THE CATHOLIC FOUNDATION

THE Good Advisor

SPRING 2019
VOLUME XXXI
ISSUE II

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 an 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.

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.

Funding the Gift

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.

The Gift Annuity Rate

Each charity determines its own annuity rate, but 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.

The Gift Amount

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.

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.[2] 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).[3] The donor must intend for the donation of the property to be a charitable gift for the income tax charitable deduction to be allowed.[4] 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.[5]

The deduction for a cash gift is limited to 60% of adjusted gross income (AGI).[6] The deduction for a gift of long-term appreciated property is generally limited to 30% of AGI.[7] 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.[8] 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.[9]

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.[10] If the annuity is deferred, the annual exclusion is generally not available since the annual gift tax exclusion is for present gifts.[11]

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.[12]

Long Range Planning—For Fun and Financial Security

Though Thor Heyerdahl only took 101 days to cross the Pacific Ocean from Peru to Polynesia, experts warn that if you plan to visit Walt Disney World or Universal Studios in Orlando, you need to have resort rooms booked 365 days in advance, dining reservations made 180 days in advance, and ride reservations in place 60 days in advance. Despite the excessive planning that is necessary, millions of people eagerly plan visits, walking away at the end of their holiday 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 a guaranteed 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 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).

3 IRC §1011(b); Reg. §1.1011-2. Rev. Rul. 81-163.

4 United States v. American Bar Endowment, 477 U.S. 105 (1986).

5 IRC §170, IRC §2522, and IRC §2055; Reg. §1.170A-1(d)(1), §25.2522(c)-3(d), and §20.2055-2(f).

6 IRC §170(b)(1)(A).

7 IRC §170(b)(1)(C).

8 IRC §170(b)(1)(C)(iii).

9 Reg. §1.170A-8(d)(2).

10 IRC §2503(b).

11 Id.

12 IRC §2039(a).

Access more information now!

An electronic copy of our companion booklet with a more details including the administration of CGAs, beneficiaries, the basics of the Philanthropy Protection Act of 1995, and more on the state regulation of charitable gift annuities may be accessed in the Professional Advisor section of our webite at **www.catholicfoundation.com.**

You can download this PDF and store it on your PC or tablet for easy access.

THE CATHOLIC FOUNDATION

12222 Merit Drive, Suite 850 • Dallas, TX 75251 • Phone 972-661-9792 • Fax 972-661-0140

www.catholicfoundation.com