Bill Laskin - Sun, 5/20/2012 - 00:00

When a donor establishes a life income gift such as a charitable remainder trust, a gift annuity, or a contribution to a pooled income fund, the arrangement usually remains in effect throughout the period set forth in the gift instrument. Sometimes, however, the donor or other beneficiary of the gift's income interest decides to end the arrangement ahead of schedule. Doing so should be acceptable from a legal standpoint, provided certain steps are taken.

Charities generally welcome such terminations. Typically terminations will result from a life income beneficiary making a charitable gift of his or her interest in the remaining payments. Nevertheless, if a life income beneficiary instead wants to "cash out" his or her interest, the charity will often accommodate the beneficiary's wish in order to receive its share of the arrangement now, rather than wait to receive what could be a smaller benefit in the future. It is even possible for an existing life income gift to be transformed or "converted" into a new life income gift.

Learn from the missteps of others.

Recognizing, then, that both charitable and non-charitable terminations are possible, this article focuses on the former, specifically on outright contributions of life income interests rather than on conversions. Moreover, it reflects the experience of several PG Calc consultants who have worked with numerous donors and charities over the years in connection with ending charitable remainder trusts, gift annuities, and pooled income fund gifts.

Indeed, many times we are called on to provide a formal appraisal of the present value of a life income interest. All too often, we notice after the fact things that really should have been done differently. In an effort to foster smoother terminations (and appraisals!), we offer a number of observations.

Make sure the contemplated termination is legally permissible.

Frequently, the trust agreement or other applicable gift instrument will be silent on the subject of having the arrangement end early. Silence is probably an indication that it's okay to proceed, assuming all parties to the gift agree, but the safer course is to have legal counsel for the donor and the charity (and, if applicable, the trustee)

confirm this under state law. Naturally, if the gift instrument does indicate how to go about terminating the arrangement, the parties should do whatever may be required.

Sometimes, however, there will be a spendthrift clause or other provision that purports to preclude an income beneficiary from making any disposition of his or her interest. Some such provisions are more “air tight” than others, so lawyers for all concerned should first weigh in on whether the language needs to be heeded. In some states, for example, spendthrift clauses can routinely be ignored if the income beneficiary is the same person who made the gift or if no one other than the charity in question will benefit from early termination.

Likewise, whereas many gift annuity agreements (including those developed by PG Calc) indicate that the annuitant may not assign his or her interest to anyone but the charity, others simply say something such as, “This annuity may not be assigned.” The latter lingo is more likely to be a problem if the annuity was funded with appreciated property and the donor was an initial annuitant, as an assignment could jeopardize the favorable capital gains treatment available under Treasury Regulation Section 1.1011-2(a)(4)(ii). Here again, legal counsel for the annuitant in particular should determine whether the termination can go forward.

Finally, in the case of a charitable remainder trust or a pooled income fund, a charity will want to be confident that a charitable termination will leave it as the undisputed owner of all remaining assets attributable to the original gift. This will mostly be a matter of confirming that applicable state law recognizes the doctrine of “merger.” Merger is the legal concept that if the charity becomes the sole beneficiary of all interests in a trust, the trust is deemed to have terminated and the charity owns the trust property outright.

Determine ahead of time what the tax consequences of a termination will be.

Even though determining tax consequences is ultimately the responsibility of the income beneficiary, a charity that values happy donors should be proactive in steering him or her to a knowledgeable, independent tax advisor. The main issue is whether the income beneficiary will be entitled to a tax deduction and, if so, what – at least approximately – the size of the deduction will be.

An income beneficiary of a charitable remainder trust or a pooled income fund needs to be aware that if he or she has held the income interest for a year or less, a contribution of that interest to the charity will not produce an income tax charitable deduction. This is because an income interest in a trust (keeping in mind that pooled income funds are structured as trusts) is a capital asset with a cost basis of zero. Thus, only when the asset has been held longer than one year is the deduction based on the asset's fair market value (which will be its present value, as calculated based on several factors).

In addition, if a charitable remainder unitrust is subject to a net-income limitation at the time of termination, the donor should be made aware that in calculating the deduction, the payout rate will be deemed to be the lower of the rate set forth in the trust instrument or the discount rate applicable to the month of termination. This is based on Private Letter Ruling 200725044.

With regard to gift annuities, PG Calc shares with many knowledgeable commentators the position that the deduction resulting from a gift of the annuity interest to the issuing charity will be the lesser of the present value of the annuity payments or the portion of the original investment in the contract that remains unreturned in the form of payments. If the annuitant has lived beyond what was at the time the annuity was established his or her life expectancy (as figured according to applicable IRS expected return multiple tables), a gift of the annuity interest will not produce any tax deduction.

In addition, if perhaps the annuity in question is a flexible deferred annuity and the annuitant has not yet elected the date on which payments are to commence, he or she should make such an election before terminating the annuity. Lack of certainty about when the payments will begin can translate into ambiguity when it becomes time to calculate the present value of the payments, a situation that could result in the annuitant taking one position and the IRS taking another.

Pay careful attention to gifts featuring more than one income beneficiary.

In instances of multiple income beneficiaries, it's most likely that there will be only two of them and that they will be spouses. Provided they file a joint income tax return, they will often be acting in concert as a single taxpaying entity when terminating a life income arrangement. Even when this is indeed the case, however, the termination document should indicate as much explicitly. Of course, spouses

can also have differing interests, especially if one of them (or some third party) has retained a right of revocation. Similarly, if a husband is the sole initial annuitant of a gift annuity and his wife is the successor annuitant, they will definitely have different interests regardless of whether a right of revocation has been retained. Also, in the case of certain charitable remainder unitrusts subject to a net-income limitation, income beneficiaries who are spouses may need to renounce their survivorship interests before terminating the trust, in order to avoid compromising each one's *gift tax* charitable deduction.

Thus, with any combination of beneficiaries, the two main factors to consider will be whether anyone has retained a right of revocation and whether some beneficiaries have a current income interest while others have a future income interest. Especially with charitable remainder trusts, the possibilities are conceivably endless. In advance of any termination, circumstances may require that one or more rights of revocation be exercised, that one or more income beneficiaries renounce their interests (including in ways that may result in not all of them receiving an income tax charitable deduction), and/or that some beneficiaries act in concert.

Settle on a suitable termination date.

The first consideration is to rule out any date in the past. A retroactive termination is an invitation to the IRS to claim that an income beneficiary is attempting to lock in tax aspects that appear more favorable in hindsight. By contrast, there should be no problem with terminating a gift either immediately or on some fixed date in the future.

Because life income gifts do indeed feature payments made to one or more income beneficiaries, it is wise for the document by which the arrangement is terminated to be explicit regarding which payment will be treated as the last one owed. Even if termination takes place on a regular payment date, it's advisable for the termination document to be clear as to whether an income beneficiary is or is not entitled to the payment owed as of that date. In some cases, any final payment may – or must – be prorated through the date of termination. For an income beneficiary wanting to terminate his or her participation in a pooled income fund, another consideration will be the points during the year when fund assets are valued.

Be mindful of issues unique to charitable remainder trusts.

Whereas gift annuities and pooled income funds feature a single, irrevocably designated charitable beneficiary, a charitable remainder trust can have any number of charitable beneficiaries. Furthermore, some or all of those entities may enjoy that status in only a tentative manner.

If in fact a donor has retained the right to name different charitable remainder beneficiaries from time to time, he or she should first confirm – in writing – which ones are to be the beneficiaries upon termination and then voluntarily renounce the right to make any further changes. This effectively vests any charity that might otherwise continue to be at risk of being removed.

In addition, because the very existence of a charitable remainder trust can be unknown to a charity that is a remainder beneficiary (even if it is a vested remainder beneficiary), the charity might wish to let its supporters know that if any of them are thinking of terminating charitable remainder trusts that may be unknown to the charity, it could be worthwhile to reveal their plans to the organization before implementing those plans. This type of communication could be something of a long shot in terms of ensuring that those who need to receive this advice actually do receive it (and heed it!), but if even one trust can be saved from being terminated improperly, the effort may well be justified.

The problem to be avoided is a donor who acts unilaterally and then informs the charity only after the fact. True, the same scenario could unfold with respect to a gift annuity or a pooled income fund, but a charity is in a better position to be proactive with the beneficiaries of such arrangements who might someday want to terminate them. This is because the charity knows who such beneficiaries are and how to be in contact with each of them directly in order to make them aware of the possibility of a termination and to encourage them to contact the charity as soon as they think they might want to take some action.

Especially when donors serve as trustees of their own trusts, they tend to not to focus on important details. This happens all too often with respect to the routine administration of a charitable remainder trust, not to mention the less common situation in which a trust is being terminated ahead of schedule.

Regardless of who the trustee is, there is merit in liquidating trust assets in advance of the termination, ideally several weeks in advance. This removes the possibility that the value of the trust’s assets will decline at the last minute, and it shouldn’t

result in any significant negative tax consequences. It also facilitates calculation of the net value of the trust’s assets as of the date of termination, as by that time there is a greater likelihood that any trailing income will have been received. In addition, there’s no trick to valuing cash.

Of course, another aspect of determining a net value is taking into account final trust expenses. These might include any last payments to income beneficiaries, trustee fees, and the cost of a final income tax return.

When all the stars align, celebrate!

Despite the number of matters that will require attention when a life income is terminated, the ultimate effect can be truly wonderful. Assuming the life income beneficiary can afford to forego all future payments (or, in the case of a partial termination, some portion of those payments), he or she can take satisfaction in knowing that an act of generosity the charity was not counting on will transform a deferred charitable impact into an immediate one.

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