donor's first annuity gift given to that charity."[17]

Current State of the State in Regulating CGAs

As you might expect, there is some variation among the states regarding the regulation of CGAs—some are silent, others require registration, and still others have more developed laws providing CGA regulation. While a thorough, in-depth treatment of state laws in this area falls beyond the scope of Techniques *ADVANCED*, we will provide a glimpse of which states fall into which broad category. State information is provided courtesy of the ACGA.[18]

Generally Silent on CGAs

- Delaware (Delaware Insurance Code Sec. 2902)
- Ohio (*Transgenstein v. Board of Trustees of Wheaton College*, 96 Ohio St. 3d 1525 (2002))
- Michigan (Attorney General Opinion)
- Rhode Island
- Wyoming

Require Initial Registration/Notification

- Alaska (Alaska Statutes Section 21.03.070 and 21.03.021)
- Connecticut (Connecticut General Statutes Sections 38a-1030 to 38a-1034)
- Idaho (Idaho Code Sections 41-114 and 41-120)
- Iowa (State of Iowa Laws Section 508F.1 through 508F.8)
- Mississippi (Mississippi Code Sections 79-11-651 through 79-11-661)
- Missouri (State of Missouri Laws Sections 352.500 - 352.520)
- Nevada (Nevada Revised Statutes, Sections 688A.281 through 688A.285)
- New Mexico (New Mexico Statutes Annotated, Section 59A-1-16.1)
- North Carolina (North Carolina Section 58-3-6)
- Texas (Chapter 102, Texas Insurance Code)
- West Virginia (West Virginia Code Section 33-13B-1-6)

Require Registration and Annual Filing

- Alabama (Code of Alabama Section 8-6-10(8))
- Arkansas (Arkansas Code Section 23-63-201(d) and Rule 90)
- California (California Insurance Code Sections 11520-11524)
- Florida (Section 627.481 of the Florida Statutes)
- Georgia (Official Code of Georgia Annotated Sections 33-58-1 to 33-58-6)

- Hawaii (Hawaii Revised Statutes Section 431:1-204)
- New Hampshire (Chapter 403-E of New Hampshire Revised Statutes Annotated)
- New Jersey (New Jersey State Statutes Annotated Section 17B:17-13.1)
- New York (New York State Insurance Law Section 1110)
- Maryland (Maryland Insurance Code Sec. 16-114)
- Montana (Montana Code Annotated, Sections 33-20-701 through 33-20-705)
- North Dakota (State Century Code Sections 26.1-34.1-01)
- Oklahoma (Oklahoma Charitable Gift Annuity Act: Oklahoma Statutes, Title 36, Sections 4071-4082)
- Tennessee (Tennessee Code Annotated, Sections 56-52-101 through 56-52-111)
- Washington (Revised Code of Washington Chapter 48.38 and Chapter 284-38 WAC)

Certain Criteria but No Registration

- Arizona (Arizona Revised Statutes Section 20-103 and Arizona Revised Statutes Section 20-119)
- Colorado (Colorado Revised Statutes 10-1-102(4) and 10-3-903(2)(i))
- Illinois (Section 215 ILCS 5/121-2.10)
- Indiana (Indiana Code Section 27-1-12.4-2)
- Kansas (Kansas Uniform Securities Act, Section 17-12a201(7))
- Kentucky (Section 304.1-120 of the Kentucky Revised Statutes)
- Louisiana (Insurance Code under Secs. 22:951(D) and 22:952 of the Louisiana Revised Statutes)
- Maine (Maine Insurance Code, under Title 24-A, Section 3 of the Maine Revised Statutes)
- Massachusetts (Chapter 175, Sec. 118 of the General Laws of Massachusetts)
- Minnesota (Minnesota Securities Statute 80A.45 Section 201(7))
- Nebraska (Nebraska's Charitable Gift Annuity Act, Revised Statutes of Nebraska, Sections 59-1801 to 59-1803)
- Oregon (Oregon Revised Statutes 731.038)
- Pennsylvania (Pennsylvania Statutes, Title 10, Sections 361-364)
- South Carolina (Section 38-5-20 of the Code of Laws of South Carolina)
- South Dakota (South Dakota Codified Laws Section 58-1-16)
- Utah (Utah Code Annotated Sections 31A-1-301(88) and (93) and 31A-22-1305)
- Vermont (Vermont Statutes Title 9, Chapter 68, Sections 2517 to 2518)
- Virginia (Sections 38.2-106.1 and 38.2-3113.2 of the Code of Virginia)
- Wisconsin (2013 Wisconsin Act 271)

Long Range Planning—For Fun and Financial Security

Though Thor Heyerdahl took a mere 101 days to cross the Pacific Ocean from Peru to Polynesia, unlike Heyerdahl, if you plan to visit Walt Disney World or Universal Studios in Orlando, experts warn that you need to have resort rooms booked 365 days in advance, dining reservations made 180 days in advance, and ride reservations in place for 60 days. Despite the meticulous planning that is necessary, millions of people eagerly await visits, walking away at the end of their trip with zero regrets and great memories of the vacation of a lifetime.

For donors, a little extra planning may provide them with the exact benefits they'd hoped for—a way to make a heartfelt gift to a favorite charity while securing an income stream for life. In fact, when a donor understands this giving tool, makes wise choices when it comes to type and funding, and realizes how to avoid potential tax hazards, it's easy to walk away with zero regrets. And while a charitable gift annuity may not make a donor vacation-of-a-lifetime happy, there can be true joy found in making a real difference for a meaningful charity while simultaneously securing future income and enjoying a current tax advantage.

ENDNOTES

1 Thor Heyerdahl Biography (https://www.biography.com/people/thor-heyerdahl-21183589).
2 PLR 9743054(1997) and PLR 200449033: In the first PLR, the donor established the annuity at age 50, and could elect to have payments begin at any time after age 55.
3 See "31 Truck Drivers Reveal Their Crazy, Bizarre and Wild Experiences on the Road," Thought Catalog, January 2014 (https://thoughtcatalog.com/hok-leahcim/2014/01/31-truck-drivers-reveal-their-crazy-bizarre-and-wild-experiences-on-the-road/) and also "Tarantulas on the March," Desert Road Trippin', October 2010 (https://www.desertusa.com/dusablog/tarantulas-on-the-march.html).
4 IRC §1011(b); Reg. §1.1011-2. Rev. Rul. 81-163.
5 *United States v. American Bar Endowment*, 477 U.S. 105 (1986).
6 IRC §170, IRC §2522, and IRC §2055; Reg. §1.170A-1(d)(1), §25.2522(c)-3(d), and §20.2055-2(f).
7 IRC §170(b)(1)(A).
8 IRC §170(b)(1)(C).
9 IRC §170(b)(1)(C)(iii).
10 Reg. §1.170A-8(d)(2).
11 IRC §2503(b).
12 Id.
13 IRC §2039(a).
14 IRC §514(c)(5).
15 "Gift Annuity Rates," American Council on Gift Annuities website, May 2018. https://www.acga-web.org/gift-annuity-rates/411-suggested-maximum-rate-schedules-effective-july-1-2018-released.
16 "H. Rept. 104-333—Philanthropy Protection Act of 1995," 104th Congress (1995-1996), Congressional website. https://www.congress.gov/congressional-report/104th-congress/house-report/333.
17 "Philanthropy Protection Act of 1995," American Council on Gift Annuities website, January 1995. https://www.acga-web.org/public-policy/53-text-of-philanthropy-protection-act-of-1995.
18 "State Regulations," American Council on Gift Annuities website. https://www.acga-web.org/state-regulations.

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