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By their nature, life income gifts (Charitable Gift Annuities, Charitable Remainder Trusts, and Pooled Income Funds) are arrangements where the donor transfers assets now, but delays the charity's use of the funds until a future date, normally the death of one or more income beneficiaries. A Charitable Remainder Trust can be established for a term of years, but until the expiration of what can be a term of up to twenty years, the assets of the trust are unavailable to charity.

Why would anyone consider giving up his or her right to income in favor of charity? A life income donor will not see their gift in action, and the charity is unable to address pressing current needs, so naturally, one reason a donor may consider is to accelerate the gift to the charity now.

Another reason to give up income may happen when a life income beneficiary finds that more income means more taxes and other expenses. For example, life income beneficiaries are mostly retired and receiving Medicare benefits. If a Medicare beneficiary's income exceeds certain income thresholds, they pay higher premiums for both Medicare Part B, and Medicare Part D. The Medicare recipient is catapulted into the next tier and will pay a higher surcharge if their income exceeds the applicable income bracket by just $1. Charitable Gift Annuity beneficiaries in particular may be those of modest means. A small gift annuity payment could cost the beneficiary more than the payment is worth, or it could reduce the net benefit to the point that the income from the annuity is not worth receiving.

But Aren't Life Income Gifts Irrevocable?

To qualify for preferential charitable tax treatment, Charitable Gift Annuities, Charitable Remainder Trusts and Pooled Income Funds cannot be revoked. Nonetheless, a life income gift can be relinquished in favor of the charitable beneficiary.

Legally, the trust doctrine of merger operates to terminate the life income gift in favor of the charitable beneficiary. The life income gift consists of two interests. There is a non-charitable component for the income beneficiary and a charitable component in the remainder left for charity at the death of the income beneficiary. If the life income beneficiary in a trust surrenders their income, the two interests merge and the underlying value of the life income gift is available for current use by the charity. For a gift annuity, surrender extinguishes the charity’s contractual obligation to pay the annuity.

So How Does Surrender Work?

The simple answer is the income beneficiary agrees in writing to surrender and otherwise forgo their right to future income in favor of the charitable beneficiary. The charitable beneficiary of Charitable Gift Annuities and Pooled Income Funds are irrevocable in favor of the issuing charity by definition. Even if a Charitable Remainder Trust has not named an irrevocable charitable beneficiary, the assets are permanently set aside for charitable purposes.

Besides the satisfaction of seeing their gift put to current use, the income beneficiaries may be entitled to an additional income tax deduction. This additional deduction can be available even if the income beneficiary was not the original donor who established the gift plan. An important point to keep in mind is that an income beneficiary may surrender a portion of their income interest, retain a portion, and continue to receive some income.

Surrendering Charitable Gift Annuities

Surrender of Charitable Gift Annuities can be particularly attractive to charities as well as income beneficiaries. Gift annuity payments are an unlimited obligation of the issuing charity even after exhausting the donor’s original principal donation. Surrender of the income interest in a Charitable Gift Annuity relieves the issuing charity of its obligation to make future payments and thus is free to now use the amount held in reserve to cover the obligation.

The amount of the income interest in a Charitable Gift Annuity is the present value of the remaining annuity payments computed as of the date of assignment. However, in the case of an assignment of an annuity interest to charity, the income tax charitable deduction will often be less than the amount of the gift.

The assignment of a gift annuity interest is arguably analogous to the forgiveness of a loan. The IRS has said that the issuance of gift annuities has historically been treated “as a borrowing of money by the issuing organization.” Thus, it would follow that the assignment of a gift annuity interest is to be treated like the forgiveness of a debt owed by the charity.

Although there are no revenue or private letter rulings specifically on point, it seems reasonable to conclude that the income tax charitable deduction for surrender of a Charitable Gift Annuity would be limited to the remaining payments that would have been paid tax-free or as long term gain (undistributed investment in contract) over remaining life expectancy if the annuity interest had not been assigned. It follows from this that no deduction is permitted for persons who have lived long enough that they are no longer receiving tax-free or long term gain income.

The reportable deduction will be limited to 30 percent of the donor’s adjusted gross income if the deduction amount includes undistributed long term gain. If the deduction is all undistributed tax free amounts, the reportable deduction will be limited to 50 percent of the donor’s adjusted gross income. In both cases there is a five year carryforward.

Surrendering Charitable Remainder Trusts

An income tax charitable deduction is allowed for a gift of all or part of the income interest in a Charitable Remainder Trust (CRT) because the income interest constitutes the income beneficiary’s entire interest, and he or she would either be giving all of that interest or an undivided portion of it.

An assignment of an income interest in a CRT is treated as a gift of a capital asset with a zero basis. If the CRT has been in existence for over a year, the deduction will be for the present value of the interest contributed, rather than its cost basis, and the reportable deduction will be limited to 30 percent of the donor’s adjusted gross income with a five year carryforward. In almost all instances, the income tax deduction for the surrender of an income interest in a Charitable Remainder Trust will equal the present value of the trust’s income interest at the time of surrender.

A CRT often includes language permitting the donor a right to change the charitable beneficiary, therefore the trust may not indicate an irrevocable gift to charity. If that is the case, it is best to name the charity as the irrevocable beneficiary before the gift making a gift of the income interest, so that there will be no doubt about whether some other charity may have an interest in the trust.

Surrendering the Income Interest in a Pooled Income Fund

Frequently, a charity that still has a Pooled Income Fund (PIF) has very few participants. The fees associated with operating a PIF can make it economically unfeasible to maintain a very small PIF. A solution is to encourage the participants to surrender their right to income in the fund. A PIF is a type of trust, and even though such a trust differs from a CRT in certain ways, a charity that maintains a PIF appears to have essentially the same options as does the remainder beneficiary of a CRT in terms of allowing participants to surrender their income interest.

A PIF participant is entitled to an additional income tax charitable deduction if they make an outright gift of their income interest to the charitable beneficiary. The present value of the participant's income interest entitles the participant to an additional income tax charitable deduction. The reportable deduction will be limited to 30 percent of the donor's adjusted gross income with a five year carryforward. Following the gift, the charity could sever from the fund an amount equal to the full value of the fund assets attributable to the beneficiary's units.

Substantiating the Income Tax Charitable Deduction for Surrendering a Life Income Gift

A qualified appraisal is required if a gift of a surrendered income interest will generate an income tax charitable deduction of more than $5,000. This is because the income or annuity interest is a non-cash asset, even if, in the case of a CRT or a PIF, the trust or fund holds only cash or marketable securities. The appraiser will complete IRS Form 8283 and have the Form countersigned by the charity acknowledging receipt of the gift.

Someone can perform a qualified appraisal with the education and experience to perform such appraisals. The appraiser must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal. The appraisal should describe the gift that resulted in the deduction claimed by the donor and indicate how the present value of the interest in question was determined. It should also address the qualifications of the appraiser. PG Calc is a qualified, independent appraiser of gifts of income interests and we perform them quite frequently.

Because the beneficiary is required to have an appraisal in order to substantiate his or her deduction, some charities prefer the beneficiary bear the cost of obtaining the appraisal. If the charity bears the cost, we recommend it disclose what it paid for the appraisal on the gift acknowledgement to avoid running afoul of the quid pro quo rules.

Conclusion

Charity and income beneficiaries can realize substantial benefits from the surrender of the income interest in a Charitable Gift Annuity, Charitable Remainder Trust, or Pooled Income Fund. Income beneficiaries can reduce their taxable income, realize an additional income tax charitable deduction, and see their gift put to work by the charity. Instead of waiting years to realize the benefit of a life income gift, charities can put gifts to work right away, thereby fulfilling their mission and the donor's object now. Surrender of a Charitable Gift Annuity or Pooled Income Fund can relieve the charity of current liabilities. For all of these reasons, consider whether you have life income gifts that could be converted to current gifts and consider approaching donors to do so.

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