ADVANCED GIFT ANNUITIES

PG CALC WEBINAR

FEBRUARY 28, 2019

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I. Introduction

This paper presupposes that the reader already has a basic understanding of gift annuities and is interested in more advanced topics.

The first section deals with the most common themes of working with gift annuities. We've heard hundreds of questions that arise regarding particular annuities and donor situations and 10 of the more interesting advanced ones have been selected for discussion. For more details on these examples, plus many others, please refer to the authoritative *Charitable Gift Annuities: Complete Reference Manual* published by PG Calc and available for purchase from our website. The second section of the paper, which describes creative applications, also draws from the manual and continues the conversation of advanced topics with examples of practical ways in which the unassuming gift annuity can be used.

II. Some Recurring Questions

While often thought of as a simple and well understood gift vehicle, numerous questions result from the issuance and later adjustments to gift annuities. Some questions concern technical issues, others pertain to the tax consequences when complicated assets are contributed for a gift annuity, and still others involve programmatic matters. In some instances the answers are quite clear, but in other cases there is a degree of uncertainty because of the absence of legislation, regulations, and rulings specifically on point. The objective of this paper is to offer some pragmatic, practical suggestions that will be of value when confronted with the challenge of operating a gift annuity program and dealing with the complex issues that inevitably arise.

A. Can an annuitant assign his or her annuity interest to the charity?

Most gift annuity agreements permit an assignment of the annuity interest to the charity. Once the assignment is made, the charity's obligation under the contract will terminate and it will be free to use the residuum.

The amount of the gift is the present value of the remaining annuity payments computed as of the date of the assignment. However, the income tax charitable deduction that can be claimed by the annuitant may be less than the amount of the gift (i.e., the benefit to the charity). The reason can be demonstrated with an example.

Example

Roy, whose date of birth is August 13, 1940, contributed $100,000 cash for a gift annuity on October 1, 2010. The charity issued a gift annuity that would pay him $5,800 per year in quarterly installments. Based on the October 2010 AFR of 2.6%, Roy's charitable deduction was $33,977.00, and his investment in the contract was $66,023. Having decided that he did not need the payments from this annuity, and wanting to accelerate the gift, he assigned his right to payments to the charity, effective July 1, 2018. His last quarterly payment was made on June 30, 2018.

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As of July 1, 2018, the present value of his annuity interest was	*$44,319.00*
(This was based on the July 2018 AFR of 3.4%)	
Original investment in the contract (total of all tax-free portions)	*$66,023.00*
Investment in the contract returned through 6/30/18	*- 32,184.20*
Unreturned investment in the contract as of 6/30/18	*$33,838.80*
Since the unreturned investment in the contract is less than the present value of the annuity ($44,319), the charitable deduction is:	*$33,838.80*

Although there are no Revenue or private letter rulings specifically on point, it seems reasonable to conclude (1) that the assignment would not result in taxable gain and (2) the income tax charitable deduction would be limited to the investment in the contract (i.e., the remaining capital that would have been returned tax-free over remaining life expectancy if the annuity interest had not been assigned). Furthermore, this gift should be subject to a 60-percent-of-adjusted-gross-income contribution limitation because the interest transferred to the charity by virtue of the forgiveness of the annuity obligation is cash.

Suppose, in the above example, that Roy had originally contributed appreciated stock with a cost basis of $25,000. However, the unreturned investment in the contract consists of $49,517 of unreported capital gain that would have been so taxed, and $16,506 of basis that would have been returned tax-free.

The annuitant would not be taxed on the $49,517 of gain, for Reg. Sec. 1.1011-2(a)(4)(iii) says that unreported capital gain is not included in the gross income of the transferor when the transferor relinquishes the annuity to a charitable organization. The income tax charitable deduction would remain the same at $33,838. However, it would be subject to a 30-percent-of-adjusted-gross-income contribution limitation because the interest transferred to the charity by virtue of the forgiveness of the annuity obligation is a long-term capital asset.

B. Is it possible for an annuitant to cash out a gift annuity, exchanging life payments for a lump sum?

This should be possible provided the cash settlement does not exceed the present value of the annuity payments determined as of the day of settlement. The annuitant would be exchanging one property right (guaranteed payments for life) for another property right (a cash sum) of equivalent or lesser value. Here, as in the case of the sale of the income interest of a charitable remainder trust, it is advisable to secure an affidavit from a physician certifying that the annuitant has no medical condition that could result in a shorter-than-normal life expectancy.

If the annuity was funded with cash, the amount of the lump sum payment in excess of the unreturned capital would be taxed as ordinary income. If the annuity had been funded with appreciated property and the gain was being ratably reported because the donor was the annuitant, then the lump sum payment would be (1) capital gain to the extent of the capital

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gain not yet reported, and (2) tax-free return of capital to the extent of the capital (the portion of the cost basis allocated to the present value of the annuity) that had not yet been paid, and (3) the balance would be taxed as ordinary income.

C. Is it possible to execute a single gift annuity agreement when contributions for the annuity are received on different dates?

This can happen when a donor transfers shares from different mutual funds. For example, shares from Fund A might be transferred to the charity's account on May 1, shares from Fund B on May 4, and funds from Fund C on May 7.

The charity could, of course, execute three different annuity agreements, one for each transfer of shares. However, the charity may not wish to do this because it entails extra paperwork and because each transfer alone is below the minimum contribution the charity requires for a gift annuity.

One possibility is to insert the contribution dates in the gift annuity agreement. For example: "Charity certifies that the Donor, as evidence of her desire to support the work of the Charity and to make a charitable gift, on May 1, 2009, May 4, 2009, and May 7, 2009 contributed to Charity the property described in Schedule A attached hereto, the combined fair market value of which is $__________, taking into account the fair market value of each contribution on the day it was made."

The agreement could then provide that the first payment be prorated from May 7 to the end of the initial payment period. Alternatively, the agreement could provide that the first payment be the combined prorations from each contribution date, but a proration from the latest contribution date is simpler.

Another possibility would be to have some documentation indicating that the charity will receive and hold the successive contributions as agent for the donor until the donor, presumably on the latest date securities are transferred, authorizes the funding of the gift annuity. In that case the securities would be valued on the date the charity ceases to be agent and funds the annuity. If the charity is acting as the donor's agent, the securities should not be sold until the agency relationship is terminated by an authorization to fund the annuity. This entails some risk that the value of the securities may decline during the holding period.

In the event there is a very long interval between contribution dates, or there is an age change or a federal discount rate change between those dates, separate agreements should be executed.

D. Can you wait to decide the amount of the annuity until the property sells?

Sometimes, especially with real estate, getting the right value for determining the lifetime payments can be tricky. Typically, a gift annuity is valued on the day of the gift and the ACGA rate is applied to it to form the annuity. But what if there is property for which the net proceeds of a sale is the real value the charity has for investing and earning a return?

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If it is likely that the property can be sold quickly, either before the end of the calendar year in which the gift is made or at least prior to the due date of the donor's income tax return for that year, the charity and donor might enter into an agreement that specifies the annuity payment shall be the net sales proceeds multiplied by the published gift annuity rate. In the event that the property has not sold by the specified date, the agreement would stipulate that the annuity payment shall be a discounted amount to which the charity and the donor have agreed.

The agreement regarding the rate can be a separate letter of understanding (with a gift annuity agreement being prepared later), or it can be within the annuity agreement itself. The latter option, however, may be problematic in states in which the charity has previously submitted forms of agreement for approval, as the charity is not free to modify the text of such forms; it would have to submit new agreement variations for approval prior to use.

While determination of the annuity amount would await the sale of the property, the date of the gift would be the date on which title to the property was transferred to the charity; the first payment date could be the end of the payment period next following the sales date, or the specified date (April 1, for example) if the property has not sold by then. Since the payment amount would be known prior to the due date of the tax return, the deduction amount could be computed and reported by the donor on that return.

When calculating the deduction and the taxation of payments, discount the gift annuity rate, not the value of the property. Suppose, for example, that the appraised value of the property is $500,000 and the normal gift annuity rate for a person the donor's age is 5.8%. The property is contributed on May 15, 2018 and is sold December 28, 2018, and the net sales proceeds are $427,801. The gift annuity payment would be $24,812, which is 5.8% of the net proceeds. When calculating the deduction and taxation of payments using *Planned Giving Manager*, enter the amount of the gift as $500,000, the date of the gift as May 15, 2018, the adjusted cost basis as whatever it was on May 15, and the annuity rate as 4.9624% ($24,812 divided by $500,000), and the applicable AFR for May or for either of the two preceding months.

What if you entered $427,801 as the amount of the gift and 5.8% as the annuity rate? That gift value will be inconsistent with the appraised value, which will have been entered on Form 8283 submitted with the tax return. An examiner might conclude that the donor sold the property, realized net proceeds of this amount and then contributed those proceeds for the gift annuity, in which case the donor would be judged liable for all of the tax on the capital gain. It is also possible that an examiner would draw the same conclusion from the arrangement where determination of the annuity amount is delayed until after the property is sold. Some organizations are choosing to set the annuity rate based on net sales proceeds in some circumstances, based on these concepts, after discussion with legal counsel.

E. Does reinsurance of a gift annuity affect the donor's charitable deduction?

The answer depends on whether the charity reinsures per a requirement or agreement to do so. In Private Letter Ruling 8322068, which concerned a situation where a charity was required to reinsure the obligation, a charitable deduction was allowed for the difference between the amount contributed and the reinsurance premium. Reg. Sec. 1.101-

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2(e)(1)(iii)(b)(1) and (2) states that if an organization is regularly engaged in issuing annuity contracts with an insurance company as the coinsurer or reinsurer of the obligation, the value of the annuity payments is to be determined by use of the discount rate and mortality tables used by the insurance company. That value would be the amount of the premium.

Neither the private letter ruling nor the regulation appears to apply to gift annuities which the charity reinsures at its own discretion. Possibly, the charity reinsures only gift annuities over a certain size, or only a portion of the obligation, and it may decide to reinsure several years after the contract is in force, long after the charitable deduction has been claimed. In any case where the charity reinsures at its discretion, the charitable deduction would be unaffected. As with self-insured gift annuities, the IRS tables and applicable federal discount rate would be used to determine the amount of the charitable deduction.

However, if, as noted above, the gift annuity agreement requires the charity to reinsure, or if the charity has an agreement with an insurance company with which it regularly reinsures all of its annuities, then, based on the private letter ruling and the regulation, the charitable deduction would be the difference between the contribution and the premium. This would affect the taxation of payments because the capital to be returned tax-free would be the amount of the premium.

F. Can the income interest of a charitable remainder trust or a pooled income fund be contributed for a gift annuity?

Yes, as long as certain conditions are met. Sometimes a trust is depleting and there won't be any remainder left for charity, as can often happen to a high-paying charitable remainder annuity trust. Similarly, payments could be decreasing in a charitable remainder unitrust and may run out, leading a donor to want to anchor into something stable.

In Private Letter Ruling 200152018, the IRS permitted the trustor (who was also the income beneficiary) of a charitable remainder unitrust to transfer his income interest to the charitable remainder beneficiary in exchange for a gift annuity. The annuity payments were to be made from the charity's general funds, the donor of the income interest was to be the sole annuitant, the annuity would be non-assignable except to the charity, and a commutation, prepayment, or refund would be prohibited by the gift annuity agreement.

The annual annuity will be the annuity rate offered by the charity multiplied by the present value of the income interest in the trust, not by the fair market value of trust assets. Suppose that at the time the income interest in the trust is contributed, the fair market value of trust assets is $600,000, the present value of the income interest is $400,000, and the present value of the remainder interest is $200,000. The annual annuity would be $400,000 multiplied by the annuity rate.

The donor will be allowed an income tax deduction for the amount by which the date-of-gift present value of the income interest of the trust exceeds the present value of the annuity payments. The income interest in the trust must not have been created to avoid the partial interest rules of IRC Sec. 170(f)(3)(A).

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The donor will be entitled to a gift tax deduction under IRC Sec. 2522(a), to the extent the date-of-gift present value of the income interest of the trust exceeds the present value of the annuity payments. In the case of a NIMCRUT or NICRUT where a couple have contributed jointly-owned or community property and are joint and survivor beneficiaries, or where a donor has contributed separate property and named a successor beneficiary, each beneficiary should disclaim his or her successor interest prior to the assignment as discussed above.

The income interest will be treated as a capital asset with a zero basis per IRC Sec. 1001(e)(1). Accordingly, the donor of the income interest (assuming he or she is the annuitant) will have long-term capital gain equal to the present value of the income interest, and it can be ratably reported as provided in Example 8 of Reg. Sec. 1.1011-2(c).

This means that the payments will be partly ordinary income and partly capital gain for the duration of the donor's life expectancy. Then they will become entirely ordinary income. No part of the payments will be tax-free. When running *Planned Giving Manager*, enter the present value of the income interest of the trust as the amount contributed and "0" as the cost basis.

Some charities have dormant pooled income funds that they would like to close, but the few participants do not want to surrender their right to life income. The charity might propose to them that they contribute their income interests in exchange for gift annuities. The tax implications and procedures for making such gifts would be like those in connection with an exchange of an income interest in a charitable remainder trust.

It is important to keep in mind that the annual annuity will be the gift annuity rate multiplied by the present value of the beneficiary's income interest in the pooled income fund. Sometimes it will be necessary to pay a gift annuity rate higher than the ACGA rate for gift annuity payments to equal the current payments from the pooled fund. This is possible if the annuity amount, divided by the distribution from the pooled fund, does not exceed the ACGA rate and if the present value of the annuity is less than 90 percent of the present value of the beneficiary's income interest, as required by IRC Sec. 514(c)(5)(A). However, if the annuity is to be established in a regulated state to which the charity has submitted a schedule of rates, it must be able to demonstrate to the state's satisfaction that the rate offered, taking into consideration the amount added to the reserve fund, will be acceptable, or reduce the rate to the ACGA rate in consultation with the donor.

G. Are annuitants entitled to an additional tax break on their final income tax return?

An annuitant of a one-life annuity who dies before the end of his/her life expectancy – or the surviving annuitant of a two-life annuity who dies prior to the end of the applicable joint life expectancy – is entitled to a posthumous income tax deduction for the unrecovered investment in the contract. See IRC Sec. 72(b)(3)(A). The annuitant is entitled to this deduction for use on the final income tax return regardless of whether the annuitant or another person funded the annuity. See IRC Sec. 72(b)(3)(B).

Per Reg. Sec. 1011-2(a)(4)(iii), when a donor-annuitant dies before the end of life expectancy, any unreported gain is not taxed on the final income tax return.

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The deduction equals the total investment in the contract that would have been returned over the annuitant's life expectancy minus the portion of that investment returned as of the date of death. If cash was contributed for the gift annuity, the investment in the contract would have been the present value of the annuity payments at the time the annuity was established (the non-deductible portion of the contribution). The tax-free portion of each payment would have been a return of the investment in the contract.

If appreciated property was contributed, the investment in the contract would have been the portion of the cost basis allocated to the present value of the annuity payments. The portion of each payment that was tax-free, but not the portion that was reported as capital gain, would have been a return of the investment in the contract.

The deduction is a miscellaneous deduction and is not subject to the 2% floor that is applicable to some miscellaneous deductions. While the 2017 Tax Act eliminated miscellaneous deductions subject to the 2% floor, it did not eliminate other miscellaneous deductions, so the deduction for the unrecovered investment in the contract in a gift annuity is still available.

<u>Example</u>

Suppose Helen, a donor who is also the annuitant, contributes $100,000 cash for a gift annuity, and the gift value is $40,000. In this case, the present value of the payments is the investment in the contract. Whatever portion of that $60,000 had not been returned at the time of the donor's death could be claimed as a deduction on her final income tax return.

Now suppose Helen contributed stock having a fair market value of $100,000 and a cost basis of $20,000.

Present Value of Payments $60,000		Gift Value $40,000	
$12,000	$48,000	$8,000	$32,000
Basis Allocated to Present Value	Gain Allocated to Present Value	Basis Allocated to Gift Value	Gain Allocated to Gift Value

For the purpose of determining the deduction per IRC Sec. 72(b)(3)(A), only the $12,000 is the investment in the contract, and the deduction on the donor's final income tax return is limited to the portion of the $12,000 that had not been returned by the time of death.

H. Can a donor change payment frequency once a CGA has started?

Occasionally, an annuitant wants to change the schedule of payments. For example, an annuitant may want to receive quarterly payments rather than the semi-annual payments stipulated in the original agreement. Changing the payment frequency should be permissible so long as the new schedule of payments does not result in a higher present value of the annuity payments.

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Whenever payment frequency is changed, whoever is administering the charity's gift annuities should be informed of the change. Moreover, the ideal timing is for the change to take effect with the first payment to be made in a calendar year, in order to simplify preparation of IRS Form 1099-R.

If payments will be made less frequently– quarterly instead of monthly, semi-annually instead of quarterly, etc. – and the total amount paid each full year remains unchanged, the present value of the payments will be lower. Since the annuitant receives no added benefit, it is unnecessary to change the total amount (though a slightly higher annual amount is supportable).

If payments will be made more frequently, the present value will be higher if the total amount paid each full year remains unchanged. This is not permitted because it would result in a smaller charitable deduction than originally claimed. Consequently, when the annuity payments become more frequent, it is necessary to reduce the total annual amount to maintain an equivalent present value. In calculating the equivalent present values, use the AFR for the month in which the change in frequency becomes effective.

If an annuitant wants to alter the timing of payments – for instance, receive monthly payments on the 15th rather than the end of the month – it would again be necessary to reduce the total annual payment to maintain an equivalent present value if the annuitant receives payments at an earlier date than the date specified in the agreement, which was used in calculating the original charitable deduction.

However, if the annuitant and the charity agree to have payments made on a later date than the date specified in the agreement – for example, quarterly payments on March 31, June 30, September 30, and December 31, instead of on March 15, June 15, September 15, and December 15, as stipulated in the agreement – then no reduction in the annual payment should be necessary. That is because the annuitant would not be accelerating receipt of money, which would slightly increase the present value of the payments.

When the payment frequency is changed and, as a consequence, the annual annuity is somewhat smaller, reduce the ordinary income (interest) portion of the annual annuity by the amount of the reduction. The portion that is a tax-free return of capital and the portion (if any) that is capital gain do not change.

I. Can a donor do an IRA rollover (more precisely known as a Qualified Charitable Distribution) into a CGA?

Not exactly, or perhaps more accurately, not yet. The Pension Protection Act, signed into law in 2006, permitted up to $100,000 per year to be distributed tax-free from an IRA to a charity, excluding private foundations and supporting organizations, and also excluding a gift to a charity for a donor advised fund. The transfer had to be for an outright gift, and the donor had to be age 70½ or older. If those conditions were met, the distribution to the charity counted towards the IRA owner's mandatory distribution and was not included in his or her taxable income.

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The law, which had been annually renewed by legislative action, was made permanent by the PATH Act of 2015. This action was welcomed by charities because their donors could now plan for a transfer well in advance. Previously, the extension often was not approved until late in a calendar year by which time most people over age 70½ had already taken the mandatory distribution from their IRAs.

Until legislation changes again, and there is much effort in the charitable community to do just that, it is still possible to fund a gift annuity with IRA assets. The procedure is to withdraw money from the IRA, withhold enough to pay the tax on the withdrawal after taking into consideration the charitable deduction, and then contribute the balance for a gift annuity. Given the increase in the standard deduction (to $12,200 for singles and $24,400 for joint filers in 2019), some donors might not be planning to itemize their deductions, in which case using the deduction to offset a taxable distribution is not applicable.

Note that if the distribution were from a Roth IRA after it had been in existence for the period necessary in order for distributions of earnings to be tax-free, the entire distribution could be contributed for a gift annuity since no tax would be owed.

The contemplated change would allow a direct rollover to a gift annuity which would simplify the arrangement, much as the direct IRA rollover to charity has done so. It would also allow the donor to put more into the gift annuity, which would typically result in more residuum to the charity, since nothing would have to be set aside to pay the initial income tax on the distribution. However, since all the income would presumably be taxable in such a direct rollover, it's not clear that the after-tax income to annuitants would be significantly greater.

J. Can a donor fund a CGA with a gift from a donor advised fund?

No.

III. Creative Applications

Most gift annuities will be the "vanilla" type. They will be immediate gift annuities funded with cash or publicly-traded securities, and there will be a single donor who is the annuitant, or a couple who are joint and survivor annuitants. However, a charity can expand the number of gift annuities if it accepts non-traditional assets and looks for new applications.

This section discusses some of those applications.

A. Gift Annuity for Someone Other Than the Donor

Sometimes it makes sense for a donor to establish a gift annuity for someone else. This means that younger individuals – for example, those providing for an aged parent or those wanting to assist a friend – could be prospects. Often, such assistance is paid with after-tax dollars, which can be quite costly for the donor. For example, a person subject to a 35-percent tax rate must earn $769 in order to provide $500. It could be advantageous to transfer capital for a gift annuity and name as the annuitant the person whom the donor

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desires to help. The donor receives an income tax deduction, and the tax paid by the annuitant will probably be minimal because a portion of the annuity payments will likely be tax-free for a number of years, and the taxable portion of the payments will be taxed at a low rate.

Example

In January of 2019, Marc contributed stock having a fair market value of $100,000 and a cost basis of $40,000 for a gift annuity and named his mother as annuitant, reserving no power to revoke her interest. His mother, age 82, will receive $7,700 per year ($1,925 per quarter) based on the ACGA rate of 7.7 percent.

Marc in the example will recognize the $28,665 of capital gain allocated to the present value of the annuity. However, his charitable deduction of $52,225 will offset the taxable gain and reduce taxes on other income somewhat, assuming he is able to use the deduction.

Since Marc will already have recognized the taxable gain, no part of his mother's payments will consist of capital gain. For the balance of her life expectancy, $5,760 will be tax-free, and only $1,940 will be ordinary income. In other words, the payments to her will be taxed the same as they would have been if Marc had contributed $100,000 cash.

Marc makes a gift to his mother of $47,775 (the present value of her annuity payments). As a present-interest gift, it qualifies for the gift tax annual exclusion of $15,000. Thus, assuming he has made no other gifts to her in the year he establishes the gift annuity, the taxable gift to his mother would be $32,775 ($47,775 – $15,000). He could avoid making any taxable gift by retaining in the gift annuity agreement the right, during his life or upon his death, to revoke his mother's annuity interest. Then he will have made no completed gifts to his mother until she actually receives the annuity payments, and since each year's payments are under $15,000, they will be covered by the gift tax annual exclusion. Whether to include revocation language is something for the donor to determine on consult with his own legal counsel.

B. Establishing a Gift Annuity for an Employee

A company can establish a gift annuity for an employee. Likewise, an individual can establish a gift annuity for a personal employee – a gardener, for example.

The company or individual employer, as the case may be, will be entitled to an income tax charitable deduction for the contribution less the present value of the payments.

In the year of the gift annuity, assuming the employer does not retain the right to revoke the employee's payments, the employee will have taxable income (W-2 wages) equal to the present value of the projected lifetime of annuity payments, and the company can deduct this amount as employee compensation. The portion of each payment that represents a return of the capital on which the employee has been taxed up front will be tax-free for the duration of life expectancy.

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If the employer does retain the right to revoke the employee's payments, the present value of the payments will not be taxed as employee compensation in the year the annuity is established. However, the annuity payments will be taxed entirely as ordinary income. Since the employee was not taxed on any portion of the contribution for the gift annuity, there will be no capital to be returned tax-free. As to the company, in addition to claiming the up-front charitable deduction for the excess of the contribution over the present value of the annuity, it can deduct each year, as employee compensation, the portion of the present value of annuity payments paid to the employee during that year. This is the amount that would have been tax-free if an individual of the same age as the employee had contributed an equivalent amount and named himself or herself as annuitant.

It is important to keep in mind that the tax consequences are different depending on whether an individual establishes a gift annuity for a friend or for an employee. For example, a person who establishes an annuity and names a relative or friend as the annuitant makes a gift to that person of the present value of the payments, which may have to be reported on Form 709, the gift tax return, but the relative's or friend's only taxable income will be the ordinary income portion of the annuity payments. On the other hand, a person who establishes an annuity and names a person in his or her employment as annuitant does not make a gift but rather provides additional compensation that must be reported as such. The only question is whether that compensation (the present value of the payments) is reported in the year the annuity is established or incrementally as payments are received, and the timing, in turn, depends on whether the employer retained the right to revoke those payments.

C. Testamentary Gift Annuity for a Survivor

It is possible under a person's will or living trust to designate a specific sum or all or a portion of the residuary estate to fund a gift annuity. In that case, the size of the payments will depend on the amount transferred to the charity and the annuity rate then in effect for the nearest age(s) of the annuitant(s) as of the time of the donor's death.

Here is possible language that could be used in the case of one annuitant:

> I give, devise, and bequeath ($[*amount*] or "the residue of my estate") to [*Charity*], provided that if [*annuitant*] survives me, [*Charity*] shall pay [*him/her*], in quarterly installments at the end of each calendar quarter, a life annuity, the annual payments of which shall be equal to the value of the property transferred to [*Charity*] multiplied by the charitable gift annuity rate suggested as of the date of my death by the American Council on Gift Annuities for a person then [*his/her*] nearest age.

If a donor wants his or her survivor to receive a specific amount, the following language could be used:

> I give, devise, and bequeath to [*Charity*] the amount [*Charity*] requires as a contribution to provide a life annuity of $[*amount*] to [*annuitant*] based on the charitable gift annuity rate suggested as of the date of my death by the American Council on Gift Annuities for a person then [*his/her*] nearest age, and I direct that the annuity be paid in quarterly installments at the end of each calendar quarter.

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In the case of a testamentary immediate gift annuity, the charity's obligation is presumed to have begun at the donor's death, and the annual annuity is the amount received by the charity multiplied by the ACGA rate for a person of the annuitant's nearest age at the time of the donor's death. The problem is that considerable time may elapse between the date of the donor's death and the actual distribution from the donor's estate to fund the gift annuity. If the charity does not receive the distribution until sometime after the beginning of the obligation, and the amount received by the charity is the exact amount on which the annuity payment is based, the charity would effectively be paying a higher gift annuity rate. To rectify this situation, the charity should ask the personal representative to make the distribution as early as possible and see that it receives all of the earnings on the distributable amount to which it is entitled. If, because of the complexity of the estate, it is anticipated that distributions might be delayed, the charity may want to encourage the donor to add, to the bequest language above, the phrase ",with the first quarterly installment payable at the end of the calendar quarter during which [Charity] receives from my estate the distribution for the annuity." No matter when the first payment is made, the date of the gift is the date of the donor's death.

In some instances, the charity may not have received a distribution from the estate by the end of the calendar year in which death occurred. For example, the donor died on July 26, 2018, and the charity received the estate distribution on April 24, 2019. If the charity is required by the laws of one or more states to calculate each year the minimum amount that must be held in its reserve account and then report that amount to the state(s), would the charity report a new gift annuity established in 2018 and deposit whatever reserve is required for that annuity even though the charity has not yet received money or started making payments? As a practical matter, it makes sense that the annuity first be included on the state report for the year funding is received for it and payments are first made (in the case of an immediate annuity).

In any case, the charity should issue a gift annuity agreement setting forth the amount of the annuity, the date payments begin, and other terms, and give copies to the donor's personal representative and to the annuitant.

D. Gift Annuity Funded with Real Estate

In accepting real estate for a gift annuity, the charity assumes considerable risk. It commits itself to fixed payments without knowing when the property will sell or for how much. A charity may accept real estate to fund a gift annuity, even in New York. However, in certain states, like California, the value of the real estate cannot be counted in required reserves. The charity would have to place in the California gift annuity trust account sufficient permitted assets to meet the reserve requirements.

There are many ways to mitigate risk:

- Adjust the gift annuity rate to take into consideration the fact that net proceeds might be less than the appraised value.
- Ask the donor to defer gift annuity payments for a period of time.
- Do advance marketing and possibly identify a buyer prior to the date the property is transferred.

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- Secure a pledge from the donor and then seek a purchaser.
- Exercise a "put" agreement with a prospective buyer in advance of the transfer of the property.

Three of these strategies relate to a charity wanting to avoid having to advance its own funds to meet reserve requirements and might want to identify a willing buyer in advance of the gift and then arrange a simultaneous closing. That is, the property is donated and then sold on the same day. Can a simultaneous closing be structured in a way that avoids unwelcome tax consequences?

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 actually 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 simply made arrangements to sell in the event it receives certain property by gift. This argument might prevail, but certainly the risk level has increased.

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,

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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 of 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?

Still another way 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."

E. Gift Annuity and Retained Life Estate Together

Some people would be willing to give their residence to a charity, provided they can continue to live in it and also receive life payments. This objective cannot be accomplished by transferring the residence to a charitable remainder trust because (1) the trustee would be unable to make payments unless the property were sold and (2) continuing to live in the residence would constitute self-dealing. But it can be accomplished by retaining a life estate in the property and contributing the remainder interest for a gift annuity.

Conceptually, the annuity paid to the donor (or donor and a spouse or other person) would be the present value of the remainder interest of the retained life estate multiplied by whatever annuity rate the charity agrees to.

The donor and charity should execute three agreements:

- A standard gift annuity agreement.
- The donor should also execute a deed conveying the property to the charity subject to a retained life estate.
- An agreement pertaining to the retention of a life estate and conveyance of a remainder interest in the property. This agreement should spell out the responsibilities of the two parties, especially for payment of expenses.

It is recommended that the annuity rate be lower than the charity would normally pay to a person or persons of the same age if the annuity were funded with cash or marketable securities. That is because the charity assumes significantly greater risk with this arrangement than with a typical gift annuity. If real estate values appreciate, and the charity does not have to make major investments for property improvement, these arrangements can be profitable. On the other hand, the charity assumes a significant risk, for it commits to advance a fixed amount for an indeterminate period and uncertain future proceeds. Thus, a charity entering into these arrangements is advised to be quite conservative in the annuity rates offered.

When the AFR is low, the present value of the charity's remainder interest in the donor's principal residence will be larger. This, in turn, will result in larger gift annuity payments, which increases the charity's risk. Thus, the ACGA rate should probably be discounted more when the AFR is low than when it is higher. If a charity is registered to offer gift annuities in

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the State of New York, it cannot accept a gift of the remainder interest in a residence for a gift annuity. This is not because the asset itself is prohibited from being used as a funding asset – New York's gift annuity statute allows for a contribution of "cash and other property." However, in an opinion issued by the Office of General Counsel, the New York Department of Financial Services has indicated that accepting a gift of real property with a retained life estate would be contrary to the prudent investor standard that governs the gift annuity reserve fund, as the charity would not have full ownership and control over the property and thus have no discretion with respect to investment of the asset.

Certain other regulated states, such as California, do not explicitly prohibit receiving real property for a gift annuity. However, real estate is not an acceptable asset for satisfying reserve requirements. Therefore, as with a direct gift of real estate as in the example above, the charity must be prepared to allocate other, acceptable assets for the required reserves.

The income tax deduction is determined in the same way as for any gift annuity, except that the amount of the contribution for the gift annuity is the present value of the remainder interest in the real estate, not the fair market value of the entire property. This is the only deduction - no additional deduction is given for the retained life estate.

Capital gains treatment can be a little tricky. When a married couple who file a joint return dispose of a principal residence and meet certain occupancy requirements, $500,000 of the capital gain can be excluded from taxation. The limit is $250,000 for a single person or for a married person who files a separate return. The exclusion is allowed if the interest being disposed of is not the principal residence itself but a remainder interest in the principal residence. (See IRC Sec. 121.) Provided the total taxable gain in the property does not exceed the excludable amount, a gift annuity can be designed so that none of the capital gain is taxed to the donor, or to the annuitant (if the annuitant is different from the donor). This result may be achieved by designing the gift in any of the following ways:

1. The donor is the annuitant, and the gift annuity agreement is drafted so that the annuity is non-assignable except to the charity. The gain would be ratably reported, and the exclusion would be applied to the amount reported each year until the exclusion has been fully used. Afterwards, the remaining taxable gain would continue to be ratably reported, and it would be taxed to the donor. An alternative that some authorities believe to be possible is for the donor first to subtract the exclusion from total taxable gain and then report the remaining gain ratably over life expectancy. The first method is consistent with how the exclusion would be applied when an owner sells a principal residence on the installment basis.

2. The donor is the annuitant, and the gift annuity agreement is drafted so that the annuity is assignable. The assignability is not limited to the charity as in option (1.) above. This causes all of the taxable gain to be recognized in the year of the gift. The donor then uses the excludable amount to offset this taxable gain. Provided the taxable gain does not exceed the excludable amount, the donor will incur no out-of-pocket cost. Since the taxable gain will have been reported, the payments, as reported on each year's Form 1099-R, will be partly a tax-free return of principal and partly ordinary income. Sometimes, though, total taxable gain will exceed the exclusion. In that case, the remaining gain, after subtracting the exclusion, would be reported over life expectancy.

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3. Someone other than the donor is the annuitant, and the gift annuity agreement, as is customary, is drafted so that the annuity is non-assignable except to the charity. Because the annuitant is someone other than the donor, ratable reporting of gain is not allowed. As with option (2) above, all of the taxable gain is recognized by the donor in the year of the gift, and the donor uses the excludable amount to offset that gain. Again, if the exclusion exceeds the taxable gain, the payments to the annuitant will be a partly tax-free return of capital and partly ordinary income.

Suppose that, per options 1, 2, and 3 described immediately above, taxable gain can be eliminated by the allowable exclusion of $250,000 or $500,000. Would the contribution ceiling be 30 percent or 60 percent of adjusted gross income? The same question could be asked regarding an outright gift of a principal residence where capital gain does not exceed the excludable amount. IRC Sec. 170(b)(1)(C)(iv), which deals with percentage limitations, says that the 30-percent limitation applies to a gift of capital gain property, and it defines "capital gain property" as a capital asset the sale of which at its fair market value at the time of contribution would have resulted in gain that would have been capital gain. IRC Sec. 121, dealing with the sale of a principal residence, says that gross income shall not include $250,000 of gain ($500,000 in the case of a married couple). If the selling price of a principal residence does not exceed the cost basis plus the excludable amount, than the seller(s) would have no taxable long-term capital gain.

One could argue that if the sale (in the case of a gift annuity, the bargain sale price) would have generated no taxable gain, the 60-percent limit should apply. The contrary argument is that the sale of a principal residence would have resulted in long-term capital gain, but $250,000 (or $500,000) of that gain is not taxed. Because it would have resulted in long-term capital gain, albeit gain that is not taxable, the 30-percent limit should apply.

Unfortunately, the Internal Revenue Code and Regulations do not provide a clear answer. The conservative reporting solution would be to apply the 30-percent limitation, but there is probably adequate authority in the language of the statute to avoid penalties, if one applies the 60-percent limitation, and the IRS challenges it and prevails.

F. Deferred Gift Annuities as a Supplemental Retirement Plan for People Still Working

While immediate annuities appeal primarily to older donors (70 and above), individuals in their 50s and 60s that are still working would be a prime target for deferred annuities. Such annuities can serve as a supplemental retirement plan and provide a charitable deduction to donors during their peak earning years, when they are more likely to be able to utilize it.

Many organizations who would only accept immediate annuities for donors 65 and above have policies allowing deferred gift annuities as much as ten or more years earlier, so long as the payment obligations don't begin until the youngest annuitant is 65.

Below are four variations on this theme, growing in both complexity and flexibility.

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1. Traditional Deferred Gift Annuity

With a traditional deferred payment gift annuity, a donor makes a contribution now and specifies a future date on which payments begin. The amount of the payment, known in advance, is determined in this manner:

- The deferred factor is determined by compounding 1.0 at a set rate (currently 3.75 percent if the charity follows the ACGA recommendation).
- The deferred factor is then multiplied by the current immediate gift annuity rate for the age the annuitant will be on the payment starting date. The result, rounded to the nearest tenth of a percent, is the deferred gift annuity rate.
- This rate is then multiplied by the amount contributed to determine the annual annuity.

Example

Alane, age 50, contributes $50,000 cash on January 19, 2019 and specifies that quarterly payments begin March 31, 2034 when she will be age 65. This means that there are about 14.9 years to the annuity starting date (which is January 1, 2034 – the beginning of the period that ends with the first payment date). That means the deferred discount factor is 1.0375^14.9 or 1.72024. Given that an immediate annuity for a 65-year-old is 5.1%, multiplying 5.1% times 1.72024 = 8.77%, which is rounded to 8.8%

Starting March 31, 2034, she will receive an annual annuity of $4,400 (8.8% annuity rate) paid in equal quarterly installments. Until the end of her life expectancy, $1,417 of the annual payment will be treated as a tax-free return of capital. Besides payments for life, Alane will receive an immediate charitable deduction of $21,816.50.

2. Gift Annuity Designed for Inflation Protection (Step Annuity)

The life income plan that offers the possibility of income growth to keep pace with inflation is the charitable remainder unitrust. However, the unitrust includes the concomitant risk of declining payments, which often happens in a bear market. Moreover, the practical minimum for establishing a unitrust - $100,000 or more, depending on who you ask - may be larger than the amount a donor is prepared to contribute.

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 number of deferred gift annuities that have successively later payment-starting 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 simultaneously execute multiple agreements, differing only in the timing and amount of

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payments. The charity could issue one quarterly check combining the amounts due from all of the annuities.

Example

Elaine's date of birth was January 20, 1954. Assume that, in order to provide for immediate cash flow as well as periodic payment adjustments, she simultaneously established six gift annuities on January 19, 2019. One was an immediate gift annuity funded with $100,000 cash. The other five were deferred gift annuities, each funded with $10,000. The payment-beginning dates of the deferred gift annuities were on June 30 of 2022, 2025, 2028, 2031, and 2034. Elaine would receive the following amounts, and her total income tax deduction for the gifts totaling $150,000 would be $64,141.

Beginning at age:	Payment per year
65	$5,100
68	5,700
71	6,420
74	7,280
77	8,310
80	9,590

These increments occur every three years rather than annually, and they exceed the average historical rate of inflation.

Suppose that a different donor, Lawrence, who was born on May 23, 1953, wants his annual payments to increase at the inflation rate for 2018 (1.9 percent). The following chart shows how much he would have contributed initially, if he wanted these adjustments annually for eight subsequent years (and then it would remained fixed at the amount in the ninth year). Actually, he could provide for annuity adjustments for whatever period he chooses. (This chart was prepared for an annuity completed on January 19, 2019.)

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Type of Annuity	Contribution Amount	Beginning Date	Payout Rate	Payment	Total
Immediate	$100,000	1/19/2019	5.2%	$5,200	$5,200
Deferred	$1,796	3/31/2020	5.5%	$99	$5,299
Deferred	$1,766	3/31/2021	5.7%	$101	$5,399
Deferred	$1,710	3/31/2022	6.0%	$103	$5,502
Deferred	$1,608	3/31/2023	6.5%	$105	$5,607
Deferred	$1,567	3/31/2024	6.8%	$107	$5,713
Deferred	$1,508	3/31/2025	7.2%	$109	$5,822
Deferred	$1,455	3/31/2026	7.6%	$111	$5,932
Deferred	$1,375	3/31/2027	8.2%	$113	$6,045

Lawrence's total contribution on January 19, 2019 was $112,785, and his payments would retain their purchasing power for the next eight years (or for whatever period he chooses), assuming the future Consumer Price Index approximates the average for last year.

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 the gift acceptance policies. However, the charity may be willing to make an exception because the total amount contributed is well above its minimum, the bundled annuities are identical except for the payment-beginning date and the annuity amount, and they can be consolidated for purposes of making the payments and issuing tax forms (Form 1099-R). The plan should not prove to be an administrative burden, and it could appeal to donors concerned about escalating prices.

3. Flexible Deferred Gift Annuity

A problem with the traditional deferred gift annuity is that the donor must determine in advance when payments begin. However, some 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 the payments later.

In 1997, the IRS approved a deferred annuity in which the donor does not have to choose in advance the starting date for payments. According to Private Letter Ruling 9743054, that decision can be made later, depending on circumstances. The older the annuitant(s) 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.

Some individuals had been concerned that the right to elect payments might result in the constructive receipt of income. The IRS was asked to rule on this issue, and in another private letter ruling concluded, "Where payments are made to an annuitant in accordance with section 72 and Treas. Reg. section 1.72, no amount will be constructively received

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by the annuitant until the annuitant actually begins receiving payments." See Private Letter Ruling 200742010.

Example

Dan, whose date of birth was March 3, 1969, wants to supplement his income when he retires, but he does not know at this time when he will be ready to retire. On January 19, 2019, he contributed stock having a fair market value of $100,000 and a cost basis of $60,000 for a gift annuity and reserved the option to start quarterly payments on June 30th of any year during the period 2029 – 2039.

The income tax charitable deduction (the lowest deduction resulting from any of the possible payment start dates) was $36,625. The following table shows Dan's annuity rate, annuity amount, and taxation of payments for full years during life expectancy, were he to elect to start receiving payments on any of the elective start dates in the schedule. For example, if he elects the earliest start date in the schedule (6/30/2029), his annuity payments will be $6,800/year, whereas if he elects the latest start date (6/30/2039), his annuity payments will be $11,800/year.

Elective Start Date	Age at Start Date	Annuity Rate	Capital Gain	Tax-free Portion	Ordinary Income	Annuity
6/30/2029	60	6.8%	$1,053	$1,579	$4,168	$6,800
6/30/2030	61	7.1%	$1,093	$1,640	$4,367	$7,100
6/30/2031	62	7.5%	$1,131	$1,697	$4,673	$7,500
6/30/2032	63	8.0%	$1,178	$1,766	$5,056	$8,000
6/30/2033	64	8.4%	$1,223	$1,835	$5,342	$8,400
6/30/2034	65	8.9%	$1,274	$1,912	$5,714	$8,900
6/30/2035	66	9.4%	$1,327	$1,991	$6,082	$9,400
6/30/2036	67	10.0%	$1,384	$2,076	$6,540	$10,000
6/30/2037	68	10.4%	$1,448	$2,172	$6,781	$10,400
6/30/2038	69	10.9%	$1,517	$2,276	$7,107	$10,900
6/30/2039	70	11.8%	$1,595	$2,393	$7,812	$11,800

4. The Super Flexible Deferred Annuity for Both Inflation Protection and Flexibility

The disadvantage for Dan, in the above example pertaining to 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.

The annuitant could control the cash flow by choosing year-by-year whether to begin payments from any of the flexible annuities. A plan that combines the inflation protection

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of the step annuity with the ability to base the timing of payments on circumstances is what is meant by the super flexible deferred gift annuity**.**

Example

Instead of establishing a single $100,000 flexible deferred gift annuity, Jill, Dan's twin sister, simultaneously funds ten of them, each with $10,000 and each having an elective period ranging from age 62 to 72. Her total deduction for creating all ten annuities is $39,476. All ten offer the elective payment schedule below.

Elective Start Date	Age at Start Date	Annuity Rate	Tax-free Portion	Ordinary Income	Total Annuity
6/30/2031	62	7.5%	$270	$480	$750
6/30/2032	63	8.0%	$282	$518	$800
6/30/2033	64	8.4%	$292	$548	$840
6/30/2034	65	8.9%	$304	$586	$890
6/30/2035	66	9.4%	$317	$623	$940
6/30/2036	67	10.0%	$331	$669	$1,000
6/30/2037	68	10.4%	$346	$694	$1,040
6/30/2038	69	10.9%	$362	$728	$1,090
6/30/2039	70	11.8%	$381	$799	$1,180
6/30/2040	71	12.4%	$398	$842	$1,240
6/30/2041	72	13.1%	$418	$892	$1,310

At age 62, Jill decides to reduce her work hours to allow more time for travel. Then, at age 65 she retires from her middle management position but continues to do some consulting until age 68. She elects to activate two of the annuities at age 62, three more at age 65, and one each year beginning at age 68. Her payments would be:

Beginning at Age	Annual Payment
62	$1,500
65	4,170
68	5,210
69	6,300
70	7,480
71	8,720
72	10,030

IV. Conclusion

Gift annuities may never look the same for readers of this paper and that's not necessarily a bad thing. Many planned giving professionals have stopped offering deferred gift annuities, opting to explain only the flexible deferred annuity. Adding flexibility for planned giving options has to be balanced with not overwhelming either the donor or your business office. Sometimes simple is just right. But with more choices often comes better optimization of a gift for the donor and the charity, and isn't that what planned giving is all about?

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