

Charitable Gift Annuity

The concept of the charitable gift annuity in America dates back to the 1870s, when a parishioner first donated a valuable asset to a church in exchange for a flow of income. Today, the concept includes valuable tax benefits for donors.

Gift Annuities Defined

A gift annuity is a simple, contractual agreement between one or two donors and the charity or charities in which you transfer assets to in exchange for their promise to pay you an annual premium.

By donating through a gift annuity, you can accomplish two things: (1) contract for a fixed payment for yourself or yourself and another individual, if you choose, and (2) make a gift to a charity or charities you specified. If you itemize deductions on your tax return, savings from the charitable deduction reduce the net cost of the gift.

For a period of years, based on a government table of life expectancies, a portion of each payment received is considered a nontaxable return of your investment in the gift. This further increases your after-tax dollars available for spending or investing.

In addition to the annuity payment you receive, an annuity funded with appreciated property results in these advantages: (1) the gain allocated to the gift portion completely avoids the capital gains tax, and (2) the portion of gain to be recognized can be spread over the expected term of the contract (provided that the donor is a primary annuitant and the annuity interest is assignable only to the charitable organization).

A special type of annuity is the deferred payment gift annuity. With this type, the start of payments is delayed until a specific date, initially determined by the donor. Deferral of payments increases the initial income tax charitable deduction, tax savings and the annuity rate. However, it also reduces the nontaxable amounts to be received.

This option is appealing to younger donors who wish to improve future income, such as at retirement.

Understanding Annuity Rates

Annuity rates are higher for older annuitants and lower for younger annuitants, based on life expectancy. As a result, gift annuity contracts are generally more appealing to older donors because the purchasing power of a fixed dollar return can shrink over any long period, even with modest inflation.

Rates are also adjusted according to the number of annuitants, with rates for two-life contracts often lower due to the extended life expectancy. The age of a recipient is the age reached at the nearest birthday, and rates are the same for men and women.

A specific annuity rate is a matter of agreement between the donor and the issuing charitable organization. Below you'll see how one-life annuity rates increase with age. These rates are recommended by the American Council on Gift Annuities and are redetermined annually. Check with your financial advisor for current rates.

One Life

<u>Your Age</u>	<u>Rate of Return</u>
50	5.3%
55	5.5%
60	5.7%
65	6.0%
70	6.5%
75	7.1%
80	8.0%
85	9.5%
90	11.3%

*Please be advised that not all organizations offer CGAs at the above ages and rates. Contact your financial advisor for specific information.

A Case Study of Benefits

Linda, age 75, plans to donate a maturing \$25,000 Certificate of Deposit. Since she needs continuing income, Linda decides to use the cash for a one-life charitable gift annuity that we will issue at the suggested rate of 7.1 percent. Payments will be made quarterly. At the time of purchase, the charitable midterm federal rate (a figure used in calculating the charitable deduction) is 4.6 percent.

Although Linda's annuity rate is 7.1 percent, her actual earnings will be higher for several reasons.

First, because Linda itemizes income tax deductions, she earns a federal income tax charitable deduction of \$10,742. With a marginal income tax rate of 28 percent, the tax savings of \$3,008 will reduce the net cost of the gift to \$21,992. Her annual payments of \$1,775 will mean an effective rate of total return of 8.1 percent, which is Linda's annual payment expressed as a percentage of the net cost.

The second advantage she will enjoy is that for the next 12.4 years, more than half of every dollar received will be considered a return of her investment in the contract and will not be subject to tax. Her after-tax, spendable dollars received over this significant length of time are calculated as follows:

- Ordinary taxable income portion \$625
- Less 28 percent marginal income tax rate (\$175)
- After-tax income from taxable portion \$450
- Nontaxable portion of cash received \$1,150
- After-tax dollars annually, to spend or invest from annuity, for 12.4 years \$1,600

For the sake of comparison, we've determined what all-taxable return would produce the same after-tax amount over the period the investment in the contract is being recovered. A marginal income tax rate of 28 percent means that Linda keeps 72 percent of each added dollar of taxable income. Her equivalent all-taxable dollar return is calculated as follows:

- \$1,600 = \$2,222 equivalent all-taxable dollar amount
- These dollars represent an equivalent taxable rate of return on net cost of 10.6 percent for the first 12.4 years.
- Keep in mind that these figures are not directly comparable to results of noncharitable reinvestments; since your primary objective is to make a gift to a charitable organization of your choosing, you will receive the added benefit of the annuity.

Other Possible Uses

One of your financial and estate planning objectives may be the supplemental support of a person other than younger, direct heirs--possibly an older sibling, a dependent parent, a friend or a former employee.

If your desire to help does not extend to heirs of the recipient, who could be the major beneficiaries of a lump-sum gift, a one-life charitable gift annuity agreement can be set up so that someone other than the donor receives the annuity payments. The age of the person receiving the annuity payments, rather than the age of the donor, determines the annuity rate and other results.

The present value of the charitable gift portion is an income tax deduction for the donor(s). The actuarial value of the income interest is a taxable gift to the individual. As a present interest, however, it qualifies for the annual gift tax exclusion of \$11,000 (\$22,000 if a husband and wife join in making the gift).

Other potential advantages include the reduction of the donor's taxable estate by the amount used for the annuity contract. If the recipient outlives the donor, the income is continued, and there is no need to establish a trust and pay for its management.

Somewhat younger donors find that deferred charitable gift annuity contracts combine philanthropy with improved retirement income. Many tax law changes have limited the amount of pretax earned income that can be sheltered from tax and invested for later financial security. For some, Individual Retirement Accounts are no longer deductible. Others with qualified salary reduction plans may find that their annual contributions are limited by nondiscrimination rules. A retirement income plan can be enhanced through a series of deferred charitable gift annuity contracts, using excess discretionary income to fund the annuity each year leading to retirement

(when the payments are scheduled to begin). Advantages to this type of arrangement include the following:

- Partial tax deduction for each amount transferred.
- Continuation of the process beyond the age of 70 1/2 when qualified plans must start payments.
- Use of any source of funds, not just earned income as required by qualified pension plans.
- No limitation on the amount used.

Areas Worth Reviewing

When considering a life income gift arrangement, consult your financial and estate planning advisors.

Professional advisors will probably want to review these key areas: the balance between fixed payments and variable payments with growth potential; the option of using capital gain property; and the unified estate and gift tax implications of plans being considered.

Fixed versus variable payments. In general, older donors are more likely to favor fixed-payment giving methods such as a charitable gift annuity. They may have less tolerance for risk and fewer years of future inflation about which to worry. With longer life expectancies, however, all donors of life income gifts should consider maintaining diversity within their investments to offset the effect of inflation.

Use of long-term capital gain property. When marketable appreciated property such as common stock is exchanged for a gift annuity, the capital gains tax implications should be considered.

As noted earlier, the portion of gain to be recognized can be spread over the expected term of the contract. The tax savings generated by the lower tax rates, however, are offset to some degree because the recognition of gain can eliminate some or possibly all of the nontaxable return of the donor's investment in the contract.

Federal estate and gift tax implications. Since transfers between spouses are tax free through the unlimited marital deduction, naming a spouse as the only, joint or successor annuitant under a gift annuity contract is not subject to the unified federal estate and gift tax.

If a nonspouse is named as the initial annuitant or the successor annuitant, the actuarial value of the entire annuity interest may be subject to gift tax unless the donor retains the right to revoke the annuitant's income interest during life or by will.

A testamentary provision (a provision spelled out by will) for purchase of a charitable gift annuity for a surviving non-spouse produces a partial charitable estate tax deduction and a partial taxable amount if the estate is taxable.

When considering this type of arrangement for a gift annuity contract, you should consult with your financial advisor to realize the full benefits and avoid any tax surprises.

For More Information

Charitable gift annuities are an excellent method of achieving your philanthropic goals and gaining substantial tax benefits. As with most contract agreements, however, before establishing a charitable gift annuity, it is best to consult knowledgeable professionals.

The information contained herein is not intended as legal, tax or investment advice. For such advice, please consult an attorney, tax professional or investment professional.