

## The Gift Annuity: A Revolutionary Idea in Charitable Giving

If you know the name John Trumbull, you may recall that he was a famous Revolutionary War artist whose work included “The Declaration of Independence” and “Battle of Bunker’s Hill.” After creating four large paintings for the Capitol Rotunda, he failed to secure commissions for four more, and his fortunes began to decline.

Widowed and alone at age 75, he had an apartment full of unsold paintings and no income. In his *Reminiscences*,<sup>1</sup> he talks about being forced to sell furniture and dishes to survive. But out of this necessity was born a modern invention. Indeed, Trumbull made financial history when he offered to give a number of his paintings to Yale University if they would in turn pay him a suitable income for the remainder of his life. In so doing, he became the first donor to ever use a charitable gift annuity to finance retirement.<sup>2</sup>

Benjamin Silliman, a Yale professor, brokered Trumbull’s gift and in the process created the nation’s first collegiate art museum. From this humble beginning in 1830, the gift annuity has evolved into the workhorse of philanthropy, benefiting both donors and charities and giving individuals of diverse means the opportunity to leave a charitable legacy.

In this issue of *Charitable Giving*, we examine how gift annuities work and look at the many ways donors can use them to make a gift and provide income.

- **Partial Interest and Payout Rates: Gift Annuity Basics**
- **Simplicity Plus: Benefits for Donors**
- **Tax Considerations**
- **Gift Annuity Planning Ideas**

### Partial Interest and Payout Rates: Gift Annuity Basics

A charitable gift annuity is a contractual agreement between a donor and a qualified charity where the donor irrevocably transfers cash or property (often long-term appreciated stock) to the charity and, in return, the charity agrees to pay a specified amount periodically for the lifetime of one or two annuitants. The donor may choose to receive payments quarterly, semiannually or annually.

However, this is not an even exchange of property for annuity. The present value of the annuity is always less than the value of the transferred property. For tax purposes, then, the transfer is considered part charitable gift and part annuity purchase—meaning that gift annuities fall under the rules for gifts of partial interests in property. And for partial interest gifts (including gift annuities), the Internal Revenue Code requires the use of the applicable federal rate (AFR) in calculating the charitable deduction for the gift portion.

Many charities offer the recommended payout rates published by the American Council on Gift Annuities (ACGA), but some establish their own rates. The donor may choose to use the AFR for the month of the gift or for either of the two preceding months. Selecting which rate to use isn’t always straightforward.

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- If a donor wants to maximize the charitable income tax deduction, the highest rate is best, since it reduces the value of the annuity and increases the amount of the gift.
- If a donor wants to instead maximize the portion of each annuity payment that is free of income tax, the lowest rate is best (although, of course, this will reduce the charitable deduction).

Recently, we have seen low AFRs. For younger donors, charities may need to reduce the payout rates below the ACGA rates to satisfy the 10% minimum charitable interest requirement, since the annuity must be less than 90% of the total value of contributed property. But in reality, gift annuities are used most often by elderly donors, who enjoy a much greater tax benefit as their life expectancy shrinks.

### A Note About ACGA Rates

Since 1927, the American Council on Gift Annuities has studied and published rates applicable to gift annuities and advocated for responsible philanthropy and consumer protections. It is a voluntary nonprofit association that represents more than 1,500 gift annuity issuing agencies.

Because their published rates are computed to incorporate a charitable gift element, they are lower than (and not in competition with) commercial rates. However, a charitable organization is not bound to adhere to Council recommendations.

The schedule of maximum rates is determined by targeting a residual charitable gift equal to 50% of transferred assets. Actuarial assumptions are then applied to determine a tentative rate for each age based on the target. The present values of the tentative rates are then determined and must equal at least 20% of the value of transferred assets.<sup>3</sup>

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Charitable organizations cannot issue commercial insurance contracts and still keep their income tax-exempt status.<sup>4</sup> Gift annuities are an exception to this rule—but only if they comply with the “Clay-Brown” rules:<sup>5</sup>

- The present value of the annuity must be less than 90% of the total value of the property transferred in exchange for the annuity (in other words, the charitable interest must be at least 10%).
- The annuity cannot be payable over more than two lives, and the individual(s) must be alive at the time the gift annuity contract is established.
- The gift annuity agreement between the donor and charity cannot specify a guaranteed minimum or maximum number of annuity payments.
- The actual income produced by the property transferred in exchange for the gift annuity must have no bearing on the amount of the annuity payments.

Only qualified charities<sup>6</sup> may offer gift annuities, and the annuity is considered a general obligation of the charity issuing the contract. In fact, state laws often require issuing charities to maintain segregated reserves to cover the potential obligations



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to annuitants under gift annuity agreements. When required by state law, the issuing charity must register with state insurance departments in all of the states in which gift annuities are solicited. The solicitation process may also be subject to state regulations.

### Simplicity Plus: Benefits for Donors

Donors are attracted to charitable gift annuities because they are simple—both easy to understand (agreements can be as short as one page) and easy to execute. Donors can use a single gift annuity for a significant gift or establish multiple annuities over time for a series of smaller donations. The minimum gift amount is typically low enough that donors don't have to make a substantial commitment, making the gift annuity an economical alternative to the more complex charitable remainder trust.

The benefits of charitable gift annuities go well beyond simplicity, though:

- An immediate income tax charitable deduction for the gift portion (part of which may be deferred if necessary due to the annual percentage-of-AGI deduction limits)<sup>7</sup>
  - The choice of one or two annuitants (in the case of spouses as joint-and-survivor annuitants, the gift annuity can provide a continuation of payments to the surviving spouse without the delay of probate proceedings)
  - The choice of beginning payments immediately or deferring them to a future start date
  - A stable income that provides a hedge against uncertain financial markets (the charity absorbs the financial risk, since the obligation to pay the annuity is backed by the charity's general assets)
  - Payouts that are currently more attractive than CDs and other interest-bearing, fixed-income investments
  - A tax-free portion of each payment (the part considered return of principal is tax free, and is greater during times of low AFRs)
  - Removal of the transferred assets from the donor's estate for estate tax purposes
- There is a further tax benefit when a donor uses appreciated property. The donor will only recognize and pay tax on that part of the capital gain that is attributed to the annuity purchase. The part attributed to the gift is not subject to tax. In addition, the tax due on the capital gain that is recognized is spread out over the donor's life expectancy (assuming the donor is the annuitant).

### Tax Considerations

There are three areas in which charitable gift annuities have a tax impact—the immediate deduction, the tax due on payments, and the circumstances under which gift and estate taxes come into play. Let's examine these areas in more detail.

### The Income Tax Charitable Deduction

The donor who itemizes may take an income tax charitable deduction for the gift portion only (i.e., the value of the transferred property less the present value of the annuity). This deduction is subject to the same limits as an outright gift—50% of the



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donor's adjusted gross income (AGI) for a transfer of cash and 30% for a transfer of long-term capital gain property.<sup>8</sup> If the deduction exceeds these limits, the donor may carry the remainder forward for up to five years.

### Taxation of Payouts

Annuity payments consist of three separate portions, each with its own tax treatment:

- 1 **A Tax-Free Return of Principal.** A portion of each payment is a tax-free return of principal. This continues until the "assumed cost" of the annuity is fully recovered when the annuitant reaches life expectancy. The donor's cost basis is allocated between the gift and sale portions of the payment in the same proportion as the value of the transferred property. For example, if a donor's \$10,000 transfer is considered a \$6,000 gift (60%) and a \$4,000 annuity purchase (40%), then only 40% of each payment will be treated as tax-free return of principal.
- 2 **Long-Term Capital Gains.** If the donor uses appreciated property held for more than one year, a portion of each payment will be taxed as long-term capital gain, reducing the income-tax-free return of principal portion of the annuity payments. Capital gain is recognized only on the sale portion of the transaction, though, and because the tax is applied only as the money is paid out, the donor essentially spreads out payment of the tax over his or her life expectancy. However, there are a couple of requirements to achieve this benefit:
  - The donor must be the sole annuitant (or the donor and another individual can be joint-and-survivor annuitants)
  - The annuity must be non-assignable (or assignable only to the charity that issued it)
 If this prohibition against assignment is not incorporated into the terms of the gift annuity agreement, the donor must recognize the capital gain in full in the year of the contribution.
- 3 **Ordinary Income.** The balance of each payment is taxed as ordinary income. If and when the annuitant reaches life expectancy, annuity payments will be fully taxable as ordinary income, as all principal will have been distributed and all capital gain recognized.

### Form 1099-R

Taxable distributions from a gift annuity are reported on IRS Form 1099-R. Box 1 is for the total amount distributed. Ordinary income is reported in box 2a. Capital gains are reported in box 3. Any non-taxable amounts are reported in box 5. The ACGA recommends that charities provide other pertinent tax information to the donor, including:

- A copy of the gift annuity contract
- Verification of assets transferred
- A copy of the tax calculation



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## Gift and Estate Taxation

### *Gift Tax*

When a donor names another as an annuitant, the donor is essentially making a gift of the present value of the annuity. This is a gift of a present interest and is covered by the annual gift tax exclusion (\$14,000 in 2015 and 2016). If the sole annuitant is the donor's spouse, the gift tax marital deduction covers the gift.<sup>9</sup>

If the spouses are co-annuitants, the unlimited marital deduction is available only if each has the right to receive payments prior to the first spouse's death (in effect, a joint-and-survivor annuity).<sup>10</sup> If the donor chooses instead to receive the entire annuity with spousal survivor benefits beginning after death, the gift does not qualify for the marital deduction unless the donor fails to complete the gift by retaining the right to revoke the spouse's interest. This means that each payment received is a completed gift and covered by the annual gift tax exclusion.

If the annuitant is someone other than a spouse, and if payments begin within a year, the gift is made at the time the annuity is established—again, unless the donor fails to complete the gift by retaining the right to revoke the non-donor's annuity interest. The annuity must commence immediately to avoid being a gift of a future interest. Thus, deferred annuities do not qualify.

### *Estate Tax*

Let's look at three situations:

- If the donor is the sole annuitant, there are no estate tax issues because the annuity terminates at the donor's death.<sup>11</sup>
- If someone other than the donor is the sole annuitant, the remaining value in the annuity is excluded from the donor's estate. (An exception exists for a joint annuity that uses only the donor as the measuring life.) However, if the donor retained a right of revocation and predeceased the annuitant, that power to revoke pulls the present value of the annuity at death back into the donor's gross estate.<sup>12</sup>

If the donor's spouse is the sole annuitant, the present value of the spouse's annuity is includable in the donor's estate but qualifies for the unlimited estate tax marital deduction.<sup>13</sup>

## Gift Annuity Planning Ideas

### Increase Tax-Free Income by Using Low Interest Rates

When we covered the basics, we discussed the choice of AFR (for the month of the gift or either of the two previous months) and the trade-off involved (a higher rate maximizes the deduction while a lower rate maximizes the tax-free portion of each annuity payment).

Let's look at a fictional example. In March, Barbara, a 75-year-old donor, transfers \$50,000 in cash to set up a charitable gift annuity paying 5.8%. Barbara must choose an AFR. As the rates decrease, note how the projected charitable deduction also decreases, but the tax-free amount of each payment goes up. If the AFR increased to 4%, the charitable deduction would jump to \$25,939, and the tax-free amount would drop to \$2,004.



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Applicable Federal Rate	2.2% (Jan)	2.0% (Feb)	1.8% (Mar)
Charitable deduction	\$22,738	\$22,338	\$21,929
Exclusion ratio	78.3%	79.5%	80.7%
Tax-free amount	\$2,271	\$2,306	\$2,340

With the low AFRs now prevailing, donors have a unique opportunity to lock in a high tax-free income for life. Short-term CD rates are hovering around 1-2% (and interest is taxable). The opportunity for a 75-year-old donor to get a 5.8% lifetime payout, more than two-thirds of which is tax-free, could be very appealing.

### Increase Benefits by Using a Deferred Gift Annuity

Payments under an immediate gift annuity arrangement must begin no later than one year after the gift is made. Donors who wish to delay the start date of their annuity payments longer than one year must purchase a deferred gift annuity, and there are a couple of important benefits to doing so:

- A larger charitable income tax deduction in the year of the contribution (subject to AGI limitations) means greater current tax savings in high-earning years.
- An increased annuity amount once payments begin can be used to supplement retirement income.

The donor usually sets a date for the deferred gift annuity to begin; however, the IRS has privately ruled that a deferred gift annuity that did not specify a fixed starting date for payments was valid.<sup>14</sup> In that ruling, the donor established the annuity at age 50, and could elect to have payments begin at any time after age 55 and before age 80. The gift annuity agreement specified a different payment amount (rising with the deferral of the start date) for each possible age at which payments might begin. The income tax charitable deduction allowed for the gift was based on the lowest possible deduction that would be available at the earliest annuity starting date (age 55 in this case). A deferred gift annuity with a variable start date is commonly called a “flexible deferred gift annuity.”

### Increase Gift and Annuity Payout through “Laddering”

If a donor is not able to give a large amount all at once, it’s possible to purchase a number of smaller deferred gift annuities over time. By using the same start date for all of them, donors can not only increase the amount of their gift, but they can increase the payout amount as well. This method (called “laddering”) also spreads out the deductions. A further benefit to laddering is that it provides a hedge against inflation. Since interest rates increase with age, the income stream is enhanced with each gift annuity purchased, assuming a static contribution amount. This is an especially good strategy when a donor is in good health and likely to outlive the actuarial age used to calculate the annuity rates.

### Provide Income to Survivors by Using a Testamentary Gift Annuity

It is possible to arrange a charitable gift annuity through a will or living trust to provide income to one or two surviving individuals. The donor can specify the creation of the gift annuity with either a certain amount or the residue of the estate, and with either immediate or delayed payments. For example, in another private letter ruling, the IRS approved a testamentary gift annuity where a decedent’s will



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left the residue of the estate to a qualified charity on the condition that the charity pay a 7% annuity to two surviving relatives. The IRS allowed an estate tax charitable deduction in the amount of the value of the residuary bequest to charity, reduced by the present value of the two-life annuity.<sup>15</sup>

Since charitable bequests that are unascertainable in amount can cause a loss of the estate tax charitable deduction,<sup>16</sup> a donor making a bequest of a gift annuity should clearly state both the bequest amount and the annuity payout in the terms of the will. The donor should also address three important possibilities by providing:

- A contingent annuitant in case the designated annuitant(s) predecease the testator (or, if this seems likely, an outright bequest to the charity might be a better choice)
- A contingent charity in case the named charity is no longer in existence at the donor's death, or is unable or unwilling to accept the gift
- Flexibility in the payout rate in case the charity needs that flexibility to ensure meeting the 10% minimum charitable interest requirement

### Consider the Benefits of Alternate Funding Options

Cash is only one of the many ways to fund a gift annuity. Let's look at a few of the more common alternate funding options.

#### Real Estate

Donors looking to contribute real estate often turn to charitable trusts because of their inherent flexibility. However, a gift annuity is a feasible option, especially when the property is readily marketable and of sufficient value to fund a lifetime annuity. If the property is subject to a mortgage, planning is more difficult and donors must recognize capital gain more rapidly than would be the case with other funding methods (e.g., donating appreciated securities).

The gift annuity payment can be any amount agreed to by the donor and the charity provided:

- The present value of the annuity is less than 90% of the value of the property (otherwise the gift annuity may result in unrelated business taxable income)<sup>17</sup>
- The interest rate established for the annuity payout cannot vary from the state's mandated schedule of rates, except to offer a lower rate with the consent of the donor

While it's legal in every state to fund a gift annuity with real estate, some charities may be reluctant to take this asset. The charity assumes the risk of committing to fixed payments without knowing that the property will sell for an amount that makes the annuity feasible. (If the sale price is lower than expected, the charity will be required to use other funds to pay the annuitant.) In addition, the charity must absorb all maintenance and sale costs.

#### Personal Property

It's possible to fund a gift annuity with valuable personal property such as jewelry, artwork or other collectibles. The deduction for such a donation depends on whether the charity uses the items in connection with its exempt purpose ("related use," such as an art museum interested in a valuable collection of paintings) or sells them and



invests the money (“unrelated use”).<sup>18</sup> If the item is unrelated and the charity sells the property, the donor’s charitable deduction is reduced by the capital gain allocated to the gift portion of the transfer. If the charity uses the property, there is no such reduction.

### ***Life Insurance***

Donors who outlive the original protection need for a life insurance policy can use the policy to fund a charitable gift annuity, whether the policy is paid-up or not. In fact, this is a common way for philanthropically minded people to make substantial gifts. If the donated policy is worth more than the donor’s cost basis, the charitable deduction is reduced by the amount of gain allocated to the gift value (the same way the reduction is calculated for a contribution of “unrelated use” tangible personal property).

## **Conclusion**

The inscription on John Trumbull’s tomb reads, “To his Country he gave his Sword and his Pencil,” memorializing both a soldier and an artist—a man who both served in the Revolutionary War and allowed others to glimpse it through his paintings. The gift annuity that Trumbull helped create has dual facets as well. It’s both a gift and a sale; a donation and an income; a benefit to charity and a benefit to the donor or another annuitant. And, as was the case with Trumbull, it is a giving tool that is not reserved for the wealthy, but is available to the many who might not otherwise have the means to leave such a lasting charitable legacy.

The gift annuity is widely used within the planned giving community and has survived nearly 200 years for good reason—it is simple, versatile, and accessible to the great majority of donors. Gift annuities have provided individuals with the funds necessary for daily life or to supplement retirement income while enabling generations to support causes larger than themselves.

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a resource for charitable gift planning professional advisors

## Endnotes

- 1 See [www.americanrevolution.org/trumbio.php](http://www.americanrevolution.org/trumbio.php)
- 2 See <http://giftplanninghistory.org/wp-content/uploads/2013/10/Part-1-Yale-gift-annuity-22-Sept-2013.pdf>. For more than 50 paintings, Trumbull was paid the annual sum of \$1,000 for life on the condition that Yale never sell a painting to fund the annuity. Trumbull was 76 when the gallery opened to the public in 1832, and he received his annuity until his death in 1843 at the age of 87.
- 3 See [www.acga-web.org/about-acga-top/faqs](http://www.acga-web.org/about-acga-top/faqs)
- 4 IRC §501(m)
- 5 These rules are found under IRC Secs. 501(m)(3)(E), 501(m)(5) and 514(c)(5).
- 6 Whether a charitable organization is “qualified” depends on which federal tax is applicable—income, gift, or estate. Each has its own list of qualifying types of organizations, which are similar but not identical. A list of qualifying organizations can be downloaded from the IRS website.
- 7 IRC §170(b)
- 8 Id.
- 9 Reg. §25.2523(b)-1(b)(6)(iii)
- 10 IRC §2523(f)(6)
- 11 Many gift annuities provide that the obligation to make payments ends with the payment immediately preceding the annuitant’s death. This avoids the issue of income in respect of a decedent (IRD) being included in the estate of the deceased annuitant.
- 12 IRC §2038
- 13 Reg. §2056(b)-1(g), Example (3)
- 14 Ltr. Rul. 9743054; reaffirmed, Ltr. Ruls. 200449033 and 200742010. A private ruling from the IRS does not constitute law, but indicates how the IRS is likely to view a particular transaction. In actuality, it is likely that many thousands of flexible gift annuities have been successfully put in place.
- 15 Ltr. Rul. 8506089
- 16 See *Est. of Marine v. Comm'r*, 97 T.C. 368 (1991), aff'd, 93-1 USTC (4th Cir.)
- 17 See IRC §§501(m) and 514(c)(5)
- 18 IRC §170(e)(2)(A)

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