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The (Baltimore) Raven Says Nevermore: Creative Advanced Gift Annuity Planning

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This session will cover the differences between CGAs and CRATs as well as why many large gift annuities are created rather than choosing CRATs. We will also explore how real estate and S-corps can be used to fund CGAs in a risk mitigated way and how laddered deferred CGAs can be used as a "switch" for income or future major gifts. Attendees will nevermore look at simple gift annuities in the same way again.

Charitable Gift Annuities vs. Charitable Remainder Annuity Trusts: Similarities and Differences

Charitable gift annuities (CGAs) and charitable remainder annuity trusts (CRATs) are two popular charitable giving tools. Although they have some similarities, there are a significant number of differences that merit examination. These differences range from legal form to deduction and income calculations to charitable beneficiary.

Similarities Between CGAs and CRATs: The planned giving vehicles have many similarities. More specific commonalities include particular aspects of tax treatment, payout, annuity structure, control of assets, and additional contributions. Below, these are discussed in more depth:

- *Tax:* Both CGAs and CRATs are prime vehicles for deferring or avoiding capital gains on appreciated assets (including the net investment income tax). In both cases, however, the income paid out to the beneficiary will be taxed in two portions – the payments will have an ordinary income element and a capital gains element. These elements of course depend on the appreciation along with the number of expected payments (which in turn derives from the age of the income beneficiaries).
- *Payout:* In each case, the payout is a fixed amount.
- *Structure:* Payments must be made at least annually, and can be set up for monthly or quarterly payments.
- *Beneficiaries:* Typically, the donor and spouse, but can be anyone the donor cares to name. Both vehicles commonly allow for one or two life annuity payment streams.
- *Control of assets:* In both cases, the donor relinquishes control of the asset. More importantly, the new administrator – whether trustee or the charity's manager – determines how the donation (or its proceeds) are invested.
- *Additional contributions:* Neither a CGA nor a CRAT may accept additional contributions from the donor.
- *Statutory value thresholds:* In both cases, there are statutory thresholds put in place to assure that the gift amount remaining is more than *de minimis*. For CGAs, the annuity value must not exceed 90% of the donated property's value. For CRATs, there are two requirements. The charitable remainder must be at least 10% of the donated property's value. The CRAT must also have less than a 5% chance of exhaustion.
- *Interest Rates:* Both the CGA and CRAT are negatively affected by low interest rates.[1] The statutory thresholds for value are more difficult to meet when rates are low. A low rate environment means low expected growth, so it is difficult in both cases for the planned giving vehicles to meet their payment obligations and satisfy the regulatory requirements.
- *Vulnerability to Inflation:* Since both vehicles have fixed dollar amount obligations, they will not keep pace with inflation. As a result, their relative value will decrease over a period of years.

Differences Between CGAs and CRATs: The differences are at least as meaningful as similarities for CGAs and CRATs. These run the gamut from practical planning concerns to investment control to charitable beneficiaries. Below, those differences are listed and explained in more depth:

- *Minimum contribution:* A CGA typically has a much lower minimum gift amount which the donee charity will accept, which can be as low as several thousand dollars. However, a CRAT typically requires a contribution of at least $250,000 to be cost effective, given the usual expenses associated with investment and administration of the trust assets.

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[1] Katzenstein, L.P. (2012), "Some Interest-Sensitive Estate Planning Techniques (with an Emphasis on GRATs and QPRTs) and a Look at the Proposed Legislation)," American Bar Association 56-58, http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/step/2012/materials/rpte_step_2012_07_13_Katzenstein_Interest_outline.authcheckdam.pdf.

- *Set Up Process:* CGAs are much simpler to set up than a CRAT. Charities typically have template forms readily available. A CRAT, however, is often customized with heavy input from the donor's professional advisors, a process which can take weeks.
- *Asset Investment Control:* In both cases, the donor relinquishes control. However, a CRAT can be set up so that the donor is the trustee, meaning that the donor would still control how the assets are invested (which would often reduce costs as well). Even if the donor is not the trustee, the donor can usually appoint a trustee of her choosing. Assets donated in exchange for CGA, are however, wholly controlled by the donee charity.
- *Remainder Beneficiaries:* By contract, any remaining assets (or proceeds thereof) from a donation to a CGA will go to the charity issuing the annuity. However, a CRAT again offers more flexibility – the remainder can be a specific charitable beneficiary, or a donor-advised fund.
- *Deferral Option:* The CRAT payment period must begin immediately. CGA payments can be structured so that they are deferred for some period of time, often an appealing option for younger donors. This effectively shortens the payment period. That increases the tax deduction on donation, while also increasing the amount of each payment once the deferral period ends (remember that the deferral is established in the initial contract including flexible deferreds).
- *Risk to Charity:* A charity often has much more risk exposure in the case of a CGA than a CRAT. Since the CGA contractually binds the charity to make annuity payments, it is obligated to pay the donee no matter what. This is particularly troublesome when the underlying asset is illiquid and does not produce income. Real estate is a good example of a risky asset for a CGA.

Funding Gift Annuities with Real Estate

This section discusses the risks of holding donated real estate, and standard mitigation techniques which nonprofits might utilize. It also suggests some lesser-known techniques that may work well, including option agreements and a unique CGA contract.

Real Estate Risks: Real estate has a reputation for being a sometimes-difficult gift to accept, considering environmental liability, property management, and an array of other potential headaches. In the planned giving context of CGAs and CRTs, this usually comes in the related forms of liquidity and marketability, as well as UBTI in some circumstances. Each is discussed in turn below.

Liquidity is important in the CGA and CRT context, because of the payment obligations the donee charity assumes (or that the trustee assumes on the charity's behalf). The charity or trustee must make payments to the annuitants or income beneficiaries. For example, imagine some very illiquid real estate – say, an undeveloped rural tract. How will the nonprofit make payments to the donors? If the tract is not generating any regular income without tenants, and until sale, there is no cash on hand. This is clearly an issue the nonprofit will need to address.

Marketability is a related concern. Some real estate is very attractive to potential buyers and will spend little time on the market. However, more time spent on the market means more time without cash proceeds from the property. As described above, this means a potential liquidity crunch, given planned giving vehicle payment obligations.

UBTI is a problem in some circumstances, due to some unique tax rules for real estate. If the real estate represents an unrelated business or has debt-financed income, then there will be UBTI. For CRTs holding real estate, this leads to a 100 percent excise tax.

Traditional and Nontraditional Real Estate Risk Mitigation: How do charities mitigate these risks when the real estate is not going to sell quickly (or if was supposed to but didn't)? Traditionally, they use one – or more – of the following strategies. First, for CGAs, they can defer the annuity payment start date. Next, again for CGAs, they can use a discounted annuity rate, based on the suggested American Council on Gift Annuities ("ACGA") rates. For CRTs, nonprofits can consider using a so-called "flip" unitrust, or FLIP-CRUT.

A deferred CGA is common, even when there is no real estate risk. The deferral allows the charity time to liquidate the property, and the donor gets a higher deduction than she otherwise would.

Another common option is for the charity to simply discount the annuity rate. Rather than defer or otherwise rearrange the CGA contract, they simply pay less. Donors may not prefer this, but the tradeoff is that they receive an increased deduction, as with the deferred CGA. The charity simply hedges on the risk of an extended sale process, or receiving settlement proceeds less than the appraised fair market value, by paying the annuitant less.

A better mitigation alternative exists for Charitable Remainder Unitrusts (CRUTs) holding real estate. A FLIP-CRUT is well-tailored to gifts of real estate, since it only begins paying a percentage of trust assets to the income beneficiary after a specified trigger event occurs. Prior to that event, the CRUT simply pays the lesser of a stated fixed percentage or net income. For real estate not producing income, this is a natural fit. The FLIP-CRUT is simply set up so that the real estate's sale is the trigger event, and the charity pays the net income (of zero dollars) to the income beneficiary until it occurs. But this requires a donor to accept a fluctuating payout.

Special Techniques: One innovative approach is to fund special deferred CGAs with real estate or other illiquid assets. The way this works is by adjusting the payments after the donee charity liquidates the donated real estate, based on the difference between any expected and actual principal. The deferred CGA can be single or joint life.

An example of this special CGA arrangement may be useful. A donor with real estate appraised at $500,000 gives the property to a charity in exchange for a CGA. The annuity pays 5% per year, with a one-year deferral period. The charity has two years after the deferral period to sell the property. If the deferral period has ended and payments are now due, but there has not been a sale, the 5% payment is based on the $500,000 appraised value. One year passes by, and the real estate sells for $450,000 in net proceeds. Going forward, the 5% annuity will use that amount as principal. Since that amount is the true principal, the payor (meaning the donee charity) will recapture the "extra" payment amounts above what was payable on the actual amount of net proceeds. Of course, if the net sales proceeds are above the appraised price, the reverse will be true.

This arrangement has significant advantages for illiquid and difficult-to-market real estate, even when compared to standard deferred CGAs. First, it provides additional time for the donee charity to sell the property. Second, if the property is (or must be) sold for less than the appraised value, it allows recapture through reduced annuity payments. It also makes the CGA more appealing to potential donors, since there need not be a discount on standard rates due to the mitigated liquidity concerns. Of course, the caveat for the nonprofit issuing the CGA is that it must have the cash on hand to pay once the deferral period ends, even if it is still holding the property.

Another iteration is where the owner/donor gives the charity an option to purchase. In a planned giving context, this would be in exchange for a CGA, which could be deferred until exercise. The charity could sell the option contract to a third-party buyer, who would pay the difference between the real estate's fair market value and the exercise price. The charity would need to ensure that the option contract price was sufficient to make the projected annuity payments.

Funding Gift Annuities with S Corporation Stock

S corporations present somewhat different issues as charitable gifts. Nonetheless, there are still some appealing options for planned giving, particularly considering their nature as closely-held businesses, usually having only one or two owners. This section outlines the risks, standard charitable mitigation tactics, and special techniques which merit consideration.

S corporations are closely-held businesses with special regulations, and therefore have some risks. UBTI is a major concern for charities accepting these interests, particularly in a planned giving context. Marketability may also be an issue.

Charities must report their share of K1 income as UBTI for every day they own the interest, including passive investment income whether distributed or not. Charities usually try to liquidate their interests as soon as possible. Additionally, sale of appreciated S corporation stock will create UBTI on all capital gain above the donor's adjusted tax basis, and is taxed at ordinary corporate or trust rates.

Current laws do not allow CRTs to hold S corporation stock. Further, "[e]ven if a charitable remainder trust could be an eligible shareholder, the UBIT from the S corporation could revoke the tax-exempt status of the trust."[2] CRTs can receive donated S corporation assets, however.

A serious practical concern with S corporation interests is marketability. The simple fact is that S corporations are always closely held, typically with not more than a few owners (they are legally limited to 100 shareholders). This means that the pool of potential buyers is often limited to an entity acquiring the entire business, the few other owners, or the S corporation itself (a redemption). Without a buyer, the charity will be holding an interest which literally may generates UBTI on a daily basis.

Traditional S Corporation Risk Mitigation: Rules barring ownership of S corporation stock only apply to charitable *remainder* trusts – a donor-advised fund ("DAF") sponsor, or other public charity, organized as a trust, may mitigate UBIT from holding S corporation stock. This means that the S corporation income is taxed at trust rates rather than corporate rates, which is particularly appealing for long-term capital gains, where the rate is currently only 20 percent. Indeed, if the DAF trust donates the proceeds from sale of the S corporation, the IRS allows a full deduction, up to 50 percent of adjusted gross income. Effectively, this means that the net federal long term capital gains rate would be only 10 percent. The trust would also be exempt for the Net Investment Income Tax as well as potentially no state income tax for a share sale.

For example, see the table below, showing the result where a top bracket California taxpayer donates an S corporation interest worth $1 million and zero basis.

	Dollars ($)
Value of donated S corp stock	1,000,000
Federal tax savings in 39.6% bracket	396,000
State tax savings in 13.3% bracket	133,000
Total federal and state tax savings	**529,000**
Taxable gain for trust form DAF	1,000,000
Charitable deduction for trust form DAF	500,000
Tax paid at 20% trust rate	100,000
Total amount for charitable giving	**900,000**

Special Techniques: Older donors may fund a CGA with S-corp stock, and then receive an annuity for 90% of the net proceeds (10% reduction for UBTI). Younger donors may donate S-corp stock for a CGA with a lengthy deferral period. This route provides significant flexibility. Not only can it provide an income stream in the future (typically well over a decade ahead), the deferred interest is itself an asset. Simply put, the donors can receive charitable deductions before the deferral period ends.

To illustrate this, begin with two married donors, making a million-dollar S corporation gift at age 45. Not needing income for many years, they settle on a 20-year deferral period. As outlined in the table above, the charity will still be subject to tax on gain from the S corporation interest – ideally at the 10% rate allowed by the combination of trust form and charitable deduction.

	Dollars ($)
Value of donated S corp stock	1,000,000
Available charitable deduction for trust form DAF	500,000
Tax paid at 20% trust rate	100,000
Total amount for CGA	900,000
Deferral period	20 years
Annuity value	711,704
Annual payment	71,100

[2] Hoyt, Christopher, "Charitable Gifts of Subchapter S Stock: How to Solve the Practical Legal Problems," Planned Giving Design Center, http://www.pgdc.com/pgdc/charitable-gifts-subchapter-s-stock-how-solve-practical-legal-problems.

Present value of remainder interest / deduction amount[3]	188,296

On making the gift, the donors receive a significant deduction, but further still, have a $711,704 annuity for potential future gifts and charitable deductions. This bonus deduction allows the donors to relinquish or otherwise assign some portion of their annuity interest to the donee charity. They would generally receive a deduction for the then-present value of the portion relinquished back to the charity (some experts suggest that this is limited to the unrecovered cost in the contract). No additional deduction is allowed for the remainder interest, since the donors already took a deduction for that amount.

As an example, imagine the same married donors decide to make a donation by relinquishing all of their annuity back to the donee charity. They do this halfway through the deferral period.

	Dollars ($)
Value of donated annuity interest	711,704
Value of annuity with 10 years of deferral remaining	526,022
Taxable ordinary income portion of annuity	19,442
Taxable portion of the gift (present value of 24.9 expected annuity payments)	362,338
Present value of donated interest / deduction amount (limited to unrecovered basis)	349,366
Remaining value of annuity	0
Total deductions for initial gift and 10-year gift	537,662

This allows a large deduction several years down the line, but, of course, comes at the cost of eliminating the annuity entirely. Imagine now that the same donors gave only half of their interest in the CGA at the 10-year mark of the deferral, rather than the entire interest.

	Dollars ($)
Value of donated annuity interest	355,852
Value of annuity with 10 years of deferral remaining	263,011
Taxable ordinary income portion of annuity	9,721
Taxable portion of the gift (present value of 24.9 expected annuity payments)	181,169
Present value of donated interest / deduction amount (limited to unrecovered cost)	174,683
Remaining value of annuity	355,852
New annuity amount payable	20,284
Total deductions for initial gift and 10-year gift	362,979

This deferred interest acts as a sort of charitable spigot, which can be used as the donors see fit. Of course, if they need the income, they can hold onto as much of the interest as they wish. Note however, that this typically requires a high-value CGA for the deduction to be worth the effort. Within this planning, an additional layer of laddered-CGAs may work as well.

The “recapture” deferred CGA described in the real estate section above works in the S corporation gift context as well. Since S corps often have marketability concerns, the deferral and sale periods can provide a significant buffer for nonprofits attempting to sell their donated interest. However, that same time period is one where UBTI will accumulate over time. To counteract that, the CGA contract could also include UBTI in the recapture language, so that the charity recovers any tax paid.

Conclusion

[3] Present value calculated using the January 2017 7520 rate of 2.4%.

The simple gift annuity structure may provide a perfect solution to complex charitable planning situations. For large gift annuities, it can provide many donor advantages over a CRAT. CGAs may also be uniquely designed to produce large deductions now or in the future, as well as receive more complex assets like real estate or S-corp stock in situations where a CRAT may or should not be presented. Hopefully these CGA advanced planning perspectives will allow gift planners more opportunities to capture more donations, and in many cases, with less risk.