TWELVE UNCOMMON THINGS YOU CAN DO WITH A GIFT ANNUITY

Presented by:

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The *common* gift annuity is funded either with cash or publicly-traded securities. It is established either by a single donor who is also the annuitant, or by a husband and wife who contribute jointly-owned or community property for a joint and survivor annuity. Annuity payments are made until the death of the sole or surviving annuitant, whereupon the residuum is used for charitable purposes.

This paper assumes that the reader has a basic understanding of gift annuities and experience with these common types and will not be interested in traversing familiar territory. Thus, it focuses on uncommon funding assets and applications, and on various technical issues that arise in practice.

The objective is to expand the usage of this historic and versatile gift instrument and to better serve donors who contribute in this manner. Although the twelve ideas presented all demonstrate financial benefits to the donors, the underlying assumption is that all persons who enter into these arrangements are motivated by the desire to make a gift to a charity that embodies their values. Often, however, their level of motivation can actually be heightened when they are made aware of options which mesh especially well with their particular situations. To that end, the following options are presented for consideration.

1. FUND THE ANNUITY WITH TANGIBLE PERSONAL PROPERTY

Many individuals with stamp and coin collections, artworks and other items of tangible personal property would be willing to contribute them in exchange for life payments and an income tax charitable deduction.

One possibility is to transfer them to a charitable remainder trust, assuming the articles have sufficient value for a trust to be practical. However, no income tax charitable deduction is allowed until the articles are sold by the trust. (IRC §170(a)(3) and PLR 9452026.) Income from the trust will also be deferred until the sale, assuming a net-income unitrust is selected.

Only with a gift annuity can the donor be assured of both immediate payments and an income tax deduction in the year of the gift. The amount of the deduction depends, in part, on whether the donated items are retained by the charity and used for its exempt purposes ("related use") or sold and the proceeds invested to cover the annuity obligation ("unrelated use"). (IRC §170(e)(2)(A).) If the charity retains the object, it will, of course, have to advance some of its own funds to cover the annuity obligation. Some organizations, such as an art gallery desirous of obtaining a particular artwork, might be willing to do that. In most cases, however, the charity will sell the donated object as quickly as possible and, consequently, the income tax deduction will be reduced by the capital gain allocated to the gift value. (If the object had been contributed to a charitable remainder unitrust, the use likewise would have been "unrelated," and the deduction would have been reduced.)

Example: *Mr. and Mrs. Morgan, whose respective birthdates are February 11, 1928 and September 20, 1929, have a stamp collection which has just been appraised for $160,000. They have kept meticulous records and have a recorded cost basis of $18,000. They have lost interest* *in further collecting and would like to convert this idle asset to a stream of income, so on July 1, 2000, they contribute it for a gift annuity.*

Their deduction is a mere $6,639.19

Present Value of Annuity – $101,011.68		***Gift Value – $58,988.32***	
A	***B***	***C***	***D***
$11,363.81	*$89,647.87*	*$6,639.19*	*$52,349.13*

A *is the cost basis of the present value of the annuity. This is the capital that is returned tax free over the donors' life expectancy.*

B *is the long-term capital gain allocated to the present value of the annuity. This gain is reported ratably by the donors over their life expectancy.*

C *is the cost basis allocated to the gift value. It is the income tax charitable deduction.*

D *is the long-term capital gain allocated to the gift value. Because the gift is for an unrelated use, the deduction must be reduced by this amount.*

If they had contributed the stamp collection to a historical museum, which kept it in the philatelist display, their deduction would have been $58,988.32.

Even though their deduction is small, they have been able to convert an idle asset to a stream of income and pay no tax on the gain at the time of the gift.

2. FUND THE ANNUITY WITH A LIFE INSURANCE POLICY OR A COMMERCIAL ANNUITY

A. Life Insurance Policy

Some individuals have life insurance policies that are either paid up or, at least, have been owned long enough to have accumulated considerable cash value. In some cases, the policy is no longer needed for family protection or liquidity to cover estate expenses, and it is just sitting in the safe deposit box. To derive some current benefit from the policy, the owner might be willing to transfer ownership to a charity for a gift annuity.

In many cases, the current value of the policy will exceed the policy holder's adjusted cost basis. The gain, if the policy were surrendered, would be taxed as ordinary income, not as capital gain. If the policy is contributed for a gift annuity, the income tax charitable deduction must be reduced by the amount of gain allocated to the gift value. The reduction is computed the same way as when "unrelated use" tangible personal property is contributed for a gift annuity.

Reg. Sec. 1.1011-2(a)(4)(ii) provides for ratable reporting of gain, and it makes no distinction between long-term capital gain and gain arising from the sale of ordinary income property. The example later cited in Reg. Sec. 1.1011-2(c)(8) concerns a gift of long-term capital gain property, but it does not follow that ratable reporting is intended to be limited to long-term capital gain. This particular example may have been selected because long-term capital gain property is the most commonly contributed non-cash asset.

Thus, our conclusion is that ratable reporting of gain in ordinary income property, as well as in long-term capital gain property, is permissible.

<u>Example</u>: *Hilda Savitz owns a paid up life insurance policy which she would like to contribute for a gift annuity. The face value is $100,000, the replacement value (approximately the same as the cash value) is $40,000, and the adjusted cost basis is $22,000. Her birthdate is September 17, 1928, and she transfers ownership on July 1, 2000.*

<u>Scenario (1)</u> *– She transfers ownership of the policy to the charity, and the taxable gain can be ratably reported.*

Payments for each full year	*$3,080.00*
Income tax deduction	*9,719.35*
Taxation of payments each full year during life expectancy:	
Ordinary income	*2,233.07*
Exempt from taxation	*846.93*
	3,080.00
Taxable gain at the time of the transfer of ownership	*- 0 -*

<u>Scenario (2)</u> *– She surrenders the policy and then contributes the cash proceeds.*

Payments for each full year	*$3,080.00*
Income tax deduction	*17,671.54*
Taxation of payments each full year during life expectancy:	
Ordinary income	*1,540.11*
Exempt from taxation	*1,539.89*
	3,080.00
Taxable gain resulting from surrender of policy	*$18,000.00*

Note that in Scenario (2) her tax deduction will offset all but $328.46 of the ordinary income resulting from using the policy to make the gift.

B. Commercial Annuity

Many people have purchased from insurance companies either fixed or variable deferred annuities, and in the years since purchase considerable gain has accrued. That gain will be taxed as ordinary income – over time if the owner elects to receive life payments, or all at once if the contract is surrendered. If the contract is given to beneficiaries (other than charities) when the donor dies, the gain will be taxed as ordinary income to them. Owners of these contracts can transfer them for a gift annuity and thereby reduce the tax on the gain, receive life payments, and have the satisfaction of making a charitable gift.

The tax savings do not result from avoidance of tax on the gain but from an income tax charitable deduction that totally or partially offsets the taxable gain. The gain in the contract will be taxed, and the only question is when. For annuities acquired on or before April 22, 1987, the donor is taxed on the gain when the donee surrenders the contract. For annuities acquired after April 22, 1987, the donor is taxed on the gain when the contract is transferred no matter when the donee surrenders it. In all probability the charity will surrender the contract for cash as soon as possible and invest the proceeds in the gift annuity reserve fund.

Since the gain will be taxed and no part of it can be reported ratably over life expectancy, it makes no difference, from a tax standpoint, whether the donor transfers the contract to the charity or surrenders it and gives the proceeds to the charity. Of course, it would make a difference if ratable reporting of gain were possible. Even if the gain has to be recognized up front, the transaction can still be attractive because the charitable deduction may enable the donor to make the transfer with little or no actual tax cost.

Example*:* *Louise Tyson, whose birthdate is July 12, 1922, transfers a commercial annuity for which she paid $25,000 and which has a current cash value of $47,000. The transfer is made on July 1, 2000, and she receives quarterly payments from the gift annuity funded with the transfer.*

Taxable gain	*$22,000.00*
Income tax charitable deduction	*$22,545.74*
Excess of deduction over gain	*545.74*
Tax savings (Assuming a 31% tax rate)	*169.18*

Taxation of payments during each full year of life expectancy:

Ordinary income	*1,760.02*
Exempt from taxation	*2,328.98*
	$4,089.00

At no tax cost she is able to convert her commercial annuity to a stream of payments, a substantial portion of which will be tax-free. Had she elected to receive life payments *from the commercial annuity, a higher percentage of the payments would have been taxable because of the accrued gain.*

IRC §1035 permits a tax-free exchange of one annuity contract for another. It is not certain whether this applies only to annuities issued by insurance companies, or whether it would also include an exchange of a commercial annuity for a gift annuity.

3. FUND THE ANNUITY WITH ASSETS IN A QUALIFIED RETIREMENT PLAN

Over the years, bills have been introduced in Congress that would permit a tax-free rollover of IRA funds as either an outright charitable gift or for a life-income gift such as a charitable remainder trust, gift annuity, or contribution to a pooled income fund. If the rollover is for a gift annuity, the annuity payments will be entirely taxable as ordinary income unless the donor had made non-deductible contributions to the IRA.

Considering the trillions of dollars in IRA's and other qualified retirement plans, passage of these bills would open tremendous marketing opportunities for charities. Even if these bills do not pass, it can still make sense to fund a gift annuity with IRA assets. The procedure is to withdraw money from the IRA, withhold enough to pay the tax taking into consideration the charitable deduction, and to contribute the balance for a gift annuity. The following example compares a gift of IRA funds under present law with a gift of IRA funds if the rollover legislation passes.

Example: *Martin Howell, whose birthdate is April 20, 1931, has substantial funds in his IRA, and would like to reduce the IRA balance as well as generate some additional cash flow now. Assume he is willing to withdraw $100,000 of IRA funds for a gift annuity, that he doesn't want to incur any out-of-pocket tax cost, that the gift annuity is funded on July 1, 2000, and that his marginal tax bracket is 36%.*

Implications under current law:

Amount withdrawn from IRA	*$100,000.00*
Amount withheld to cover taxes	*24,626.50*
Amount contributed for gift annuity	*75,373.50*
Total annual annuity payments	*5,577.64*
Taxation of payments during each full year of life expectancy:	
Ordinary income	*2,956.08*
Exempt from taxation	*2,621.56*
	5,577.64
After-tax income	*$4,513.45*

Implications if rollover legislation were in effect

Amount transferred from IRA	*$100,000.00*
Tax on transfer	*- 0 -*
Total annual annuity payments	*7,400.00*
Taxation of payments during each full year of life expectancy:	
Ordinary income	*7,400.00*
Exempt from taxation	*- 0 -*
	7,400.00
After-tax income	*$4,736.00*
Additional annual after-tax income if rollover bill were in effect	*$222.55*

The donor would receive more after-tax income if the rollover bill were in effect. However, the difference is not as great as one might expect.

The rollover bill would offer two other advantages:

1. The transaction would be easier to understand and simpler to market.

2. Since no deduction is allowed, there would be no concern about possible loss of a portion of the charitable deduction if adjusted gross income exceeds $128,950.

Persons who want to proceed under current law can calculate the amount of the IRA withdrawal that can be contributed using the following formula:

$$C = \frac{W\,(1 - R)}{1 - RD}\text{, where}$$

C = contribution for gift annuity,
W = withdrawal from IRA,
R = donor's marginal tax rate,
D = deduction factor (percentage of contribution that is deductible).

4. Fund the Annuity with Closely Held Stock

It is possible to contribute stock in either a C or S corporation for a gift annuity, whereas only C corporation stock can be contributed to a charitable remainder trust. The 1996 tax legislation added charities to the list of eligible shareholders of S stock but did not add charitable remainder trusts. In the case of gift annuities, the stock is given directly to the IRC §501(c)(3) charity, which is now an eligible shareholder.

If a charity receives S corporation stock for a gift annuity and then continues to hold the stock and to receive its share of income paid by the corporation, the charity will be taxed on that income. This is because the distribution will be treated as unrelated business taxable income.

A charity probably would be unwilling to accept S stock for a gift annuity unless it is reasonably certain that (1) it can sell the stock to other shareholders in the near term or (2) the corporation will make regular distributions of income. Unfortunately, either scenario subjects the charity to taxation. If the charity sells the stock, it will be taxed on the gain. If it retains the stock, any income received from the corporation will be taxed as unrelated business taxable income. Even income deriving from interest, dividends, and rents – the type of passive income normally not taxable to a charity – will be taxed. Because of these tax consequences, the charity would be well-advised to offer a lower-than-normal gift annuity rate when accepting S stock for a gift annuity.

Sometimes, the potential purchasers of closely held stock are members of the donor's immediate family. If C stock were transferred to a charitable remainder trust, the donor's children would be disqualified persons. For them to purchase the stock would be a prohibited act of self-dealing under IRC §4941. However, if the stock were transferred directly to the charity in exchange for a gift annuity, the children would be able to purchase it. Although the charity can be under no obligation to sell the stock to the children, or to anyone else, it would be imprudent to accept such an asset for a gift annuity unless there is a ready and willing buyer. Otherwise, the charity will have to advance its own funds for the annuity payments, not knowing when and for how much it may eventually sell the stock.

5. FUND THE ANNUITY WITH REAL ESTATE

The preferred instrument, when a donor wants to contribute real estate and receive life payments, is a net-income charitable remainder unitrust, probably containing a "flip" provision allowing it to convert to a standard charitable remainder unitrust upon sale of the property. However, some donors may prefer a gift annuity because the amount of the payments is predetermined and guaranteed by the charity. Also, the gift annuity may be the only practical life-income alternative if the value of the property is too low to justify establishing a trust, or if the property is subject to a mortgage for which the donor is personally liable.

All states except New York permit the funding of a gift annuity with real estate, but the charity assumes considerable risk. It commits itself to fixed payments without knowing when the property will sell or for how much. Prior to the sale, it must advance its own funds to make the annuity payments, service any debt, and cover various expenses. The net amount remaining for investment after absorbing these expenses and paying selling costs may be insufficient to sustain the payments for the life of the annuitant, in which case the charity will lose money.

The charity can reduce its risk by taking any or all of the following actions:

1. Make sure the property is marketable before accepting it for a gift annuity.

2. Offer a lower-than-normal gift annuity rate to allow for uncertainty about the amount of the net sales proceeds and when they will be received. (If the donor lives in a state that requires a submission of the schedule of rates the charity will follow, it may have to obtain the donor's written consent to a rate lower than the applicable one on the schedule. The same procedure should be followed when the charity offers a lower rate because the annuity will be funded by some other illiquid asset, such as tangible personal property or S corporation stock.)

3. Ask the donor to agree to defer payments for two years or more to avoid advancing money for annuity payments prior to the anticipated sale.

The following example, which concerns a gift annuity funded with mortgaged property, is presented not because it is a common transaction but to demonstrate the tax implications for the donor and the financial risks for the charity. Donors may back away from such a gift when they realize that they have to recognize up front the capital gain allocated to the mortgage balance. In some instances, the donor may incur a net cost in the year of the gift because the gain recognized exceeds the usable charitable deduction. Still, the transaction may be attractive to a donor who wants to be relieved of the mortgage payments and count on guaranteed annuity payments.

<u>Example</u>: *On July 1, 2000 Gretchen S, whose birthdate is August 25, 1929, contributes for a gift annuity an apartment building which has an appraised fair market value of $1,200,000 and an adjusted cost basis of $500,000, and which is subject to a $300,000 mortgage. The mortgage was placed on the property fifteen years ago when she purchased it. According to the financial statement provided by Ms. S, annual gross rents last year were $93,000, and expenses for taxes, utilities and maintenance were $40,000. Her annual mortgage payments are $39,000. Her adjusted gross income last year was $100,000.*

Although the ACGA suggested rate for an annuitant age 71 is 7.6%, the charity agrees, in this instance, to pay a rate of 6.0%. The property is sold one year later, and net proceeds, after selling costs, are $1,000,000.

<u>Tax Implications for Ms. Snyder</u>

Mortgage $300,000		***Present value of annuity $402,386***		***Gift Value $497,614***	
A *$125,000*	***B*** *$175,000*	***C*** *$167,661*	***D*** *$234,725*	***E*** *$207,339*	***F*** *$290,275*

A *is the cost basis allocated to the mortgage.*

B *is the capital gain allocated to the mortgage. It is recognized in the year of the gift.*

C *is the cost basis of the present value of the annuity. This is the capital that is ratably returned tax-free over the donor's life expectancy.*

D *is the capital gain allocated to the present value of the annuity. It is reported ratably over the donor's life expectancy.*

E + F *is the amount by which the equity exceeds the value of the annuity. This is the charitable deduction.*

E *is the cost basis allocated to the gift value.*

F *is the capital gain allocated to the gift value, and it is not taxed.*

Although Ms. Snyder's charitable deduction exceeds the gain she recognizes, the amount of deduction actually usable in the year of the gift (because of the 30-percent-of-adjusted-gross-income limitation) may be less than the recognized gain, in which case she will incur a net cost in the year of the gift. During the carryover years she will have net tax savings.

Taxation of payments during each full year of her life expectancy will be:

Ordinary income	*$27,527.21*
Exempt from taxation	*11,030.32*
Long-term capital gain	*15,442.47*
	$54,000.00

Financial Implications for the Charity

Assume that the charity sells the property after one year and nets $1,000,000.

Cash outlay prior to sale of property:

Annuity payments	*– $54,000*
Net cash flow after expenses and mortgage payments	*+ 14,000*
	– $40,000

Amount available for investment in gift annuity reserve fund:

Net proceeds from sale	*$1,000,000*
Mortgage balance	*– 300,000*
Net outlay prior to sale	*– 40,000*
	$660,000

Amount remaining for charity at the end of Ms. Snyder's life, assuming:

Ms. Snyder lives	*Charity's net total return is 6%*
10 years	*$464,636*
15 years	*313,627*
20 years	*110,240*
25 years	*(163,691)*

6. Create a Flexible Deferred Gift Annuity

Deferred gift annuities have not been very popular. In fact, only about five percent of all gift annuities are deferred. One reason for their lack of appeal has been their inflexibility. The donor had to select years in advance precisely when payments would begin, and this date was unalterable.

In PLR 9743054 the IRS approved a deferred annuity in which the donor does not have to choose in advance the starting date for payments. That decision can be made later, depending on circumstances. The older the donor (or other annuitant(s)) when payments begin, the larger the payments.

Example: *On July 1, 1999 David Gould, whose birthdate is March 23, 1949, contributed $25,000 for a flexible deferred gift annuity. The gift annuity agreement allowed him to start his quarterly payments on March 31 of any year not earlier than 2010 nor later than 2020. The amount of payments is based on the year in which payments begin per the following schedule.*

Date Payments Begin	*Annual Payment Amount*
3/31/10	*$2,925*
3/31/11	*3,150*
3/31/12	*3,375*
3/31/13	*3,575*
3/31/14	*3,825*
3/31/15	*4,100*
3/31/16	*4,400*
3/31/17	*4,725*
3/31/18	*5,050*
3/31/19	*5,425*
3/31/20	*5,800*

The IRS ruled that such a contract meets the definition of a gift annuity as described in IRC §501(m)(5), that issuance of gift annuities of this type will not result in income from an unrelated trade or business as defined in IRC §511-513, and that the investment of annuity funds will not be unrelated debt-financed income under IRC §514.

The PLR request proposed claiming the smallest charitable deduction that would result from any beginning date, and this was approved. The planned giving software programs that now include the flexible deferred gift annuity calculations provide the following information:

1. A schedule of payments based on ACGA rates (or others entered by the user).

2. The charitable deduction (which is the lowest deduction that would result from a deferred gift annuity with any of the possible starting dates).

3. A schedule of how payments would be taxed for each of the possible beginning years. This schedule should be kept on file by the Gift Annuity Administrator, for the information will eventually be needed to complete the Form 1099R.

Two modifications of the typical gift annuity agreement are necessary. The "Payment of Annuity" paragraph should reference an attached schedule on which the amount of payments for each possible beginning year is listed.

There should be an "Election of Commencement Date" paragraph with language such as the following: "To elect irrevocably the commencement date of payments hereunder, which shall be the last day of March and which shall not be earlier than March 31, 2010 nor later than March 31, 2020, the Donor during his life shall deliver written notice to Charity no later than ninety (90) days prior to the desired commencement date."

One question that has been raised is whether the right to receive payments as of a certain date results in constructive receipt of income as of that date. Our opinion is that it does not. By analogy, the owner of a commercial deferred annuity contract has a right to elect life payments at any time but does not have taxable income until the election is made.

7. Establish a Gift Annuity to Benefit Someone Other Than the Donor

Some individuals provide supplemental financial support for aged parents who have limited income or to subsidize siblings who are struggling financially. Still others may want to help a friend have a better quality of life or reward a long-time employee who is retiring. Often, such assistance is paid with after-tax dollars, which can be quite costly for the donor. For example, a person subject to a 36-percent tax rate must earn $781 in order to provide a $500 monthly check. It could be advantageous to transfer capital for a gift annuity and name as the annuitant the person whom the donor 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, and the taxable portion of the payments will be taxed at a low rate.

Example: *Margaret Lipscomb wants to help her sister who is living on limited retirement income. On July 1, 2000 she contributes $100,000 cash for a gift annuity and names her sister as annuitant. The sister's birthday is June 10, 1930. Ms. Lipscomb receives an income tax charitable deduction of $42,612 which, given her 36-percent marginal tax bracket, reduces her income tax by $15,340. Her sister receives payments totaling $7,500 per year. During each full year of her life expectancy, these payments are taxed as follows:*

Ordinary income	*$3,890.66*
Exempt from taxation	*$3,609.34*

Ms. Lipscomb makes a taxable gift to her sister, which in this instance is $57,388. The taxable gift can be reduced by $10,000 because, as a present-interest gift, it qualifies for the gift tax annual exclusion. She can avoid making any taxable gift by retaining in the gift annuity agreement the right, during her life, to revoke her sister's annuity interest. (See Reg. §25.2511-2(c).) Then she will have made no completed gifts to her sister until she actually receives the annuity payments, and since each year's payments are under $10,000, they will be covered by the gift tax annual exclusion. By retaining the right to revoke her sister's payments she can use the annual gift tax exclusion year after year. If she does not retain the power to revoke, she can use the exclusion only once, in the year of the gift. In the event she predeceases her sister and has not revoked her interest in the annuity, the present value of his annuity payments, computed as of the date of her death, will be included in her taxable estate.

Suppose she funds the annuity not with cash but with appreciated stock, which she purchased several years ago for $40,000 and which is now worth $100,000. She will have to recognize the capital gain allocated to the present value of the annuity which is $34,433 ($57,388/100,000 X 60,000). This gain cannot be reported ratably over life expectancy when the donor is not the annuitant. Rather it is all recognized in the year of the gift. The deduction in Ms. Lipscomb's case is large enough to offset the taxable gain.

Occasionally, one spouse will establish with his or her own property a gift annuity solely for the benefit of the other spouse. There will be no taxable gift, assuming an immediate annuity, because of the marital deduction. However, if the annuity is funded with appreciated property, the donor-spouse will recognize the gain allocated to the present value of the annuity. This consequence can be avoided by an interspousal transfer of the property prior to the gift.

<u>Note:</u> If a person or company establishes a gift annuity for an employee, the present value of the annuity will be treated as compensation and taxed in the year the gift annuity is funded.

8. COMMUTE THE LIFE PAYMENTS TO LARGER INSTALLMENTS RECEIVED DURING A LIMITED PERIOD OF TIME

Though a gift annuity cannot be for a term of years or guarantee a minimum number of payments, per IRC §514(c)(5), the IRS in certain private letter rulings has approved gift annuity agreements that permit an exchange of life payments for a lump sum or for installments to be received during a limited period of time. (See, for example, PLR 9042043.) Such a commutation provision is typically included in the agreement for a "college annuity," but it conceivably could be used anytime a donor wants to give an annuitant the option of receiving term rather than life payments.

In the case of the college annuity, a donor initially contributes assets for a deferred annuity naming a child or grandchild as annuitant with life payments to begin at age 18. Prior to the annuity starting date the annuity is commuted to four or more annual installments. Thus, instead of receiving very modest payments for life beginning at age 18, the annuitant receives large installments during the college years. The installments would have the same present value as the life payments.

<u>Example</u>: *A grandparent contributed stock having a fair market value of $50,000 and a cost basis of $30,000 for a "college annuity" for his grandson, who was born March 13, 1997. The gift is made on July 1, 1999, and the agreement provided for the grandson to start receiving quarterly payments for life beginning September 20, 2015. It also contained a provision allowing a commutation of life payments. Two years before the lifetime payments are to begin the grandson's father, as his guardian, assigns his annuity interest to the charity in exchange for eight semi-annual installments.*

Amount contributed	*$50,000.00*
Grandparent's income tax charitable deduction	*23,469.00*
Capital gain recognized by grandparent	*10,612.40*
Taxable gift	*26,531.00**
Total amount paid to grandson during each college year	*22,867.14*
Installments taxed as follows:	
Ordinary income	*16,234.32*
Exempt from taxation	*6,632.82*
	$22,867.14

* *Since this is a future-interest gift, it does not qualify for the gift tax annual exclusion. The grandfather could postpone any taxable gift by retaining the right to revoke the grandson's payments during the grandfather's life.*

Some practitioners have the annuitant (or guardian) exercise the commutation right immediately after the annuity is funded, but this could appear as merely a sham to get around the prohibition against annuities for a term of years. It may be more prudent to stipulate that the right to exchange the life annuity for installments not be exercisable until two or three years before the starting date of the payments. This lapse of time would entail some mortality risk, which is characteristic of deferred gift annuities.

In our opinion, the size of the installments cannot be determined in advance, for they must be based on the CMFR and mortality tables in effect at the time of the commutation. A financial illustration can show what the installments would be based on the current CMFR and mortality tables.

A college annuity enables a donor to receive an income tax charitable deduction while providing for a descendant's education. Moreover, there is tax-free growth within the annuity, and the payments are taxed at the student's low tax rate. On the other hand, the college annuity has a number of disadvantages:

1. With the recent ACGA suggested rate reduction for young annuitants, the installments paid during college years will be smaller.

2. The donor recognizes capital gain if the annuity is funded with appreciated property.

3. The 10% penalty tax per IRC §72(q) apparently applies to the taxable portion of term payments started before the annuitant reaches age 59½. This tax would be in addition to whatever income tax the student would pay on the installments. The penalty tax does not apply after a person attains age 59½, or when the person receives life payments, whatever the age of the person when those payments begin.

9. Contribute to the Charity the Right to Receive Annuity Payments

Some annuitants, discovering that they do not need the annuity payments, are willing to forfeit their future right to them. Once they assign their annuity interest, the charity's obligation under the contract would terminate, and it would be free to use the residuum. An assignment of an annuity interest raises several questions, and the answers to some of them are not entirely clear.

A. Does an annuitant who assigns his or her interest receive a charitable deduction and, if so, how is the amount of the deduction determined?

The annuitant is entitled to a charitable deduction for the present value of the remaining annuity payments computed as of the date of assignment. To compute this, enter into your planned giving software program the original amount contributed, the original annuity rate, the payment frequency, the birthdate(s) of the annuitant(s), the date of the assignment as the gift date, and the CMFR as of the date of assignment without reference to what the CMFR was during either of the prior two months. The charitable deduction in this instance is the amount shown as the present value of the annuity.

B. Is the deduction subject to a 50 percent or a 30 percent of adjusted gross income limitation?

The 50 percent limitation should apply if the gift annuity was funded with cash and, 30 percent if it was funded with long-term appreciated property.

C. Does the assignment cause the annuitant to have any taxable gain?

The owner of a commercial annuity is taxed on the gain in the annuity when transferring it either to an individual or a charity. If it passes by beneficiary designation at the death of the donor, the beneficiary is taxed on the gain. If the assignment of a gift annuity were like the transfer of a commercial annuity, the annuitant arguably would not be taxed on any portion of the present value that represents unreturned capital, but would be taxed on the balance either as ordinary income, or a combination of ordinary income and capital gain, depending on how the annuity was funded.

However, the assignment of the right to gift annuity payments is not necessarily analogous to the transfer of a commercial annuity. According to General Counsel Memorandum 39826, the issuance of gift annuities has historically been treated "as a borrowing of money by the issuing organization," and that is why IRC §514(c)(5) exempts qualifying gift annuities from being considered acquisition indebtedness. Thus, it would follow that the assignment of a gift annuity interest is to be treated like the forgiveness of a debt owed by the charity. By this line of reasoning the assignment would not result in any taxable gain. (The author is indebted to Marc Carmichael for first advancing this argument and to David Newman for his analysis of the General Counsel Memorandum in the submission that led to PLR 9743054.)

10. CONTRIBUTE A LIFE INTEREST IN A CHARITABLE REMAINDER TRUST OR A POOLED INCOME FUND

Sometimes beneficiaries of charitable remainder trusts and pooled income funds are dissatisfied, or a charity would like to close out a small pooled income fund, so an exchange of the life interest for fixed payments is appealing to the beneficiaries and the charity.

Annuity payments may be smaller than the payments to which the beneficiary was accustomed because the annuity rate applies only to the present value of the life interest, but this problem may be overcome by offering a higher-than-normal gift annuity rate, state law permitting. A life interest in a trust is a capital asset with a zero basis. (IRC §1001(e).) Thus, the annuity payments will be partly capital gain and partly ordinary income with no tax-free component.

Example: *A charity has a dormant pooled income fund with only three participants and total assets of $63,500. The charity would like to shut down the fund and save the operating costs, and the participants are willing to contribute their life interests for gift annuities provided there is no significant reduction in income. The fund's highest adjusted rate of return during the immediately-preceding three years was six percent, and this also happens to be the approximate current return. One of the participants is Harry Green, whose birthdate is September 2, 1931. On July 1, 2000 he contributes his life interest, and at that time his units are valued at $28,100.*

Value of units (This amount is transferred to the charity for Mr. Green's annuity)	*$28,100.00*
Present value of life interest	*14,750.81*
Annuity rate offered by charity	*11.0%* [(1)]
Annual payments	*1,622.60*
Approximate annual payments from pooled income fund	*1,686.00*

Taxed as follows during each full year of life expectancy:	
Ordinary income	*859.96*
Long-term capital gain	*762.64*
	1,622.60
Charitable deduction	*$2,014.70* [(2)]

[(1)] *The ACGA rate for a person Mr. Green's age is 7.4%. If the charity paid that rate, Mr. Green would receive only $1,091.56 per year, considerably less than he would receive from the pooled income fund. The charity is willing to offer a higher rate because it has $28,100 to invest in the gift annuity reserve fund. In fact, the annuity rate offered by the charity, expressed as a percentage of the value of the assets it receives, is 5.64%, which is well below the ACGA rate. If the annuity is issued in a regulated state to which the charity has submitted a schedule of rates, the charity may have to show that the rate, expressed as a percentage of the assets transferred, is lower than the published rate and obtain the donor's written consent.*

[(2)] *To meet the requirements of IRC §514(c)(5), the charitable deduction must exceed 10% of the value of the property contributed for the annuity. The annuity rate is about as high as the charity can offer and still meet that requirement.*

11. CHANGE THE FREQUENCY OF ANNUITY PAYMENTS

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.

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 actuarial value.

<u>Example</u>: *Harold Jenkins has been receiving quarterly installments of $3,922.50 from his annuity. In the future he wants to be paid in monthly installments. Currently, payments total $15,690 per year ($3,922.50 × 4). To maintain an equivalent actuarial value, the total payments made each year must be reduced to $15,591.24. Thus, monthly installments will be $1,299.27. To make the change, Mr. Jenkins and the charity could execute an agreement containing the following wording:*

> *"Harold Jenkins and (Charity) hereby agree that, effective January 1, 2000, the annual annuity amount paid to Harold Jenkins shall be $15,591.24, and it shall be paid in equal monthly installments of $1,299.27 at the end of each calendar*

month. The first monthly payment under the new schedule shall be made on January 31, 2000.

They further agree that this adjustment in the annual annuity amount and payment frequency does not change the present value of the annuity, because the present value of an annual annuity of $15,591.24 paid in monthly installments of $1,299.27 at the end of the month is equal to the present value of an annual annuity of $15,690 paid in quarterly installments of $3,922.50 at the end of the quarter."

12. A TESTAMENTARY GIFT OF IRA ASSETS

Much has been written about naming a charitable remainder trust as beneficiary of IRA assets remaining at the death of the donor. Since the trust is tax exempt, the IRA funds are not taxed when distributed to the trust, though the beneficiary's payments will be entirely tier one income (ordinary income) unless the donor had made some non-deductible contributions to the IRA or to another plan which was rolled into an IRA.

It is also possible to use IRA assets remaining at death to fund a gift annuity to benefit a survivor. The question is whether none of the funds transferred to the charity will be taxed at the time of distribution, or whether funds equal to the present value of the annuity will then be taxed.

Arguably, none would be taxed because the charity, like a charitable remainder trust, is tax-exempt. However, the IRS might take the position that, since a gift annuity is partly a gift and partly a purchase of an annuity for the benefit of one or two individuals, the portion of the IRA attributed to the purchase is subject to income tax. There are no rulings dealing specifically with testamentary gift annuities funded with IRA funds. In the event that none of the IRA funds are taxed at the time of distribution for the annuity, the annuity payments would be entirely taxable as ordinary income because there would be a zero basis.

A tantalizing question is whether the IRC Sec. 691(c) deduction for federal estate tax would pass through to the annuitant, in which case some portion of the payments would be effectively tax-free. However, based on recent Private Letter Ruling 199901023, dealing with testamentary charitable remainder trusts funded with IRA assets, it is questionable whether the pass through would be allowed.

ADDENDA

1. State Regulation of Gift Annuities

As of July 25, 2000

I. STATE LAW REQUIRES CERTIFICATION, RESERVE AND ANNUAL FILING (11):

State	Years in operation	Board resolutn	Disclos. in agrmt	Reserve .required	Annual filing	Investment limitations	Notes:
AR	5	yes	- - -	yes[1]	yes	less strict[1]	[1] May elect to segregate AR annuitants
CA	10	yes	- - -	yes[2]	yes	strict[2]	[2] CA annuitants only
HI	10 in HI	- - -	- - -	yes	yes	- - -	Law requires $5 million of assets in Hawaii
MD	10 in MD	- - -	yes	yes	yes	- - -	
ND	- - -	- - -	- - -	yes	yes[3]	- - -	[3] Submission of audited financial statements
NJ	10	yes	- - -	yes[4]	yes	strict[4]	[4] May be possible to segregate NJ annuitants
NY	10	yes	- - -	yes	yes	strict[5]	[5] Rules apply to reserves for all states
OR	20 in OR[6]	- - -	yes	yes	yes	- - -	[6] Certain types of charities
TN	- - -	- - -	yes	yes[7]	yes	less strict[7]	[7] Rules apply to reserves for all states
WA	3	- - -	- - -	yes	yes	- - -	Requires $500,000 of unrestricted net assets
WI	10	- - -	- - -	yes	yes	less strict[8]	[8] Rules apply to reserves for all states

II. STATE LAW PROVIDES FOR BLANKET OR CONDITIONAL EXEMPTION (30):

State	Years in operation	Board resolutn.	Disclos. in agrmt.	Reserve Required	Notice to state	Avail. Assets	Notes:
AL	- - -	- - -	yes	- - -	yes	- - -	Exemption granted by Securities Dept.
AZ	- - -	- - -	yes	- - -	- - -	- - -	
CO	3	- - -	yes	- - -	- - -	- - -	
CT	3	- - -	yes	- - -	yes	$300k	
FL	5	- - -	yes	yes	yes	- - -	Investment limitations in some cases
GA	3	- - -	yes	- - -	yes	$300k	
ID	3	- - -	yes	- - -	yes	$100k	
IL	20[8]	- - -	- - -	- - -	- - -	$2 mil.[8]	[8] Waived if annuities reinsured
IN	- - -	- - -	- - -	- - -	- - -	- - -	
KS	- - -	- - -	- - -	- - -	yes	- - -	Exemption granted by Securities Dept.
KY	- - -	- - -	- - -	- - -	- - -	- - -	Certain charities must file copy of Form 990
LA	- - -	- - -	- - -	- - -	- - -	- - -	
ME	5	- - -	- - -	- - -	- - -	- - -	Must be qualified as a foreign corporation
MA	- - -	- - -	- - -	- - -	- - -	- - -	
MI	- - -	- - -	- - -	- - -	- - -	- - -	
MN	3	- - -	- - -	- - -	yes	$300k	Exemption granted by Securities Dept.
MO	3	- - -	yes[9]	- - -	yes[10]	$100k	[10] Notifications currently not being accepted
NE	3	- - -	- - -	- - -	- - -	- - -	
NV	3	- - -	yes	- - -	yes	$300k	
NH	3	- - -	yes	yes	yes	$300k	Annuity rates must not exceed ACGArecomnd.
NM	3	- - -	yes	- - -	yes	$300k[11]	[11] Either in unrestricted assets or reserve fund
NC	3	- - -	yes	- - -	yes	$100k	
OH	- - -	- - -	- - -	- - -	- - -	- - -	Agreement signed by both donor and charity
OK	3	- - -	yes	- - -	yes	$100k	Annual submission of audited fin. statement
PA	3	- - -	yes	yes	- - -	$100k	Must comply with PA char. solicit. law

SC	5	- - -	- - -	- - -	- - -	- - -	
SD	5	- - -	yes	- - -	- - -	- - -	Exemption applies to SD charities only
TX	3	- - -	yes	- - -	yes	$100k	
UT	- - -	- - -	- - -	- - -	- - -	- - -	
VA	3	- - -	yes	- - -	- - -	$100k	

[9] Although the statute was declared unconstitutional (the title of the original bill was not clearly stated and the bill contained more than one subject) legislation is expected to be reintroduced. Therefore, we recommend continuing to include disclosure language.

III. STATE LAW DOES NOT SPECIFICALLY ADDRESS GIFT ANNUITIES (10):

AK DE D.C. IA MS MT RI VT WV WY

2. Questions for Discussion

1) When should revocation language be included in gift annuity agreements?

2) Is it permissible for only an officer of the charity to sign gift annuity agreements? Or must they be signed by both an officer of the charity and the donor(s)?

3) How do you compute the charitable deduction and the taxation of payments when both capital loss and capital gain property are contributed for a gift annuity?

4) Suppose certain securities and mutual funds intended to fund a gift annuity are transferred on different dates. Is it necessary to execute multiple gift annuity agreements?

5) What are the most effective marketing techniques for gift annuities?

6) What are the tax implications when an annuitant dies prior to the end of life expectancy? If a deduction is allowed, where is it reported?

7) Can a gift annuity be designed to benefit more than one charity?

8) Are there appropriate ways that financial advisors and insurance agents who initiate gift annuities can be compensated?