

[admin](#) - Tue, 1/7/2014 - 11:48

In this last of three articles on the gift annuity, we will discuss the taxation of gift annuity payments. Unlike remainder trusts, the taxation of gift annuity payments is determined at the time the annuity is established. This taxation is unaffected by the actual investment performance of the donated assets. Annuities funded with cash make payments that are considered partially tax-free return of principal and partially ordinary income. Donors who fund an annuity with appreciated property must also report a certain amount of capital gain income.

Taxation of Annuities Funded with Cash

If a donor makes a gift of cash to fund a gift annuity, a portion of each distribution from the annuity is taxed as ordinary income and a portion of the annuity is a tax-free return of principal. The division of the interests in the annuity between the charitable and non-charitable interests is critical in determining how the annuity will be taxed.

The *investment in contract* is the present value of the annuitant's interest in the gift annuity. It is, in other words, the annuity's non-charitable portion. The charitable deduction represents the present value of the charitable interest in the annuity. The share of the annuity funding amount that each of these present values represents dictates how the annuity is taxed.

The calculation of the taxation of a cash annuity is done in three steps:

Step one: First, calculate the life expectancy of the single annuitant or the joint life expectancy of the two annuitants. This life expectancy is also the number of full annuity payments the gift annuity is expected to make during its term without taking into account the payment frequency. In gift annuity circles, this value is called the expected return multiple. The expected return multiple is determined using the 1983 Basic mortality table. The 1983 Basic mortality table is based on monthly payment timing. If the annuity payment timing is other than monthly, there is a slight adjustment in the expected return multiple.

Step two: Calculate the expected return to be paid. This is the total face value of all the annuity payments that the gift annuity is expected to make during its term. This total equals the annuity amount multiplied by the expected return multiple.

Step three: Calculate the exclusion ratio, which is the fraction of each annuity payment that is considered excluded income rather than ordinary (fully taxable) income. The exclusion ratio equals the investment in contract divided by the expected return. The exclusion ratio is merely spreading out the return of the dollars used to buy the annuity (investment in contract) over the annuitant's life expectancy. Since we have assumed this annuity is funded with cash, the excluded portion is treated as a completely non-taxable return of principal. The rest of the annuity, not included in the excluded portion, is taxable at the annuitant's ordinary income tax rate. An example using the Actuarial Calculations chart from Planned Giving Manager is instructive. A portion of an Actuarial Calculations chart is reproduced below. You may want to print a complete chart to follow along. Suppose annuitants aged 72 and 70 use \$50,000 in cash to fund a gift annuity that pays 4.7% or \$2,350 each year in quarterly installments. The taxation breakdown is as follows:

**BREAKDOWN
OF ANNUITY**

	Tax-Free Portion	Ordinary Income	Total Annuity
2013 to 2013	4.62	1.77	6.39
2014 to 2032	1,699.05	650.95	2,350.00
2033 to 2033	1,187.93	1,162.07	2,350.00
2034 onward	0.00	2,350.00	2,350.00

[8] Investment in Contract ([6] x [7c])

\$33,474.50

[10] **CHARITABLE DEDUCTION** ([2] - [8])

\$16,525.50

The non-charitable interest in the \$50,000 gift principal is equal to the investment in contract, \$33,474.50. The charitable interest equals the charitable deduction amount of \$16,525.50.

[11] [a] Expected Return for ages on [1]
(Table VI in Reg. 1.72-9)

19.8

The life expectancy of individuals aged 72 and 70 based on monthly timing is 19.8 years. Therefore, this annuity will make 19.8 payments if the annuitants live to life expectancy.

[b] Adjustment for payment schedule on [4]
(Reg. 1.72-5(a)(2)(i))

-0.1

Since the annuity makes quarterly payments, the life expectancies adjusted slightly.

[c] Expected Return per \$1 ([10a] + [10b])

19.7

After adjusting for payment frequency, these annuitants will receive 19.7 annuity payments during their joint life expectancy.

[12] Expected Return ([6] x [10c]) \$46,295.00

These annuitants will be paid \$2,350.00 a year (4.7% times \$50,000) for 19.7 years, or a total of \$46,295.00

[13] Exclusion Ratio ([8] / [11]) 0.723
(Regs. 1.72-4, 1.1011-2(c) Example (8))

Divide the non-charitable interest (investment in contract) by the total payments that will be paid to the annuitants during their life expectancy (expected return) to calculate the exclusion ratio. 72.3% (\$1,699.05) of each year's annuity (\$2,350) will be tax-free until the annuitants have been paid all of the donors' investment in contract in the annuity.

Capital Gain Income

If a donor makes a gift of appreciated property to purchase the gift annuity, a portion of the capital gain must be realized. The donor's basis is allocated between his retained interest (the investment in contract) and the charitable gift (the deduction). This is the application of the bargain sale rule. The donor must recognize the amount of capital gain that bears the same ratio to the donor's total gain in the funding asset as the investment in contract bears to the fair market value of the property. In other words, reportable gain = total gain x (investment in contract/fair market value).

If the primary annuitant is not the donor, the reportable capital gain must be reported in the year of the gift. For most gift annuities, however, the donor is the primary annuitant and is able to recognize any gain proportionally over his life expectancy, rather than in the year the gift is made. To receive this treatment, the donor or the donor and designated survivor must be the only annuitants and the annuity must not be assignable except to the charity.

The total reportable gain is expressed as a percentage of the investment in contract and equals the percentage of gain in the funding asset. This percentage is multiplied by the excluded portion of each year's annuity payment in order to determine the capital gain to be reported for the year.

The yearly reportable capital gain is limited to the amount of the excluded or tax-free portion calculated above. In the case of a two-life agreement that has one donor, particularly if the donor is quite elderly and there is a large amount of gain, the donor may not be expected to live long enough to report all the capital gain. In this case the capital gain is spread over the additional number of years necessary to recognize all the reportable gain.

Capital gain is reported only until all reportable gain has been recognized; afterwards, the capital gain portion of the annuity becomes tax-free income. However, please note that for gifts made after 12/31/1986, all tax-free income becomes ordinary income at the expiration of the life expectancy of the annuitant(s), so for practical purposes, capital gain income becomes ordinary income once it has all been recognized. If all the annuitants die or the annuity is assigned to the charity before all capital gain has been reported, then the unreported gain is not taxed. However, if the donor dies before the entire amount of gain has been reported, a surviving annuitant must continue to report gain until all the gain has been reported. For gifts of joint or community property where the annuity is paid to both donors and then to the survivor, the gain may be recognized proportionally over the joint life expectancy of the two donors.

Let's use the previously mentioned example to illustrate the calculation of capital gain income distributions by a gift annuity. Let's assume the annuity is funded with appreciated property valued at \$50,000 with a cost basis of \$20,000. We will assume the donors jointly owned the appreciated property so gain can be reported over their joint life expectancy. First let's look how the breakdown of taxation changes:

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Since the reportable capital gain can be reported over the joint life expectancy of both donors in this example, the reportable gain is divided by the annuitants' joint life expectancy. Divide the reportable gain (\$20,084.70) by the joint life expectancy of the donors (19.7 years) to compute the capital gain reportable each year, \$1,019.43.

Conclusion

Gift planners present any number of gift annuity proposals every week and many result in completed annuity contracts. While the charitable gift annuity is described as "simple," this series of articles has focused on how complicated the calculations for these gifts can be. We hope our customers are now better able to answer the question, "Now where does this number come from?" As always, do not hesitate to contact our client services department with your questions (888-474-2252).

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