WHAT TO USE AND WHEN: CGAS VS. CRATS AND CRUTS

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Presented by:

Jeff Lydenberg, Vice President, Consulting
PG Calc
129 Mt. Auburn Street
Cambridge, MA 02138
617-497-4997

I. Introduction

The practice of planned giving fundraising has transformed itself since the turn of the 21st century. Previously, the planned giving specialist kept the keys to the knowledge required to complete planned gifts. Development offices were heavily siloed. In the past, small shops without a planned giving officer thought they couldn't talk about planned giving. It was just too complicated!

The landscape has shifted. Planned gifts are now integrated into all areas of fundraising, the annual fund, major gifts, events, and more. Collaboration is encouraged. The reasons are simple. It is objectively true that the clear majority of estate gifts come from wills, trusts, and qualified retirement plans. Complicated trusts and annuities account for a small amount of realized deferred gift revenue. Anecdotally, and supported by academic research, planned gifts come from a deep, abiding connection to the charity. Taxes influence giving but does not drive the decision to make a planned gift.

Nonetheless, it is the case that certain donors will want to make their planned gift in the form of a charitable trust or annuity. Sophisticated planned giving offices typically have the resources to issue gift annuities and may even act as trustee of charitable trusts. Even a modest planned giving program may be the beneficiary of outside managed charitable trusts.

Given that non-specialists and small organizations can all talk about simple planned gifts like bequests, fundraisers need a basic familiarity with more complex gifts. By far, the life income plan most commonly discussed is the gift annuity. If a prospect ever uses the words income, the typical fundraising generalist will reflexively suggest a gift annuity.

There are some situations where either a charitable remainder trust or a gift annuity would be appropriate, and there are other situations where one or the other is clearly preferable.
This paper describes how gift annuities and charitable remainder trusts work and how to suggest which vehicle may be best for the donor. The specific donor situations covered are:

- Donors who are older, risk averse, and want the security of fixed payments.
- Donors who are comfortable with risk and want income to keep pace with inflation.
- Donors who are still working and want to supplement their income in retirement.
- Donors who want to contribute real estate and other illiquid assets.

This paper will not include a discussion of the charitable lead trust.

II. Older, Risk Averse Donors

A. Gift Annuities

The gift annuity is the vehicle of choice for older donors who want to make a gift and receive income. These donors are typically your oldest supporters, typically 75 or older. A national survey of gift annuity programs concluded the average age at first annuity is 79. These donors

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like the security of fixed regular payments for the rest of their lives. Since the annuity creates a contractual obligation to pay, their payments are not subject to fluctuations in the stock market.

Gift annuity rates are published by the American Council on Gift Annuities (ACGA). Most charities follow the ACGA rates and those rates are accepted as actuarially sound in highly regulated states. Annuity rates are based on the ages of the annuitant and the number of annuitants. The older the annuitant, the higher the rate. A two-life annuity will have a lower rate than a one-life annuity and generate a smaller charitable deduction.

Example

Leah, age 78, has a $50,000 CD that is maturing. She could purchase another CD paying three percent, but instead she contributes the $50,000 for a gift annuity. Here is a comparison of her cash flow from another CD and the gift annuity.

CD Investment

Invested in CD	$50,000
Interest	1,500
Income tax on interest (24% rate)	-360
Net spendable	$1,140

Gift Annuity

Contributed for gift annuity	$50,000
Annual payment (6.8%)	3,400
Taxed as follows:	
Ordinary income	925
Tax-free	2,475 *
Income tax (24% x $925)	-222
Net spendable	$3,178

* At the end of her actuarial life expectancy (10.5 years), the annuity payments will become fully taxable as ordinary income.

In addition to nearly tripling her cash flow from the $50,000 that had been invested in CDs, Leah receives a charitable deduction of $22,440. If Leah itemizes and her deduction is 60% or less of her income, she could enjoy tax savings of $5,765.

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Caution: This illustration raises an important issue. While gift annuity payments can be competitive with safe fixed-income commercial investments, a gift annuity should never be discussed or marketed as an investment. The annuity is a gift with income and tax benefits.

The gift annuity is an irrevocable arrangement. The donor cannot get back what they contributed to make their gift. The donors retain an irrevocable income stream but are not able to get their money back.

Nonetheless, the gift annuitant can either surrender their annuity in favor of the charity (and potentially receive an additional tax deduction) or choose to take a lump sum payment equal to the value of the remaining income.

B. Rules Applicable to all Charitable Remainder Trusts

A charitable remainder trust (CRT) is an irrevocable trust, established by the donor either during life or at death, which pays to one or more beneficiaries a specified amount until the termination of the trust, at which point the trust remainder is paid to, or for the use of, one or more charitable organizations. At least one of the beneficiaries cannot be a charity and the payments must last for the lifetime of one or more individual beneficiaries or for a term not exceeding 20 years (or for a combination of lives and a term of years). The specified amount paid to beneficiaries must be either (1) an annuity amount, i.e., a fixed dollar amount, which is not less than 5 percent or more than 50 percent of the initial fair market value of the property transferred to the trust or (2) a unitrust amount, i.e., a fixed percentage, which is not less than 5 percent or more than 50 percent of the net fair market value of trust assets as re-valued annually.

A CRT is simply one of many types of trusts, all of which share certain basic characteristics. Fundamentally, a trust is a legal entity created to own and manage assets for the benefit of various persons or entities. The person or entity – or, in some cases, the combination of persons or entities – that manages the trust is known as the "trustee." In all but the most unusual circumstances, a trust is established pursuant to a set of written instructions, known as a "trust instrument." Such a document will typically be styled as a trust agreement (or, if the donor will also be serving as the trustee, a declaration of trust), although a person's will can be a trust instrument if a portion of the will contains enough instructions to enable a trust to be created using assets that are part of the person's probate estate. A trust created during the donor's lifetime is referred to as an *inter vivos* trust, and one established upon the death of the donor is referred to as a testamentary trust.

One of the key aspects of a trust is whether it can be revoked by the donor or whether it will be irrevocable once it has been established. Other important terms of a trust include how long it is to last, as well as who will benefit from the trust in what ways and at what points during its existence. Even though there are many ways in which a person or an entity might benefit from a trust, the primary distinction is between "income beneficiaries" (those that benefit from the trust during its existence) and "remainder beneficiaries" (those that benefit from the trust when it ends).

C. Charitable Remainder Annuity Trusts

Individuals may be able to increase their cash flow by choosing either a charitable remainder unitrust (CRUT) or a charitable remainder annuity trust (CRAT) as defined above. This section

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discusses the use of the CRAT. The CRAT bears some similarity with the charitable gift annuity with some important differences. The gift annuity makes a contractually required payment to the annuitant, even if the donor's original gift is exhausted. If a CRAT runs out of money the trust no longer makes payments to the beneficiary. The CRAT doesn't create a liability for the charity.

The gift annuity may only have up to two beneficiaries. The CRAT may have as many beneficiaries as the donor wants so long as the deduction for the trust is at least 10% of the contribution. In addition, there must be no greater than a 5% chance that the CRAT will run out of money. Gift annuities are subject to significant regulation in some states (such as CA, NY, NJ, MD, and WA). CRATs are governed by state and Federal trust law. There is no state reporting requirement with a CRAT.

Large gift annuities can create significant liabilities for the issuing charity. A program with few annuities may suggest a donor consider a CRAT instead of a gift annuity to avoid the risk of losing money on a large annuity obligation. A donor cannot create a gift annuity to benefit multiple charities. A CRAT can distribute its remainder for the benefit of multiple charities. The CRAT donor can even reserve the right to change the named charities.

Finally, if a donor wants fixed income, the gift annuity is cheaper, easier, and less complex than a CRAT to establish and administer. For these reasons, the CRAT is the least common type of remainder trust. In 2012, the last year for which IRS statistics are available, the total number of CRATs in existence was only 14,616.

Charitable Remainder Annuity Trust Example

The prototype CRAT donor will typically be older than the typical CRUT donor. Older donors are more concerned about having a reliable source of income than about inflation protection. CRAT donors may want to benefit multiple charities. The CRAT may be a better choice if the gift amount is more than your organization is interested in taking on as a liability in a gift annuity. Funding minimums have increased over the years and most trust companies would not consider any CRT funded with less than $250,000.

<u>Example</u>

George and Sally, ages 85 and 84, own stock with a fair market value of $2,000,000 and a cost basis of $750,000. The stock pays a 2% dividend and they receive on average of $40,000 in pre-tax dividends each year. Sale of the stock would trigger $1,250,000 in capital gain income to George and Sally.

They could contribute that stock to a charitable remainder annuity trust with a five-percent payout rate. They would realize a charitable deduction of $1,253,460 and receive $100,000 from the CRAT for the rest of their lives. If the investment returns match or exceed the 5% payout, the trust shouldn't run out of money. But if the trust is poorly invested or subject to significant market drops, the trust could run out of money and the payments to George and Sally could stop. There would be no capital gain due upon the funding of the trust. Rather the income paid by the trust to George and Sally would be taxed as capital gain to the extent payments exceed trust income from interest and dividends.

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A gift of appreciated property like this stock may only be deducted up to 30% of the donor's income in any one year. If George and Sally can't take the entire deduction in the year of the gift because of the income limitation, the balance of the deduction can be carried forward for up to five years.

D. Comparison of a gift annuity to a CRAT

1. Advantages of a CRAT.

   - There is no limit on the number of income beneficiaries, provided the charitable deduction is at least 10 percent of the contribution. Also, the annuity trust may not have a greater than 5% chance that the trust will exhaust the original gift. By contrast, there can be no more than two annuitants of a gift annuity, also subject to the 10% minimum deduction.

   - The trust remainder can be divided among any number of charitable beneficiaries, and the donor can reserve the right to change these beneficiaries. The contribution for a gift annuity becomes the property of the issuing charity, and the only way other charities can benefit is for the issuing charity to make grants to them.

   - The trust can last for the lifetime of named beneficiaries, for a term of years, or for a combination of lives and term. A gift annuity cannot be for a term-of-years, alone or in combination with lives. Rather, payments must be made for the lifetime of one or two individuals.

   - The donor can select a trustee to handle the investment of trust assets, whereas the charity makes all investment decisions regarding gift annuity assets.

   - A charity is not exposed to financial risk in being named as a remainder beneficiary, though it is accountable as a fiduciary if it acts as trustee. A gift annuity is a general obligation of the charity.

   - Payout rates are determined by the donor and the trustee, subject to IRS requirements, and are not strictly age-based as with a gift annuity.

   - The sometimes-burdensome state regulations imposed on charities that issue gift annuities do not apply to charitable remainder trusts.

   - The donor is not subject to up-front taxation of gain if appreciated property is contributed and someone other than the donor is the first beneficiary. In this case, the payments from the annuity trust are taxed as capital gain only to the extent the trust realizes capital gain and then distributes it. In the case of a gift annuity, the donor is taxed in the year of the gift on the gain attributable to the present value of the annuity.

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2. Advantages of a gift annuity.

- The payments are backed by all the assets of the charity, so annuitants can rely on payments unless the charity becomes insolvent. If trust assets should be exhausted, income beneficiaries would receive no more income.

- Charities generally will accept relatively small contributions for a gift annuity. A common minimum contribution is $10,000. For a trust to be practical the contribution probably should be $250,000 or more. (Some charities that act as trustee might accept as little as $250,000 for a trust, but a corporate trustee may set the minimum at $500,000 or higher.)

- A gift annuity is inexpensive to establish. Generally, the donor pays nothing except fees for consultation with professional advisors about the advisability of the gift. Establishment of a charitable remainder trust could cost several thousand dollars, depending on the complexity of the trust agreement and who drafts the agreement.

- If the donor contributes cash, there will probably be more tax-free income with a gift annuity than with a CRAT.

- Gift annuities are easy for donors to understand. A charitable remainder trust is more versatile but also more complex.

- While a donor can't add to a gift annuity, gift minimums are low enough that giving additional gift annuities is appealing to many donors. It is rare for donors to create multiple CRATs.

II. Wealthy, Financially Savvy Donors

A. Charitable Remainder Unitrusts

Charitable Remainder Unitrust (CRUT) pays to beneficiaries a fixed percentage (not less than 5 percent or more than 50 percent) of trust assets as re-valued annually. IRC Sec. 664(d)(2). CRUTs are the most popular type of remainder trust with 91,250 in existence in 2012. The appeal of the CRUT to donors is that trust payments will increase if the trust assets increase in value. This appeals to individuals who would like for income to keep pace with inflation if possible, although there is also a risk that income will decrease from one year to the next. Unlike with a CRAT, the donor can make additional gifts to an existing CRUT in years after its initial funding.

These variations of a CRUT are permissible:

- Standard Charitable Remainder Unitrust (SCRUT) – Pays a fixed percentage of trust assets even if principal must be invaded. This is the most common type of CRUT.

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- Net-income Charitable Remainder Unitrust (NICRUT) – Pays the lesser of the fixed percentage and the trust's net income. IRC Sec. 664(d)(3)(A). Principal may not be invaded.

- Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT) – Pays the lesser of the fixed percentage or trust net income but can pay make-up distributions to beneficiaries to the extent of accrued past deficiencies in payments due to the net income limitation. IRC Sec. 664(d)(3)(B). Again, principal may not be invaded.

- Flip CRUT – It is possible to create a NICRUT or NIMCRUT and subsequently flip or convert the trust to a SCRUT upon the occurrence of a triggering event. The triggering event must not be in the discretion or control of the donor, trustee, or any other person. Examples of permissible triggering events include a date certain, events such as the marriage, divorce, death, or birth of a child of the Donor; and the sale of unmarketable assets that are not readily sold. The change is effective at the beginning of the taxable year immediately following the taxable year in which the triggering event occurs. Reg. Sec. 1.664-3(c). If the trust starts out as a NIMCRUT, any make-up amount not paid out by the end of the year in which the triggering event occurs is forgone. A trust may flip only once. The Flip CRUT is the vehicle of choice for retirement planning or funding a CRT with an illiquid asset such as real estate.

Payments are typically made quarterly at the end of the calendar quarter, although they can also be made annually, semi-annually, or monthly. The present value of the income tax charitable deduction when the trust is created must be at least 10 percent of the value of the property contributed to the trust. The same 10% rule applies to any additional gifts to the CRUT at the time the additions are made.

B. Using a CRUT to Diversify Assets and Increase Cash Flow

Some individuals have a concentration of their investments in one stock that has appreciated significantly but which pays little or perhaps even nothing in dividends. A significant investment in one stock creates a concentration risk. The donor's net worth is tied to the performance of that one stock. A donor in this position would like to lessen the risk associated with a large investment in one asset. The donor might hesitate to sell shares in the stock because of the tax on capital gain they would incur.

Accordingly, the donor might consider funding a CRUT with some of these shares. The trustee could then sell those shares and invest all of the proceeds in a diversified portfolio. Since the trust is tax-exempt, it would not be taxed on the capital gain. It might also be the case that this single stock pays little or no dividend, in which case the CRUT likely will increase the donor's cash flow.

The profile of the CRUT donor is more diverse than the CGA or CRAT donor. The CRUT can appeal to donors as young as their 50s or older donors over 80. The CRUT donor will typically have a high net worth, be comfortable with investment risk, and have significant experience with investing.

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Example:

Sarah and Andrew Anderson are both 72 years old. Mr. Andrews retired from a publicly traded company and acquired many shares in the company over his career. Sale of the stock would trigger significant capital gain. They own several million dollars of this one security that pays a dividend around 1 percent. They would like to sell at least $1 million of the stock with a cost basis of $250,000 and reinvest the proceeds in a more diverse portfolio of securities to reduce their risk exposure. These shares pay them around $10,000 in dividends in a typical year. Therefore, they would also like to increase their income. Nevertheless, they are reluctant to do so because they know that selling the stock will trigger $750,000 of capital gain income. Assuming a capital gain tax rate of 20%, they would owe $150,000 of capital gain tax. That only leaves them with $850,000 to reinvest. In reviewing their overall estate plan, they realize that they can afford eventually to leave something for the benefit of various charities, provided they retain enough to support themselves during their lifetimes.

The Andrews use the $1million in stock to establish a CRUT with a 5-percent payout rate that makes payments as long as either of them is still living.

5% Charitable Remainder Unitrust

Contributed for CRUT	$1,000,000	
Income tax charitable deduction	$445,080	
Income tax savings (37% rate)	$164,680	
Payment in first full year of trust	$50,000	
Assume annual CRUT investment returns of 2% income and 4% capital gain:	6% total return	
$50,000 taxed on a worst in first out basis:		
First year ordinary income	$20,000	(2% of $1M)
First year capital gain income	$30,000	
Ordinary income tax due (37% x $20,000)	-$7,400	
Capital gain tax due (20% x $30,000)	-$6,000	
Net spendable	**$36,600**	
Before-tax income in year 10 assuming 6% returns	**$54,684**	

Mr. and Mrs. Anderson triple their before-tax income from $10,000 to $36,600 in the first year of the CRUT. They avoid the potential capital gain tax of $150,000 upon funding the trust. The entire $1,000,000 is fully invested without reduction by capital gain tax. The Andersons report capital gain income only as a portion of their annual payments. That income is taxed at capital gain tax rates only to extent of payments received.

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Assuming a modest 6% annual investment return on a CRUT paying 5% of its value each year, the Andersons see their income increase each year of the trust. Once again, the CRUT is subject to market risk and a drop in the value of the CRUT investments could cause their income to go down.

III. Security Versus Growth Potential

An advantage of a gift annuity is that payments never go down. A disadvantage is that they never go up. Because they do not increase, they will lose purchasing power over time. While unitrust income may keep pace with inflation, it can also decline sharply in a bear market.

Suppose, however, that the contribution would be large enough for either a gift annuity or a charitable remainder unitrust. Which is preferable? The following graphs show how cash flow would have compared in the case of charitable remainder unitrusts and gift annuities established, respectively, on January 1, 1990 and January 1, 2001. Market return data from Dimensionals Matrix Book 2016 and DFA Returns 2.0 Software program. The gift annuity payments are for a single individual age 80. The market returns for the relevant periods are below:

Year	% return	Year	% return
1990	-3.1	2001	-11.9
1991	30.5	2002	-22.1
1992	7.6	2003	28.7
1993	10.1	2004	10.9
1994	1.3	2005	4.9
1995	37.6	2006	15.8
1996	23.1	2007	5.5
1997	33.4	2008	-37
1998	28.6	2009	26.5
1999	21	2010	15.1
2000	-9.1	2011	2.1
Average	16.45	Average	3.5

Below is a line graph showing the before-tax income from the 5% CRTs using actual market returns for a 10-year period. The gift annuity rate for the 80-year-old beneficiary is 7.1% using the July 1, 2018 ACGA rates.

The blue line below represents a 5% unitrust invested for the 10-year period beginning January 1, 1990 and concluding December 31, 1999. The total before-tax-income from that trust would have totaled $979,229. A 5% unitrust using historical returns for the period January 1, 2000 to December 31, 2010 would have paid $442,000 in before-tax-income. The gift annuity would have paid $710,000 in before-tax-income without regard to market performance.

Which vehicle is better for the donor, the gift annuity or charitable remainder unitrust? Obviously, the answer is, it depends. The gift annuity offers fixed, reliable payments not subject to market risk. The unitrust provides the opportunity for significant upside performance. Regardless, investment performance over time is a key variable for the unitrust.

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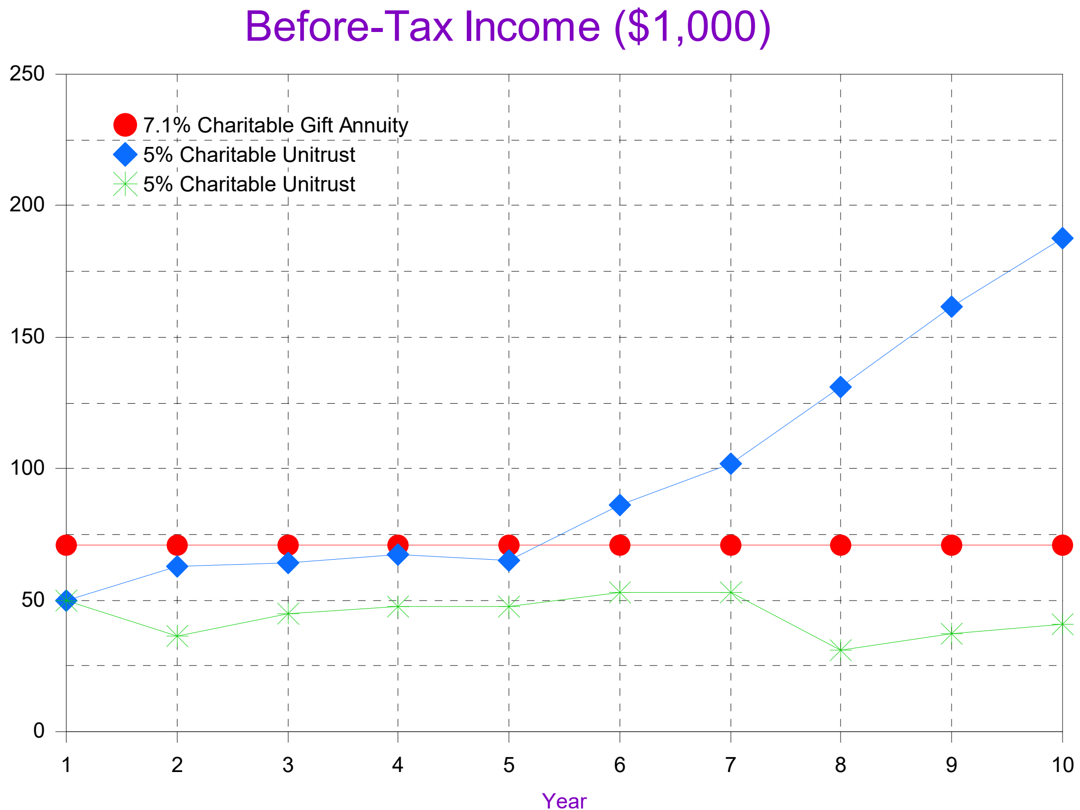

IV. Life Income as a Supplement to Retirement

A. The Charitable Remainder Flip Trust (Flip CRUT)

In 1998, the IRS and Treasury Department created what we now know as the Flip CRUT. A deferral provision such as is possible with a CGA is not available with any charitable remainder trust. The Flip CRUT created a mechanism to suppress income from a CRU until an event that causes the trust to flip or convert to a regular payment CRUT. The Flip CRUT created the opportunity to use remainder trusts for income planning.

The Flip CRUT operates as a net-income charitable remainder unitrust paying the lesser of the income earned by the trust (interest, dividends, etc.) or the stated unitrust amount. Upon the occurrence of a triggering event, which could be a specific date, the trust flips from paying the lesser of net income and a percentage of its value each year to simply paying a percentage of its value each year. A permissible flip event must be one "whose occurrence is not discretionary with, or within the control of, the trustees or any other persons." For example, a trust that flips "upon the retirement of the beneficiary" would not be a permissible triggering event. Obviously, it is in the discretion of the beneficiary when to retire. On the other hand, a date certain, say when the donor turns 70, is a permissible flip trigger. Also, the sale of an unmarketable asset, such as real estate, will not be considered discretionary or

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within the control of the trustees or any other persons and therefore is a permissible triggering event. (Reg. Sec. 1.664-3(a)(1)(c) and (d)).

The Flip CRUT has become a flexible and popular tool when a donor is doing income planning. A mid-life donor with charitable intent, who wants to establish a supplemental retirement fund, could establish a Flip CRUT today and be paid the lesser of the income earned by the trust or the stated trust percentage until the year she anticipates retirement. The trustee can reinvest in low-income assets with favorable growth potential in the years leading up to the trigger date. During that time, the trust can be managed to produce little income. When the donor reaches the selected date, the trust begins making payments like a straight payout remainder unitrust in the year following the flip event. The trustee then reinvests the portfolio to maximize total return. Then, the CRUT starts paying to the donor the set percentage of the fair market value of trust assets, as determined annually.

Example

Dr. Mahoney, an orthopedic surgeon, and his wife have been contributing the maximum allowable to their qualified retirement plans. They would like to accumulate more for retirement on a tax-favored basis, and they want to establish a named endowment at the hospital where he practices. He and his wife have a large stock portfolio in addition to their employer-sponsored qualified plans. They own stocks that have performed well but would like to reduce their position in them. They would be willing to transfer a stock that is now valued at $250,000. In addition to the initial transfer, they believe they could contribute an additional $40,000 per year of cash or securities towards the couple's future retirement. Dr. Mahoney and his wife are both 55, and they want to retire at 70. They have two adult children, but they are confident that they can make significant transfers to a charitable instrument and still provide adequately for the children.

To create a supplemental retirement plan, Dr. Mahoney and his wife establish a NIMCRUT with a five-percent payout rate and initially fund it with stocks valued at $250,000. Then, each year for the next 10 years, they add $40,000 in cash and/or securities to the trust. The trust contains a provision that causes it to "flip" or convert from a NIMCRUT to a SCRUT when they reach age 70. The trustee invests in growth stocks, and the dividends are sufficient to cover the trustee fee and sometimes to make small payments to Dr. and Mrs. Mahoney.

The amount of income payable to Dr. and Mrs. Mahoney after Dr. Mahoney attains age 65 depends on investment returns. The following results are assumed to demonstrate how the plan works:

Contributions, over the 11-year period between when the trust is established and when Dr. and Mrs. Mahoney reach age 70

Total trust contributions:	$650,000
Trust fair market value at the beginning of the year the Mahoney's attain age 70 (3.5% income and 2% appreciation pre-flip, 2% income and 4% appreciation post-flip)	$764,082

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Trust income at age 70 (5% x $764,082) (Income in subsequent years will vary.)	$37,826
Total income tax charitable deductions, approximately	$169,360

The remaining trust assets will be available to fund the hospital endowment after the passing of both Dr. Mahoney and Mrs. Mahoney.

B. Deferred Payment Gift Annuity

A donor can fund a gift annuity and specify a future date on which payments begin. This is a deferred payment gift annuity. The donor takes the income tax charitable deduction in the year the deferred annuity is funded. Why would a donor consider deferring payments on an annuity? First, the annuity rate is higher than the donor could get for an immediate annuity. Second, the donor may not need immediate income, but wants annuity payments in retirement. The amount of the payment, known in advance, is determined in this manner:

- Step one in the calculation of the deferred annuity rate begins by determining the annuity rate for the age the annuitant will be on the payment starting date.
- Step two is to compute the period of time between the date of gift and the annuity start date. A deferred interest rate factor is calculated by raising the interest rate of 3.75% (under the 7/1/2018 ACGA table) by the number of full and partial years in the deferral period.
- The deferred interest rate factor is multiplied by the annuity rate determined in step one above to compute the deferred annuity rate.

<u>Example</u>

Linda Sommers, age 50, contributed $50,000 cash on July 1, 2018 and specified that quarterly payments begin September 30, 2033, when she will be age 65. Starting then, she will receive an annual annuity of $4,450 (8.9 percent deferred gift annuity rate) paid in equal quarterly installments. Until the end of her life expectancy computed on the date of the gift (19.9 years in this case), $1,500 of her annual payment will be tax-free. Besides payments for life, Linda will receive an immediate charitable deduction of $20,125.

The problem with the traditional deferred gift annuity is that the donor must determine in advance when payments will begin. However, unforeseen circumstances could make it advisable to accelerate or delay the payments. For instance, the donor could become disabled and need the money sooner, or she might decide to postpone retirement and prefer to start receiving payments later.

C. Flexible Deferred Gift Annuity

In 1997, the IRS approved a deferred annuity in which the donor does not have to choose in advance the starting date for payments. Instead, the annuitant can choose from a range of start dates. See Private Letter Ruling 9743054. The decision when to begin payments can be

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made any time after the gift date and before the chosen start date. The older the annuitants when payments begin, the larger the payments.

It was reassuring to see in Private Letter Ruling 200449033, issued seven years later, that the position of the IRS had not changed. In both cases, the IRS ruled that the flexible deferred gift annuity met the requirements of a gift annuity and that the charity would have no unrelated business taxable income.

Example

Richard Runcey, born June 3, 1959, wants to supplement his income when he retires, but he doesn't know when he will be ready to retire. On August 23, 2018, he contributed stock having a fair market value of $100,000 and a cost basis of $60,000 for a gift annuity. He reserves the option to start quarterly payments on September 30 of any year during the period 2024-2034.

The income tax charitable deduction (the lowest deduction resulting from any of the possible payment start dates) was $39,528. The following table shows taxation of payments for full years during life expectancy.

Elective Start Date	Age at Start Date	Annuity Rate	Capital Gain	Tax-free Portion	Ordinary Income	Total Annuity
9/30/2024	65	6.3%	$1,214.64	$1,821.96	$3,263.40	$6,300.00
9/30/2025	66	6.7%	$1,267.64	$1,901.46	$3,530.90	$6,700.00
9/30/2026	67	7.1%	$1,320.60	$1,980.90	$3,798.50	$7,100.00
9/30/2027	68	7.3%	$1,381.16	$2,071.74	$3,847.10	$7,300.00
9/30/2028	69	7.8%	$1,447.68	$2,171.52	$4,180.80	$7,800.00
9/30/2029	70	8.4%	$1,522.08	$2,283.12	$4,594.80	$8,400.00
9/30/2030	71	8.8%	$1,591.04	$2,386.56	$4,822.40	$8,800.00
9/30/2031	72	9.3%	$1,666.56	$2,499.84	$5,133.60	$9,300.00
9/30/2032	73	9.8%	$1,752.24	$2,628.36	$5,419.40	$9,800.00
9/30/2033	74	10.5%	$1,848.00	$2,772.00	$5,880.00	$10,500.00
9/30/2034	75	11.1%	$1,949.16	$2,923.74	$6,227.10	$11,100.00

V. How a Gift Annuity Can Provide Inflation Protection and Income Security

Donors may be attracted to a plan that combines the security of fixed payments with periodic increases in cash flow. That plan is the step annuity, which is the bundling of an immediate gift annuity with a series of deferred gift annuities that have successively later payment start dates. While it may be possible to draft a single gift annuity agreement that contains all of these provisions, the more prudent course is to execute simultaneously multiple agreements that differ only in the timing and amount of payments. The charity could issue one quarterly check combining the amounts due from all of the annuities and a single 1099-R tax form each year.

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Example:

Matthew Kennedy, born May 23, 1954, wants his annual payments to increase at the average historical inflation rate of approximately 3.5 percent. The following chart shows how much he would need to contribute on July 1, 2018 if he wanted these adjustments annually for eight years.

Type of Annuity	Payment Beginning Date	Funding Amount	Payment Increment	Total Annuity
Immediate	9/30/2018	$100,000		$5,000
Deferred	9/30/2019	$3,302	$175	$5,175
Deferred	9/30/2020	$3,234	$181	$5,356
Deferred	9/30/2021	$3,177	$187	$5,544
Deferred	9/30/2022	$3,181	$194	$5,738
Deferred	9/30/2023	$3,089	$201	$5,938
Deferred	9/30/2024	$3,012	$208	$6,146
Deferred	9/30/2025	$2,947	$215	$6,361
Deferred	9/30/2026	$2,892	$223	$6,584
Deferred	9/30/2027	$2,810	$230	$6,814

Matthew's total contribution on July 1, 2018 was $127,645, and his payments would retain their purchasing power for the next nine years (or for whatever period he chose), assuming the future rate of inflation approximates the historical average.

A charity might hesitate to agree to this plan because the amount contributed for each deferred gift annuity is less than the stated minimum in its gift acceptance policies. However, the charity may be willing to make an exception because the total amount contributed is well above the minimum, the bundled annuities are identical except for their payment start dates and the annuity amounts, and they can be consolidated for purposes of making the payments and issuing tax forms. The plan should not prove to be an administrative burden, and it could appeal to donors concerned about escalating prices.

A. Comparison

1. Advantages of a Charitable Remainder Unitrust.

   - If the portfolio performs well, payments during retirement will be larger than those from a gift annuity.
   - Possibly, a significant portion of payments will be taxed as capital gain.
   - The donor, if acting as trustee, has control over investments.
   - Additions to the trust can be made anytime.

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- Allows more than two beneficiaries and more term options (fixed term, combination of lives and fixed term)

2. Advantages of a Gift Annuity.

- Although the compounding rate during the deferral period is modest, it is guaranteed.
- There is complete deferral of payments until the payment starting date, whereas the flip unitrust must make distributions in any year there is net income during the pre-flip period.
- With a flexible deferred gift annuity, the annuitant can decide later when to start receiving payments.

B. A Plan That Provides Both Retirement Flexibility and Inflation Protection: Stacking Flexible Gift Annuities

The disadvantage for Richard in the example of the flexible deferred gift annuity is that once he makes the election, he must start receiving the entire amount. To maximize flexibility, he could simultaneously establish 10 flexible deferred gift annuities, each funded with $10,000. Then he could elect payments as needed. In the event he becomes disabled or ill, he could elect payments from all 10 annuities at the same time.

This bundle of flexible deferred gift annuities could also be combined with an immediate gift annuity to provide inflation protection. However, unlike the step annuity described in the example pertaining to Matthew above, the increases in cash flow would not be predetermined. The annuitant could control the cash flow by choosing year-by-year whether to begin payments from any of the flexible annuities. By stacking multiple flexible annuities the plan combines the inflation protection of the step annuity with the ability to base the timing of payments on the annuitant's circumstances

Example:

Suppose that Richard, instead of creating a single $100,000 flexible deferred annuity, created 10 flexible deferred gift annuities, each funded with $10,000. He could elect payments from any of the annuities per the following schedule:

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Elective Start Date	Age at Start Date	Annuity Rate	Payment from each annuity	Potential Total Annuity if All Elected in One Year
9/30/2019	60	4.8%	$480	$4,800
9/30/2020	61	5.0%	$500	$5,000
9/30/2021	62	5.3%	$530	$5,300
9/30/2022	63	5.6%	$560	$5,600
9/30/2023	64	6.0%	$600	$6,000
9/30/2024	65	6.3%	$630	$6,300
9/30/2025	66	6.7%	$670	$6,700
9/30/2026	67	7.1%	$710	$7,100
9/30/2027	68	7.3%	$730	$7,300
9/30/2028	69	7.8%	$780	$7,800
9/30/2029	70	8.3%	$830	$8,300

IV. Individuals Who Want to Contribute Real Estate or Other Illiquid Assets

A. Flip Charitable Remainder Unitrust

The ideal instrument for a donor who wants to contribute real estate or other illiquid assets such as closely held business interests and receive income is the charitable remainder unitrust with a "flip" provision, described in more detail above. Until the property sells, the trust will pay income beneficiaries the lesser of the actual net income or the stipulated percentage of trust assets. Beginning with the trust tax year immediately following the sale of the property, the trust converts to a standard unitrust and starts paying the percentage amount. The triggering event for the conversion of the trust is the sale of the property.

If the property is raw land, or rental property that does not generate enough net income to cover expenses, it is advisable for the donor to contribute some cash or marketable securities along with the property so that the trust can cover property taxes, insurance premiums, and administrative expenses. The donor will receive additional income tax charitable deductions for these additional contributions to the unitrust.

<u>Example</u>

James and Linda, ages 71 and 70 respectively, contribute an apartment building to a "flip" unitrust with a five-percent payout rate. The property is appraised at $1,600,000, and their adjusted cost basis is $400,000. If they sold the property themselves, $500,000 of gain (that attributable to depreciation and defined in IRC Sec. 1250) would be taxed at 25 percent. The balance of the gain would be taxed at a 15-percent rate. The resultant tax on the gain would have been $230,000 if the net sales proceeds equaled the appraised value. The trust is not taxed on this gain, however, so the trustee can reinvest the entire sales proceeds to generate income for James and Linda. Moreover, they receive an income tax charitable deduction of $673,616. The apartment building earned $64,000 of net rent each year after the payment of taxes, maintenance, and insurance. James and Linda will continue to receive the net income until the apartment building sells. The table below shows how their income might increase if

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they contribute the building to a charitable remainder unitrust with a flip provision. The illustration assumes the building sells in the second year following the gift. The trust converts to a straight payout unitrust in year 3 following the sale:

Year	Year-End Principal	Capital Appreciation (0%)	Income (4%)	Before-Tax Payments
Year of gift 1	$1,600,000	$0	$64,000	$64,000
Sale in year 2	$1,600,000	0	$64,000	$64,000
		(4%)	(2%)	
Flip in year 3	$1,616,000	$64,000	$32,000	$80,000
4	$1,632,160	$64,640	$32,320	$80,800
5	$1,648,482	$65,286	$32,643	$81,608
6	$1,664,966	$65,939	$32,970	$82,424
7	$1,681,616	$66,599	$33,299	$83,248
8	$1,698,432	$67,265	$33,632	$84,081
9	$1,715,417	$67,937	$33,969	$84,922
10	$1,732,571	$68,617	$34,308	$85,771

B. Gift Annuity for Real Estate or Other Illiquid Assets

The vehicle of choice for generating life income from an illiquid asset is the flip charitable remainder unitrust. Nonetheless, it is possible to fund a gift annuity with real estate, but the charity would assume greater risk than with a gift annuity funded with liquid assets. That is because it would be committing to fixed payments without knowing when the property will sell or for how much. To limit its risk, the charity might want to identify a buyer in advance.

According to Rev. Rul. 78-197, a sale will not be considered prearranged, and the donor will not be taxed on the capital gain, if the charity is under no binding obligation to sell. If the charity, in anticipation of a gift of real estate, talks to prospective buyers, determines that one or more of them is seriously interested, receives the property, and soon thereafter enters into a purchase and sale agreement with one of these buyers, the donor should not be exposed to taxation on the gain because the charity was under no binding obligation to sell at the time of the gift.

Wanting more assurance, the charity might go a step further and enter into an oral agreement to sell for a certain price, contingent upon its receiving the property for a gift annuity. Some would say the charity has not gone too far because it has stopped short of a legally enforceable sales agreement (assuming state law does not treat an oral commitment as binding).

Suppose the charity goes still further and enters into a written contingent sales agreement with a prospective buyer and possibly opens an escrow account. It could be argued that the donor has not subjected the charity to an obligation to sell, but that the charity, being under no compulsion to do so, has arranged to sell in the event it receives particular property by gift. This argument might prevail, but certainly the risk level has increased.

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Some charities, having entered into a contingent sales agreement, arrange for a simultaneous closing. On the same day, title is transferred to the charity and then to the prospective buyer. To avoid excise tax on both transactions, a charity might have title transferred directly from the donor to the buyer, in which case the charity does not appear on the chain of title. The question is whether a transfer of title directly from the donor to the buyer, if done at the direction of the charity, would be treated as a gift of the property to the charity. In the case of *Guest v. Commissioner* 77TC9 (1981), Temple Emanuel of Yonkers, New York, agreed to accept certain properties from Winston and Lucy Guest, and the Temple instructed them to retain the properties as nominee on its behalf and to have their attorney prepare deeds conveying the property to the purchaser, whom it would later identify. As to whether Mr. and Mrs. Guest made a completed gift of the proceeds from the sale of the properties, the Court said, "We see no difference between the situation where a donee sells a gift prior to actual receipt of it, and, instead of accepting delivery himself, the donee directs that delivery be made to the purchaser."

While agreeing that the direct deeding did not affect the issue of whether a gift of property was made, the Court found that it did affect the timing of the gift. According to the Court, the gift occurred not in year one when Mr. and Mrs. Guest informed the Temple of their intent to make the gift, but rather in year two when delivery was completed. This means that by the time the gift occurred (delivery of deeds to the purchaser) the charity was under a binding obligation. Of course, it has, acting on its own volition, bound itself. Would this cause a donor to be construed as having sold the property, using the charity as agent, and contributing the net cash proceeds?

There are other, less risky, ways to mitigate the risk when real estate is contributed for a gift annuity. One is to offer a discounted gift annuity rate. Another is to do advance marketing, stopping short of an actual purchase agreement. Another is to have the donor defer payments for a year or so to allow time for a sale. Still another is to identify a potential buyer and enter into a "put" agreement that would state that if the charity receives a gift of "x" property, it has a period of "y" days to require the buyer to purchase the property based on certain terms and conditions, which would then be set forth. This appears to satisfy the conditions of Rev. Rul. 78-197 because the charity has the right to compel a purchase, but it is under no obligation to exercise the "put."

Fearing that the net sales proceeds may be substantially less than the appraised value, some charities offer to pay an annuity equal to the published rate for a person of the annuitant's age multiplied by the net sales proceeds. Sometimes they delay executing the gift annuity agreement until the property is sold, and they indicate on Schedule A of the gift annuity agreement that the value of the property contributed was the net sales proceeds. In an IRS audit, it may appear that the donor sold the property, with the charity acting as agent, and then contributed the net proceeds. If that were the conclusion, the charitable deduction would stand, but the donor might be taxed on all of the capital gain in the property in the year it was sold.

The safest way to proceed is to make a conservative estimate of the net proceeds to be realized and offer a gift annuity rate equal to:

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$$\frac{\text{estimated net proceeds}}{\text{appraised value}} \times \text{normal gift annuity rate}$$

C. Comparisons

1. Advantages of a "flip" charitable remainder unitrust.

   - The charity is not at financial risk.

   - Not being under a time pressure, the trustee can market the property so as to secure the best price.

   - The income paid to beneficiaries will be based on the net proceeds with no discounting. If the property is contributed for a gift annuity, the charity will likely offer a discounted annuity amount to protect itself in case of a delayed sale for a lower-than-anticipated price.

2. Advantages of a gift annuity.

   - Annuitants **may** start receiving payments immediately. However, to protect against advancing the annuity payments before the real estate sells, the charity should issue a deferred annuity in these cases.

   - Annuitants know in advance the size of the payments they will receive and how they will be taxed, and they can plan accordingly.

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