Giving Through Life Income Plans for Your Advisors

Charitable Gift Annuities

A gift annuity is a contract between the donor and a charitable organization. Under the gift annuity contract, the donor transfers cash (or other acceptable property) to the organization, which agrees to pay a specified annuity. The annuity may be payable for one or two lives. See IRC section 514(c)(5).

Payment rates typically increase with age. See the Gift Annuity Rate Table for examples of gift annuity rates for one or two persons at various ages.

Charitable deduction and taxation of payments: A charitable deduction is allowed for the difference between the amount used to establish the annuity and the initial present value of the annuity. See Regulation section 1.1011-2.

In general, part of each annuity payment is taxed to the annuitant as ordinary income. The remainder is tax free as a return of investment for a period of time based on life expectancy, after which the payments are fully taxed. See IRC section 72(b)(2).

Capital gains reporting: When an individual funds a gift annuity with appreciated property, he or she must report capital gains (as determined under the "bargain sale" rules) along with any ordinary income received with respect to the gift annuity. If the annuity payments are made to just the donor or to the donor and a survivor, and if the annuity is non-assignable, the reportable gain may be spread ratably over the donor's life expectancy. In other cases, a portion of the gain must be reported in the year of the gift. See Reg. section 1.1011-2.

The ability to report a portion of income received from a gift annuity as capital gain income may be especially attractive to those whose ordinary income is taxed at rates that are significantly higher than capital gain income.

Deferred payment gift annuities: A deferred payment gift annuity can be a very attractive way for a person to supplement his or her income in future years. An amount is transferred now for a gift annuity, with payments to begin at a future date. Payment rates will be higher than those for an immediate payment gift annuity. The charitable deduction is taken now.

Estate and gift tax considerations: If the annuity is for the life of someone other than the donor (including a survivorship annuity), the present value of the annuity (determined at its inception) is subject to gift or estate taxation. See IRC section 2039. An annuity payable to the donor's spouse, however, qualifies for the gift or estate tax marital deduction. See IRC section 2056(b) and the regulations thereunder.

Charitable Remainder Trusts

The Tax Reform Act of 1969 laid down ground rules for the creation of several types of qualified charitable remainder trusts.

A "qualified" charitable remainder trust is generally exempt from income taxes, and gifts to a "qualified" charitable remainder trust typically are accepted for a charitable deduction. See IRC section 664 for definitions.

There are two types of qualified charitable remainder trusts: the *annuity trust* and the *unitrust*. Both must be valid trusts under applicable local law, and both must meet specific requirements. Income may be paid to the donor annually, quarterly, or at other intervals.

Annuity trusts: A charitable remainder annuity trust makes payments each year of a fixed dollar amount, at least 5% of the initial fair market value of trust assets. The annuity payments are paid first out of income and then, to the extent necessary, out of principal. Trust income in excess of the required annuity payout must be accumulated and added to principal or be distributed to a qualified charity. See IRC section 664(d)(1).

Unitrusts: A charitable remainder unitrust pays out each year an amount generally equal to a fixed percentage — at least 5% — of the value of trust assets for the particular year. The trust assets are commonly valued, as directed by the trust agreement, on the first business day of each taxable year.

A unitrust may also be designed to pay out whichever is less — its net income for the year or the specified fixed

percentage amount. This is commonly called a “net income” unitrust.

With a net income unitrust, the trust agreement may provide that for years in which trust net income exceeds the specified unitrust amount, the excess income may be used to “make up” for past years in which trust net income was less than the specified unitrust amount. This type of unitrust is known as a “net income unitrust with a makeup (or catchup) provision.” See IRC section 664(d)(2).

A net income unitrust (with or without a makeup provision) is ordinarily used when the charitable remainder trust is to be funded with unimproved real estate or another type of asset that produces relatively little or no income.

Another use for the net income unitrust with a makeup provision is in retirement planning. The trust assets are invested voluntarily by the trustee in low-yield, high-growth assets during working years. At or near retirement, the gains are taken tax free within the trust, and the trustee voluntarily invests the proceeds in high-yield assets to better meet retirement needs.

Flip unitrusts: Final IRS regulations issued in December 1998 allow for the creation of so-called “flip unitrusts” — trusts designed to begin as net income or net income with makeup unitrusts, before they “flip” to become straight-payout unitrusts following some “triggering event.”

The triggering event generally must be an event outside the control of the trustee or any other person. Permissible triggering events include marriage, divorce, birth or death. The sale of an unmarketable asset is also a permissible triggering event. Impermissible triggering events include the sale of a marketable asset or a request from the donor or any other person or entity that the trust flip. The flip occurs as of the first day of the taxable year following the year in which the triggering event occurs. See IRC section 664 for additional information.

Payout and deduction limitations: Annual unitrust or annuity trust payments may not exceed 50% of the initial amount contributed or 50% of the annual value of trust assets, and the charitable deduction amount must be at least 10% of the amount transferred to fund the trust. See IRC section 664.

Trustee: The donor can select an appropriate trustee. An individual, a trust institution or other entity having experience in the management of charitable remainder trusts may be selected. The donor, with certain limitations, may name himself or herself as trustee.

Reformation of defective trusts: For a number of years, practitioners were sometimes reluctant to draft charitable remainder trust agreements because of the perceived risk that the agreement would fail to meet one or more technical requirements and therefore fail to create a “qualified” charitable remainder trust.

In the Tax Reform Act of 1984, however, Congress established a procedure by which many defective charitable remainder trusts may be reformed and transformed into qualified trusts. See IRC section 2055(e)(3).

Specimen provisions: To aid drafters of charitable remainder trust agreements, the IRS has issued specimen provisions to be included in such agreements. See Rev. Proc. 2003-53 through 2003-60 and Rev. Proc. 2005-52 through 2005-59. Visit www.irs.gov for additional guidance.

Charitable remainder trusts for a term of years: An annuity trust or unitrust may be set up for a specified number of years, not to exceed 20. It is also possible to specify certain time periods based on one or more lives. See IRC section 664(d).

Tax considerations: When the trust is created, a current tax deduction is allowed for the value of the charitable remainder interest (except in certain situations involving funding the trust with tangible personal property — see IRC section 170(a)(3)). The method of computing the deduction is described in Reg. section 1.664-4.

If an individual establishes a charitable remainder trust for his or her life, the trust assets will be included in his or her gross estate under IRC section 2036. The amount included, however, will “wash out” as an estate tax charitable deduction under IRC section 2055. A surviving spouse’s interest in a qualified charitable remainder trust qualifies for the estate tax marital deduction. See IRC section 2056(b)(8). Note that the marital deduction is lost if there is any non-charitable beneficiary of the trust other than the donor and the donor’s spouse.

There is a “four-tier” system of attributing ordinary income, capital gain, tax-free income and corpus to the trust payout. See IRC section 664(b) and IRS Notice 98-20. Under the four-tier system, it is possible to receive tax-free income from a charitable remainder trust. For example, if an individual funds a 5% annuity trust with tax-exempt bonds having a 5% coupon payment rate, the interest from the bonds when received by the donor will retain its tax-exempt character. The retention of the tax-exempt bonds must be voluntary on the trustee’s part, however,

and must be defensible under local law governing fiduciary duties.

In Letter Ruling 9015049, the IRS ruled privately that a trust cannot be a qualified charitable remainder trust if any trust income (which includes realized capital gain) is used to pay a mortgage debt for which the donor is personally liable. There are, however, ways to use property subject to such a mortgage to establish a charitable remainder trust. The most obvious way is for the donor to pay off the mortgage before transferring the property to the trust.

Spousal waiver: Revenue Procedure 2005-24 provides a safe harbor procedure concerning spousal rights of election and the qualification of charitable remainder trusts.

Wealth Replacement Trust

A little-known but powerful technique that can be used in connection with gift annuities, charitable remainder trusts and other life income gift plans is for the donor to "replace" the asset he or she gives away using life insurance on his or her life.

Life insurance may be purchased using the income received from the gift plan, the immediate tax savings generated by the gift plan or some combination of both. In many cases, the life insurance is owned by and payable to an irrevocable insurance trust—a so-called *wealth replacement trust*. This can help ensure that the insurance proceeds will be free from estate taxation.

Charitable Lead Trust

Under a lead trust agreement, a guaranteed annuity or a unitrust amount is paid to a non-profit organization for a term of years or for the life of an individual. On termination of the lead trust, trust assets either revert to the donor or are distributed to others (almost always heirs).

Lead trusts have been used to make significant charitable gifts for a period of time before transferring wealth from generation to generation free or largely free of estate and gift taxes. Although the amount given to a lead trust is subject to gift or estate taxes, the present value of the annuity or unitrust payout to charity is subtracted from this amount in determining how much is actually taxable for gift and estate tax purposes. See IRC section 2055(e).

As a starting point for lead trusts and the generation skipping tax, see IRC section 2642(a).

General Tax Information

Charitable gifts may be generally deducted in one year up to 60% of a donor's adjusted gross income for gifts of cash. In the case of large charitable gift annuities funded for tax year 2020, the AGI may be waived—but there is no clear IRS guidance at this time. The limit is in most cases 30% of adjusted gross income for gifts of appreciated property held more than one year.

Gift amounts in excess of these limits may be deducted in as many as five succeeding tax years. See Internal Revenue Code section 170(d)(1)(A).

When a gift plan is funded with an appreciated asset (securities or real estate, for example) held long-term, the donor generally receives a charitable deduction based on the current fair market value of the asset. Special rules may apply if an asset has been subject to certain types of depreciation or if it is not a capital asset. See IRC sections 170(a), 1250(a), and 1250(b).

If the appreciated asset consists of tangible personal property which the organization does not use in a manner related to its exempt purposes, the deduction will be limited to the asset's basis. See IRC section 170(e)(1)(B).

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