Giving Through Charitable Gift Annuities

A charitable gift annuity is described generally as a transaction in which an individual transfers cash or property to a charitable organization in exchange for the charity's promise to make fixed annuity payments to one or two annuitants for life.

Charitable Gift Annuities

Contractual nature of the gift annuity agreement: The charitable gift annuity is a contract between the donor and the issuing charitable organization. It is not a trust arrangement. The organization promises to pay a certain annuity; the consideration for this promise is the donor's transfer of property to the organization. The promise to pay the annuity is a general obligation and, in this sense, is "backed" by all the unencumbered assets of the organization issuing the gift annuity.

The fact that a gift annuity is a contract and not a trust has several important tax consequences.

First, in establishing a gift annuity, the donor is not deemed to make a "partial interest," or "split interest," type of gift. The contribution the donor makes for tax purposes is simply the difference between the amount he or she transfers to the issuing organization and the present value of the annuity. This is a current gift (a gift of a "present interest" for federal gift tax purposes).

Second, because in establishing a gift annuity the donor does not contribute a partial interest, the gift annuity is not subject to the various restrictions that apply to charitable remainder trusts and other split-interest gifts under Internal Revenue Code sections 4941-4945 (which include a broad prohibition against self-dealing and other activities). This allows for considerable flexibility in designing gift annuity arrangements.

Third, because the gift annuity donor is deemed to make a current charitable gift rather than a gift of a future interest, it is possible for the donor to obtain an income tax charitable deduction for "funding" the annuity with tangible personal property subject to the "related use" rule. To put this in perspective, IRC section 170(f)(3) disallows (with certain exceptions) any income tax charitable deduction for contributing a future interest in tangible personal property—such as occurs when an individual transfers tangible personal property to a charitable remainder trust.

Often, for these three reasons, the gift annuity is the gift plan of choice when, because of the particular situation, a charitable remainder trust (or pooled income fund) is not desirable.

General Tax Information

Charitable gifts of cash and "cash equivalents" may generally be deducted in one year up to 60% (limit may be waived for 2021) of a donor's adjusted gross income. The limit is 30% of adjusted gross income for gifts of long-term appreciated property, unless a special election is made and the value of the donated property is reduced by the amount of the appreciation element. In that case, the donation will be subject to a higher AGI limit. See IRC section 170(b)(1)(C).

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

Other Tax Considerations

How the donor's charitable deduction is determined: When an individual creates a gift annuity, he or she is deemed to make a charitable gift equal in amount to the difference between the amount transferred in exchange for the annuity and the present value of the annuity.1

The present value is determined using the same IRS tables as are generally used to calculate the present value of any other type of annuity. This is typically done through the use of any number of commercially available software programs.

These tables are based on a monthly changing interest, or discount, rate equal to 120% of the adjusted federal midterm rate (AFMR), based on annual compounding. See IRC section 7520. The higher this rate, the higher the donor's charitable deduction, but the lower the tax-free portion of the donor's annuity payments (discussed below).

Ordinarily, the donor uses the rate in effect for the month the annuity is established. Under IRC section 7520(a), however, the donor may elect to use the rate in effect for either of the two preceding months.

In order to make the election, the donor must attach to his or her federal income tax return for the year in which the annuity is established a statement that the donor is making an election under IRC section 7520(a). It must also include:

1. The date of the gift.
2. The month for which the discount rate would be used if the election were not being taken.
3. The month and discount rate elected by the donor.

Tax-free portion of annuity payments: A certain portion of gift annuity payments is tax-free because it represents, in part, a return of the donor's "investment in the contract" (as that term is used in IRC section 72). The investment in the contract is equal to the initial present value of the annuity. The donor (assuming the donor is the annuitant) recovers his or her investment in the contract ratably over his or her "life expectancy"2 under Income Tax Regulation section 1.72-9. If someone other than the donor is the annuitant, the investment in the contract is recovered ratably over that person's life expectancy.

Currently, the tax-free portion of annuity payments is typically between 50% and 90% of the payment if the gift annuity is funded with cash.

Once the annuitant reaches his or her life expectancy, the annuity payments become fully taxable.

Final year tax deduction when donor dies before life expectancy: For gift annuities entered into after 1986, if the annuitant dies before recovering tax free the full investment in the contract, a tax deduction is allowed on the annuitant's final income tax return equal in amount to the unrecovered portion of the investment in the contract.

It is worth noting that this is not a charitable deduction, but rather a deduction allowed by IRC section 72 (which deals with annuities in general).

Capital gains tax consequences of "funding" the annuity with appreciated property: When appreciated property is used to establish a gift annuity, the donor realizes a gain under the bargain sale rules of Reg. section 1.1011-2.

If certain conditions set forth in this regulation are met, the donor can spread the realized gain ratably over his or her life expectancy rather than having to report the gain in lump sum right away. This can be especially advantageous when capital gain income is taxed at lower rates than the tax imposed on ordinary income, often at a 0% rate.

These conditions are that (l) the annuity be payable either to the donor alone or to the donor and a designated survivor annuitant and (2) the annuity be non-assignable. (Note: Gift annuity agreements routinely provide that the annuity is non-assignable.)

The amount of gain (G) realized by the donor is determined according to this equation:

G = (FMV - B) x (PVA/FMV), where

"FMV" is the fair market value of the asset used to establish the annuity.
"B" is the basis of the asset in the donor's hands.
"PVA" is the initial present value of the annuity.

Example: Donor transfers $10,000 worth of stock in which she has a $6,000 cost basis to a charitable organization in exchange for a gift annuity having an initial present value of $4,000.

Donor realizes a gain equal to ($10,000 - $6,000) x ($4,000/$10,000), or $1,600. If the donor's life expectancy when the annuity is established is 20 years (according to IRS tables), and if the annuity is payable only to the donor or to the donor and a survivor annuitant, this gain may be reported ratably by the donor over 20 years at the rate of $1,600/20, or $80, per year.

If the donor is the only annuitant and dies before reporting all the gain realized, the unreported gain as of death is "forgiven" in the sense that no one (neither the donor's estate nor the charity) is required to report it.

If there is a survivor annuitant, however, the survivor continues to report the gain over the period represented by the donor's life expectancy.

In some situations, usually involving older donors/annuitants, the capital gain otherwise reportable each year exceeds the tax-free part of the annuity payment. Example (8) under Reg. section 1.1011-2(c) appears to provide that in this situation, the gain reportable each year is limited in amount to the tax-free portion of the annual annuity payment.

A tax trap to be avoided: We have noted previously the fact that a charitable gift annuity is not a trust arrangement but is instead basically a two-party contract.

If not handled properly, however, a transaction intended to create a gift annuity can take on the attributes of, and be characterized as, a trust for federal tax purposes. If this occurs, various tax problems can arise (including the loss of the donor's income tax charitable deduction) unless the deemed trust meets all the requirements of a qualified charitable remainder trust, which it usually will not.

This tax trap arises if the annuity payments are: (1) payable only out of assets that are segregated in some way from the issuing organization's other assets or (2) based on the income earned by specific assets.

Example 1: Donor transfers assets to a charitable organization pursuant to an agreement which provides that the donor is to receive a life annuity of $720 a year payable just out of the assets he or she transfers to the charity. This arrangement has the substance of a trust because the obligation to pay the annuity is limited to specific assets. Unless the agreement in question meets all the requirements of a charitable remainder annuity trust, the donor will not be entitled to any income tax charitable deduction for his or her gift, and various other adverse tax consequences may result for both the donor and the donee organization.

Example 2: Donor transfers assets to a charitable organization pursuant to an agreement whereby the donor is to receive lifetime payments based on the earnings of the charity's endowment. This arrangement also has the substance of a trust because the obligation to pay the annuity is not a general obligation of the organization, backed by its entire assets, but rather is dependent on the earnings of specific assets.

Deferred Payment Gift Annuities

Some organizations offer another option known as the deferred payment gift annuity. A deferred payment gift annuity is an annuity under which payments commence more than one year after the annuity is established.

There are several basic differences between a deferred payment gift annuity and an immediate payment gift annuity from a tax standpoint.

Donor's tax deduction: The donor's charitable deduction is significantly larger in the case of a deferred gift annuity than in the case of a corresponding immediate payment gift annuity. This is because the present value of the annuity is smaller in the case of a deferred gift annuity, which means, among other things, that if the annuity is established with appreciated property, the gain realized by the donor will be relatively small.

Reporting of gain: It appears from Reg. 1.1011-2(c), Example (8), that if an individual uses appreciated property to establish a deferred gift annuity for himself or herself (or for a survivor annuitant also), that individual may defer reporting the gain realized under the bargain sale rules until the annuity payments commence.

Tax-free return of investment: As discussed above in connection with immediate payment gift annuities, the tax-free portion of each annuity payment is determined by dividing the present value of the annuity by donor's "life expectancy" (assuming the donor is the annuitant). In the case of a deferred payment gift annuity, this determination is essentially made as of the time the annuity payments commence, using the life expectancy factors then in effect. It is not possible, therefore, to know exactly how much of each annuity payment will be excluded from taxation in the case of a deferred gift annuity until that time.

Deferring payment: IRS Private Letter Ruling 9743054 allowed the individual's deferred gift annuity contract to contain an option to defer receiving payments until a later date and receive higher payments at that time.

Estate and Gift Taxes

In establishing a charitable gift annuity, an individual may face several estate and gift tax considerations.

The gift to the issuing organization qualifies for the annual gift exclusion. To the extent that it exceeds this exclusion, it qualifies for the gift tax charitable deduction.

If the donor names an annuitant other than himself or herself, the donor is deemed to make a gift to that person equal in amount to the initial present value of that person’s annuity.

In the case of a joint and survivor annuity, to the extent the other person’s annuity does not qualify for the annual gift exclusion, it does qualify for the gift tax marital deduction under IRC section 2523 if the other person is the donor’s spouse.

If an individual establishes a gift annuity that is to make payments first to himself or herself and then to another person for life, the donor may reserve the power, exercisable only by will, to revoke the other person’s annuity and, in this way, prevent there being a completed gift to the other person for federal gift tax purposes.

If the donor subsequently predeceases the other person, the then-present value of the other person’s annuity will be included in the donor’s gross estate under IRC section 2038 (as it would under IRC section 2039 if the donor did not retain the power to revoke). The survivorship annuity, however, will qualify for the estate tax marital deduction if the survivor annuitant is the donor’s spouse.

Other tax considerations: Two other tax considerations affecting gift annuities arise under IRC section 514(c)(5).

If a gift annuity agreement (1) provides for a minimum or a maximum number of payments or (2) provides for payments to more than two persons, the obligation to pay the annuity is “acquisition indebtedness,” meaning that the annuity is treated as “commercial insurance” under IRC section 501(m). The result is that the issuing organization has to account for the annuity for tax purposes under the rules governing life insurance companies—a highly undesirable situation.

For this reason, it is generally inadvisable to establish a gift annuity for more than two lives or one that provides a “cap” or a “floor” in terms of the annuity payments. If an individual wishes to “cap” the annuity payments, he or she can always relinquish the right to receive the payments, in which case a charitable deduction may possibly be claimed subject to certain limitations.

Footnotes

1. Some charitable organizations “reinsure” gift annuities by purchasing a commercial annuity to cover their payment obligation. If the gift annuity agreement specifies that the annuity will be reinsured in this manner and names the reinsurance company, the donor’s charitable deduction is figured by subtracting the amount paid by the charity for the commercial annuity from the amount transferred by the donor in exchange for the gift annuity.
2. Technically, the term “life expectancy” is inapplicable to individual persons and has meaning only when applied to a group of persons of the same age. For the sake of convenience, however, it is common to use the term with respect to individual persons, inasmuch as IRS life expectancy factors are brought to bear in various individual situations.

For further reading, see also from the Planned Giving Design Center:

Technical Reports:

- Charitable Gift Annuities

Articles:

- Twelve Uncommon Things You Can Do with a Gift Annuity
- Gifts for All Seasons

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