

## [¶712]

**EXEMPT ORGANIZATIONS AND CHARITABLE GIFT ANNUITIES**

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Among the arrows in the quiver of the charitable gift planner is the charitable gift annuity. The nature, advantages, and disadvantages of this giving technique are discussed below under the following topics:

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**Charitable Gift Annuities**

**[¶712.1]** A charitable gift annuity is a gift to charity, not in trust, in exchange for a lifetime annuity. The value of the gift is worth considerably more than the present value of the annuity and so contains a significant charitable component. The charitable component is allowable as an income or estate tax deduction as long as the annuity is one described in IRC §514(c)(5).<sup>1</sup> That component is 50% under the recommended rates of the American Council on Gift Annuities ("the Council").<sup>2</sup>

A charitable gift annuity essentially is a bargain sale with an installment payment in the form of an annuity. It is an unsecured claim against the charity's assets, a characteristic that distinguishes it from a charitable remainder trust (CRT), in which payouts are made from a specific trust corpus.

**Survey.** The Council made an extensive survey of charitable gift annuities in 1994.<sup>3</sup> According to that survey, the percentage of gift annuities issued by various organizations are as follows:

Religious organizations	25.4%
Private colleges/universities	24.8%
Hospitals/health care groups	19.2%
Public colleges/universities	7.4%
Social service organizations	6.8%
Arts organizations	1.5%
Other	14.8%

<sup>1</sup> IRC §501(m)(5). Under IRC §514(c)(5), the annuity must be:

- The sole consideration issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90% of the value of the property received in the exchange.
- Payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time.
- Payable under a contract that (1) does not guarantee a minimum amount of payments or specify a maximum amount of payments, and (2) does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

<sup>2</sup> American Council on Gift Annuities, *Charitable Gift Annuity Rates* (March 1, 1997).

<sup>3</sup> Minton, *Report and Comments on the American Council on Gift Annuities 1994 Survey 2* (1994).

△ Charitable Giving See Cross Reference Table

Organizations issuing gift annuities issued an average of 16.7 of them each year. The average amount per contract was \$18,950. The average total dollar volume of gift annuities was \$480,185, though the median was \$167,914. Immediate-payment gift annuities made up 94.2% of the total, while deferred-payment annuities were only 5.8% of the gift annuities issued. Only 31.6% of the gift annuities issued were joint and survivor annuities; the remaining 68.4% were one-life annuities.

The minimum gift annuity written was typically \$5,000. The minimum age permitted averaged about 55 for immediate-payment annuities and about 45 for deferred-payment annuities. However, the average ages were 77 for immediate-payment annuities and 57.4 for deferred-payment annuities.

The entire contribution was kept in reserve until the donor's death by 87.4% of charities in explicitly regulated states, while only the required reserve was kept and the rest was used by 8.7% of the charities.

In concluding that charitable gift annuities are cost-effective for charities, the Council's survey offered the example of such an annuity funded with \$18,950 with one annuitant 77 years of age and an eventual residuum of 94.6% (the dollar, age, and residuum figures used were the averages for 1993). "After 11.2 years (the age 77 unisex life expectancy), the charity would receive \$17,908. The present value of this gift, discounted at 8%, is \$7,563. Assuming the median residuum . . . the present value would still be a respectable \$6,338."<sup>4</sup>

**Valuation.** The present value of a commercial gift annuity is determined "by reference to the cost of a comparable contract purchased from an insurance company."<sup>5</sup> The value of the annuity is computed using an interest rate equal to 120% of the midterm applicable federal rate (AFR) for either the current month or one of the two prior months.<sup>6</sup> IRS actuarial tables (IRS Publication 1457, "Actuarial Values—Alpha Volume") do not apply if the donor has a terminal illness, however.<sup>7</sup> Special rules apply if the contributed property is appreciated or encumbered (see ¶712.2, below).

The value of the charitable contribution, which is deductible, is the difference between the value of the contributed property and that of the annuity.<sup>8</sup>

**Options.** Because charitable gift annuities are privately negotiated, the following characteristics can be varied by donors to achieve the most favorable result.

- Annuity payout percentage.
- Annuity present value as a percentage of the contribution.
- Annuity start date (immediate or deferred for more than a year).
- Single-life or joint-and-survivor annuity.
- Donor or third-party beneficiary.

The following examples assume a 7.60% adjusted federal rate<sup>9</sup> and a charitable gift annuity with a \$100,000 contribution, a lifetime quarterly

<sup>4</sup> *Id.* at 20. This conclusion does not consider any development office cost beyond an assumed 0.75% per year, however.

<sup>5</sup> Reg. §§1.170A-1(d)(2); 1.101-2(e)(1)(iii)(b)(2).

<sup>6</sup> IRC §7520; Notice 89-24, 1989-1 CB 660.

<sup>7</sup> Reg. §§1.7520-3(b), 20.7520-3(b), 25.7520-3(b).

<sup>8</sup> Reg. §1.170A-1(d)(1); Rev. Rul. 70-15, 1970-1 CB 20.

<sup>9</sup> The 120% mid-term AFR.

payout beginning in three months, and an annuity rate recommended by the Council:<sup>10</sup>

**Example 1.** A charitable gift annuity measured by two lives, ages 65 and 60, with an annuity rate of 6.7% (\$6,700 per year) yields an annuity present value of \$71,825 and a gift value of \$28,175.

**Example 2.** A gift annuity measured by one life, age 65, with an annuity rate of 7.2% yields an annuity present value of \$57,651, and a gift value of \$42,349.

**Example 3.** A gift annuity measured by two lives, ages 75 and 70, with an annuity rate of 7.2% yields an annuity present value of \$63,930, and a gift value of \$36,070.

**Example 4.** A gift annuity measured by one life, age 75, with an annuity rate of 8.4% yields an annuity present value of \$54,994, and a gift value of \$45,006.

### Advantages and Disadvantages of Charitable Gift Annuities

¶ 712.2] A charitable gift annuity offers advantages to both the charity and the donor.

The principal advantage to the charity lies in the immediate availability (at least theoretically) of the contribution, which is equal to the difference between the value of the property contributed and the present value of the annuity.<sup>11</sup> This amount, which is normally about half the value of the property contributed, can be immediately withdrawn and used if applicable reserve requirements are met. In fact, the charity may not promise the annuity out of the contribution. If it did, the annuity would be treated as a trust, thus depriving the donor of income and gift tax deductions because that "trust" would not qualify under IRC §664.<sup>12</sup>

The simpler administration of an annuity (compared to a CRT) is another advantage for the charity.

The advantages for the donor include life income, even if the contributed property is illiquid, to the donor or a beneficiary named by the donor. Part of the life income is a nontaxable return of principal and part is taxable income.<sup>13</sup> There is also a charitable deduction for the difference between the contribution and the annuity value. The charitable deduction can be taken currently by a high-income donor, even though the annuity start date may be deferred until the income is needed. (The deduction is available only if the donor complies with the substantiation rules of IRC §170(f)(8).) Finally, the contributed property is removed from the donor's gross estate, except to the extent that the donor saves the annuity payments or gives a survivor annuity to someone other than a spouse.

On the other side of the ledger are the disadvantages of charitable gift annuities for both the charity and the donor.

The charity must administer the annuity or pay to have it administered. It must pay the annuity beginning immediately, even if the property is illiquid. If the contribution is illiquid (real estate, for example) the charity has to sell the contribution before getting its benefit. If that property is mortgaged there is a risk of adverse tax consequences—possible unrelated

<sup>10</sup> American Council on Gift Annuities, *Charitable Gift Annuity Rates* (March 1, 1997).

<sup>11</sup> Reg. §1.170A-1(d)(1); Rev. Rul. 84-162, 1984-2 CB 200.

<sup>12</sup> Ltr. Rul. 8223014.

<sup>13</sup> IRC §72.

business income tax or unrelated debt-financed income (UDFI) tax— unless the donor owned the property and got the mortgage more than five years before the contribution, in which case the UDFI rules will not apply for ten years. In addition, the charity may lose its exemption unless its charitable gift annuities meet several requirements:

- The contributed property must generate a deduction under Section 170 or Section 2055 (which makes complying with the substantiation requirements crucial).
- The charitable component must be more than 10% of the value of the contributed property.
- The annuity must be paid over the life of one or two living individuals (not over a term of years).
- The charity must not have a minimum or maximum number of payments.
- The annuity must not vary with income received.<sup>14</sup>

One disadvantage from the donor's point of view is loss of control over the property. Another is the fact that the promise of annuity income is unsecured, except to the extent that the charity has met any reserve requirements *and* those reserves are not subject to the claims of the charity's creditors.

The donor will face taxable gain under the bargain sale rules if the contributed property is appreciated or encumbered. This gain would be equal to (1) the fair market value of the annuity minus (2) that part of the adjusted basis in the property attributable to the annuity portion of the transfer. Normally, it is spread over the donor's life expectancy unless the annuity is assignable to a party other than the charity,<sup>15</sup> and so long as the annuitant is either the donor alone or the donor and a designated successor annuitant. The gain is taxable to the donor even if he or she gives the annuity to a third party.

There are other potential tax liabilities as well. Gain may be subject to the alternative minimum tax to the extent it is allocated to the contribution rather than the annuity. The surviving annuitant's interest in a joint and survivor annuity is included in the donor's estate.<sup>16</sup> There is also the prospect of gift tax liability if the annuitant or survivor annuitant will be someone other than the donor, unless one of the following is true:

- The annuity is a one-life annuity given to a spouse who is a U.S. citizen, so a gift tax marital deduction is available.
- The annuity is a joint and survivor annuity paid to a spouse who is a U.S. citizen from joint property, meaning there is joint ownership, and therefore no gift.
- The annuity is a joint and survivor annuity paid to a third party and the property funding the annuity is joint property with reciprocal revocation rights, which means the gift is necessarily incomplete.
- The annuity is a one-life annuity paid to a third party and the payments do not exceed the annual gift tax exclusion.

<sup>14</sup> IRC §§514(c)(5), 501(m)(3)(E).

<sup>15</sup> Reg. §1.1011-2(a)(4).

<sup>16</sup> IRC §§2039(a) and (b).

### Developments Involving Charitable Gift Annuities

¶712.3 Recent years have seen several judicial and legislative developments that affect charitable gift annuities.

**The Texas litigation.** In 1988, a 96-year-old woman named Louise Peter created a living trust with the Lutheran Foundation of Texas (the Foundation) as trustee. Part of that transaction involved the creation of two charitable gift annuities. A few years later, a lawsuit was begun against the Foundation, the Council, and about 1900 charities using annuity rates suggested by the Council. The suit alleged that the defendants violated federal and Texas antitrust laws by price fixing, violated federal and Texas securities laws by selling unregistered securities, violated Texas insurance law by selling commercial annuities without insurance company registration, and violated Texas banking law by acting as a trustee without bank trust department powers. The Council and other defendants pointed out that the annuities were not commercial annuities because their payouts were much lower (because of the charitable component), and were instead bargain sales. The Council's suggested rates were based on a 50% annuity present value and a 50% residual to charity, and were contained in three tables (single-life, joint-and-survivor, and deferred annuities).

A U.S. district court granted partial summary judgment against the charitable gift annuity issuers under Texas insurance law, holding that the issuers violated Texas insurance and trust law by selling the annuities. The court found as a matter of law that:

- (1) the Foundation's sale of annuities and charging of annuity management fees to Ms. Peter constitutes the unauthorized business of insurance under the Texas Insurance Code; and (2) ... the Foundation illegally accepted and exercised the office of trustee of Plaintiffs' Texas trusts in violation of Texas law.

*Ozee v. American Council on Gift Annuities*, 888 F. Supp. 1318, 1328 (DC Tex., 1995).

This decision prompted many states to enact exemption or permit statutes that reduced general insurance requirements for charitable gift annuities. It also prompted passage of the federal Charitable Gift Annuity Antitrust Relief Act of 1995.<sup>17</sup> That statute was designed to eliminate the grounds on which the district court had based its decision, but the court held otherwise, denying a motion to dismiss. (*Richie v. American Council on Gift Annuities*, 943 F. Supp. 685 (DC Tex., 1996).)

The U.S. Court of Appeals for the Fifth Circuit refused, on petition for mandamus, to reverse that decision. (*Ozee v. American Council on Gift Annuities*, 110 F.3d 1082, 79 AFTR2d 97-2209 (CA-5, 1997). In fact, the Fifth Circuit sanctioned the charities' counsel \$15,000, saying that they should have brought a certified appeal (before final judgment) or a direct appeal (after final judgment), rather than a petition for mandamus.

The appellate decision prompted Congress to pass, unanimously in both houses, The Charitable Donation Antitrust Immunity Act of 1997.<sup>18</sup> This is another attempt to cut off the federal basis for the suit. The Foundation has again moved for dismissal in district court.

<sup>17</sup> P.L. 104-63 (December 8, 1997), 15 U.S.C. §§37 and 37a, prior to amendment by the Charitable Donation Antitrust Immunity Act of 1997, P.L. 105-26 (August 3, 1997).

<sup>18</sup> P.L. 105-26 (August 3, 1997), 15 U.S.C. §§37 and 37a.

**The associated antitrust legislation.** As mentioned above, the first attempt to end the uncertainty created by the Texas litigation was the Charitable Gift Annuity Antitrust Relief Act of 1995, which provides that it is not a federal antitrust violation for charities to use a uniform annuity rate when issuing charitable gift annuities qualifying under IRC §501(m)(5). It also frees the use of such rates from state antitrust prohibitions, except where a state affirmatively acts within three years to make that an antitrust violation. It was retroactive, and so applied to the Texas litigation.

The Council's suggested annuity rates are indeed designed to reduce annuity rates and avoid competition among charities. The Council was formed to end annuity rate competition among charities, and to foster charitable giving with prudent annuity rates.

The Charitable Donation Antitrust Immunity Act of 1997 amended the 1995 act's antitrust exemption for Section 501(c)(3) organizations using common or recommended annuity rates. The 1997 act makes clear that charitable gift annuities and charitable remainder trusts are exempt from antitrust laws. It also makes issuers of charitable gift annuities and charitable remainder trusts immune from suit under antitrust laws.

These two acts do not address the treatment of charitable gift annuities as insurance under state law. About three-quarters of the states actively or potentially treat charitable gift annuities as insurance, which may not be offered in the state without registration as an insurance company and as insurance agents. The remaining quarter of the states offer exemptions that generally require application but, in a few cases, are automatic.

**Philanthropy Protection Act.** The Philanthropy Protection Act creates an exemption from many federal securities laws (except anti-fraud provisions) for charities offering gift annuities, pooled income funds, charitable remainder trusts, and charitable lead trusts.<sup>19</sup> It exempts charities from the Securities Act of 1933 and the Securities Exchange Act of 1934 (regulating disclosure and registration of securities), and the Investment Company Act of 1940 (regulating funds). The exemption from broker-dealer registration applies only to employees or volunteers soliciting charitable gift annuities who do not receive any special compensation based on the volume or value of annuities. The act also creates an exemption from most state securities laws (again, except anti-fraud provisions), except where a state affirmatively passes legislation to the contrary within three years (through December 8, 1998). Compliance with the act may be used as a defense in all administrative and judicial actions pending on or commenced after the date of enactment (December 8, 1995).

The act also requires charities to provide to each donor to a fund, at the time of the donation, written information describing "the material terms of the operation of such fund." That requirement is undefined. A 90-day grace period (to March 7, 1996) applied to allow disclosure for a time after the donation. There is some dispute whether disclosures must be made for annuities issued before December 8, 1995.

<sup>19</sup> P.L. 104-62 (December 8, 1995), 15 U.S.C. §§77c, 78c, 78l, 80a-3, 80a-3a, 80a-7, 80b-3.