Bill Laskin - Fri, 5/20/2011 - 00:00

There are some situations where either a charitable gift annuity (CGA) or a charitable remainder trust (CRT) would be appropriate, and other situations where one or the other is clearly preferable. This article will explore some of the considerations that should go into making a well-informed choice between the two.

Criteria That Point Definitively in One Direction or the Other

There are some donor goals that will make the choice between a gift annuity and a CRT an easy one, assuming you have already established that the donor is interested in a life income plan.

- **Funding amount** – A gift annuity can be an effective gift at a much lower funding amount than a CRT. Most charities set gift minimums for these types of gifts, with $10,000 a typical minimum for gift annuities and $100,000 a typical minimum for CRTs. The CRT minimum is so much higher because of the greater costs associated with setting one up and, more importantly, with administering and investing it as a separate trust. If your donor is interested in a gift plan that can provide payments for life and wants to transfer less than $100,000, you know immediately to focus on the gift annuity.

- **Number of payment beneficiaries** – A gift annuity can have one or two annuitants. No more. A CRT can have any number of beneficiaries as long as its charitable value is at least 10% of the funding amount and, in the case of a charitable remainder annuity trust, there is less than a 5% chance of corpus exhaustion. If your donor is interested in a gift plan that can provide payments to three or more beneficiaries and is considering a funding amount of sufficient size, you know immediately to focus on the CRT. It then becomes a question of which type of CRT will work best, a charitable remainder unitrust (CRUT) or charitable remainder annuity trust (CRAT).

- **Control** – When a donor funds a gift annuity, he transfers assets to the charity and has no say over who invests them or how. With a CRT, in contrast, a donor names the trustee, who can be the donor or a trusted advisor. While the trust agreement cannot dictate investment strategy, the donor can retain some

influence over investment decisions by naming himself or a trusted advisor as trustee. For the donor who wants to retain some control over how his funding assets are invested, the CRT is the clear choice. What's more, financial advisors will have an incentive to refer clients if they may be engaged by a donor-trustee to handle investment of the gift assets.

- **More than one charitable beneficiary –** A CRT can split its remainder among any number of charities based on instructions in the trust agreement. In contrast, the contribution for a gift annuity becomes the property of the issuing charity. The only way other charities can benefit is for the issuing charity to make grants to them. If the donor wishes to make a single life income gift that will benefit more than one charity, a CRT is the better option.

Situations Where the Choice Will Depend on Various Factors

We won't attempt to cover all of the donor goals and gift characteristics that may enter into a donor's decision on whether to fund a gift annuity or a CRT, but we will try to review several common situations.

Desire for Payments That Can Keep Pace with Inflation

When a donor indicates a preference for life income that can grow over time, the CRUT immediately comes to mind. As long as the annual investment return of the trust is greater than its payout percentage, the value of the trust will grow each year and with it the payments to the trust's income beneficiaries. But don't discount the gift annuity as an attractive option for this donor. A step annuity may be just what he or she is looking for.

Suppose you are in discussions with a prospect, Ruth Harris, who is interested in life income for herself and is considering a gift in the $200,000 range. Ruth is only 70 and has expressed concern about the effect of inflation on the fixed payments from her pension plan.

If Ruth were to fund a 5% CRUT with $200,000, she would receive a charitable deduction of approximately $105,000 and her payments would be $10,000 in the first year of the trust. Her payments in subsequent years would increase or decrease with the value of the CRUT's assets.

Alternatively, Ruth may be attracted to a gift plan that combines the security of fixed payments with periodic increases in cash flow. This way, there's no risk of

decreasing payments and she'll know the amount and timing of future increases from the outset.

You can accomplish these twin goals with a step annuity, which is the bundling of an immediate gift annuity with a set of smaller deferred gift annuities that have successively later payment-starting dates. While it may be possible to draft a single gift annuity agreement that contains all of these provisions, the simpler solution is to execute simultaneously multiple agreements that differ only in the timing and amount of their payments. Despite the multiple contracts, your charity can keep administration simple by issuing a single payment each quarter that combines the amounts due from all of the annuities, and a single 1099-R tax form at the end of each year that covers all of the annuities.

For example, suppose Ruth wants her annual payments to increase at the average historical inflation rate of 3.5 percent. The following chart shows how much she would have to contribute in 2011 if she wants this adjustment applied annually for ten years. The payment amounts are based on the American Council on Gift Annuities rates that became effective on July 1, 2010.

Type of Annuity	***Contribution Amount***	***Payment Begin Date***	***Payment Increment***	***Total Payment***
Immediate	$150,000	6/30/2011	$0	$8,700
Deferred	$4,992	6/30/2012	$305	$9,005
Deferred	$4,924	6/30/2013	$315	$9,320
Deferred	$4,727	6/30/2014	$326	$9,646
Deferred	$4,625	6/30/2015	$338	$9,983
Deferred	$4,480	6/30/2016	$349	$10,333
Deferred	$4,357	6/30/2017	$362	$10,695
Deferred	$4,206	6/30/2018	$374	$11,069
Deferred	$4,078	6/30/2019	$387	$11,456
Deferred	$3,893	6/30/2020	$401	$11,857
Deferred	$3,773	6/30/2021	$415	$12,272

Ruth's total contribution would be $194,055, and her payments would retain their purchasing power for the next ten years (or for whatever period she chose), assuming the future rate of inflation approximates the historical average. She would receive a total charitable deduction of $75,551.50.

Although the amount contributed for each deferred gift annuity is under $5,000, less than the stated minimum in the gift acceptance policies of most charities, your charity may be willing to make an exception in Ruth’s case because the total amount contributed is well above the minimum and the bundled annuities can be consolidated for the purposes of making the payments and issuing Ruth’s 1099-R tax form each year.

Note that there’s nothing magical about choosing ten consecutive years of payment escalations. Ruth could create annuities to provide payment increases over whatever period she desires.

Advantages of Ruth Funding a Charitable Remainder Unitrust

- At least initially, the CRUT would make larger payments than the step annuity. In these days of very low IRS discount rates, it will also generate a larger charitable deduction.
- As mentioned earlier, there is the potential for payment growth to keep pace with inflation for the duration of the trust, not just the first ten years. Of course, there is also the possibility that payments will decline in years where trust value declines (think 2008 and 2009).
- Unlike with a gift annuity, your charity would not be exposed to financial risk in being named as a remainder beneficiary, though it would be accountable as a fiduciary if it were to act as trustee.
- Ruth could choose a higher payout rate, such as 6%, in cooperation with the trustee, rather than be limited to the age-based rates offered for the gift annuities.
- The sometimes onerous state regulations imposed on charities that issue gift annuities do not apply to CRTs. If Ruth lives in a state that heavily regulates gift annuities, such as California or New York, and your charity is not registered to issue gift annuities in that state, your charity will want to weigh carefully the immediate and ongoing costs of registering in that state before pursuing the gift annuity option further.
- Ruth could set up the CRUT without informing your charity, allowing her anonymity that is not possible when funding a gift annuity.

Advantages of Ruth Funding a Step Annuity

- Ruth will know at the outset the annuity amounts she will receive each year. Her payments will not be affected by fluctuations in stock values or interest rates.
- Ruth's payments will be backed by all of the assets of your charity, so she can rely on her payments unless your charity becomes insolvent.
- She will know in advance how her payments will be taxed, and some of what she receives will be treated as tax-free return of principal. Under the four-tier system for taxing CRT payments, Ruth won't know how a given year's CRT payment will be taxed until that year has ended.
- The step annuity will be inexpensive for Ruth to establish. She should incur no costs other than fees for consultation with professional advisors about the advisability of the gift. Establishing a CRT could cost Ruth several thousand dollars in legal fees, depending on the complexity of the trust agreement and who drafts the agreement.

Desire to Provide Payments to Others

Sometimes donors want to provide payments to someone else – a parent, sibling, child, friend, or perhaps a domestic worker who has no retirement plan. It is possible to use either a gift annuity or a CRT for this purpose, provided the gift amount will be sufficiently large to make a CRT practical. One or the other might be preferable, however, depending on the type of asset to be transferred.

When a donor contributes cash for a gift annuity, typically a significant portion of the payments will be tax-free. This feature, along with fixed and secure payments, may be attractive to a donor who wants to be certain of the annual benefit he or she is arranging for someone else.

For example, suppose Ruth wants to provide her sister Helen, age 75, with some additional and very dependable cash flow. Ruth could create a gift annuity or a charitable remainder annuity trust to provide fixed payments to Helen for life. The benefits of creating a $200,000 gift annuity or a $200,000 charitable remainder annuity trust would look like this:

1. **1. Contribution of cash for a gift annuity**
2.

Annual annuity to Helen	$12,800

Taxation of payments: • Ordinary income Tax-free	$3,533 $9,267
Charitable deduction (for Ruth)	$85,042
Taxable gift to Helen	114,958*

1. **2. Contribution of cash for a 6.0%** charitable remainder annuity trust**

Annual payment to Helen	$12,000
Taxation of payments	Depends on investment results
Charitable deduction (for Ruth)	$92,884
Taxable gift to Helen	107,116*

* The taxable gift for either option can be reduced by the amount of the gift tax annual exclusion. Also, Ruth may avoid paying any gift tax by using part of her lifetime $5 million gift tax exemption, assuming it is still available. In the case of the gift annuity, Ruth could avoid a taxable gift by retaining the right to revoke her sister's payments and thereby avoid using any of her remaining lifetime gift tax exemption.

** A charitable remainder annuity trust for Helen with a payout rate over 6.06% will fail the 5% probability of exhaustion test, so Ruth cannot create a CRAT for Helen that quite matches the payment amount of the gift annuity.

The gift annuity would appear to be the more attractive option in this case. It can make modestly higher payments than the CRAT and will offer secure cash flow for life that will be over 70% tax-free for many years.

What if Ruth wants to fund her gift with $200,000 in appreciated stock that she purchased for just $20,000 years ago? The payments, charitable deduction, and

taxable gift would not change. However, Ruth would be taxed up front on her capital gain in the non-gift portion of a gift annuity. When the IRS discount rate is low, as it is now, the amount of gain taxed to the donor is especially large. In contrast, Ruth's capital gain in the non-gift portion of a CRAT would not be taxable to her. It would be taxed to Helen only if and when distributed to her under the four-tier system.

1. **1. Contribution of securities for the gift annuity**
2.

Capital gain taxable to Ruth in the year of the gift	$103,462

1.
2. **2. Contribution of securities for the charitable remainder annuity trust**
3.

Capital gain taxable to Ruth in the year of the gift	--0--

The $103,462 of capital gain that Ruth would have to report were she to fund a gift annuity would add about $15,000 to her tax bill that year. This cost might be enough to persuade her that funding a CRAT for Helen would be the wiser course.

Desire to Supplement a Retirement Plan

You may find yourself in conversation with a donor who mentions that he plans to retire in a few years. His ears perk up when you mention that there are gift arrangements that would enable him to fulfill his desire to establish an endowed fund at your organization and supplement the income from his existing retirement plan.

One option is a flip unitrust, a unitrust that starts out as a net-income charitable remainder unitrust (NICRUT) or a net-income with make-up provision charitable remainder unitrust (NIMCRUT), and then converts ("flips") to a standard CRUT after a triggering event. The triggering event could be a specific date, the sale of an unmarketable asset (such as real estate), or an event "whose occurrence is not discretionary with, or within the control of, the trustees or any other persons." (Reg. Sec. 1.664-3(a)(1)(c) and (d)).

A flip trust can be managed in such a way that little or nothing is paid out to the donor until he has reached his expected retirement age. After that, the trust flips to a standard CRUT and starts paying to the donor each year the standard percentage of its value, as determined annually.

For example, suppose Dr. Smith, age 60, tells you he plans to retire in ten years and would like to donate $250,000 in appreciated stock that he purchased for $50,000 some years ago. He mentions that he is contributing to his 401(k) the annual maximum amount allowable.

Dr. Smith could contribute his stock to a 5% NIMCRUT with a provision that causes it to flip to a standard CRUT when he turns 70. The amounts paid to Dr. Smith before and after the trust flips payment methods will depend on the trust’s investment returns. The trustee could focus on asset growth during the pre-flip period, earning perhaps 1% income and 5% appreciation each year. While payments would grow from just $2,500/year to $3880/year during the first ten years of operation under these assumptions, the trust would grow in value to over $410,000 by the time Dr. Smith retires. In this case, the trust payments in his first year of retirement would be about $20,300. Payments would continue to increase 1% per year if the trustee is able to maintain a net total investment return of 6% per year thereafter. Dr. Smith would receive a charitable deduction of $95,655 for funding this trust regardless of its future investment performance.

Advantages of a CRUT

- If the portfolio performs well, payments during retirement will be larger than those from a gift annuity.
- Possibly, a significant portion of payments will be taxed as capital gain rather than ordinary income, reducing taxes, because 1% current income will cover only a fraction of the 5% payout.
- Dr. Smith, if acting as trustee, will maintain control over investments.
- Additions to the trust can be made anytime.

With a traditional deferred gift annuity, a donor makes a contribution now and specifies the date one or more years in the future on which payments will begin. The amount of the payment, known in advance, is based on the age of the annuitant at the time payments start and then adjusted upward according to the length of time payments are deferred.

Suppose Dr. Smith contributes his $250,000 in stock in exchange for a deferred gift annuity with payments beginning at age 70. The ACGA rate would be 8.9%, which would translate to an annuity of $22,250. In addition, $1,960 would be tax-free during his life expectancy (15.9 years) and $7,850 would be taxed at favorable capital gains tax rates during the same period. He would earn a deduction of about $94,000 in the year of his gift. Under our investment assumptions, the payments and deduction for the flip CRUT would be similar.

It is possible to build flexibility into a deferred gift annuity, which could work well if Dr. Smith is unsure when he will retire. A flexible gift annuity would allow Dr. Smith to include a schedule of start dates and corresponding annuity amounts in his agreement. Once he is sure when he will retire, he would elect the payment start date that falls in the year he plans to retire as the date to begin receiving payments. The later the date he elects, the greater the annuity amount he will receive.

Dr. Smith could even create a bundle of flexible gift annuities, rather than just one, which would give him the ability to start payments in a staggered fashion or all at once, depending on his needs.

Advantages of a Charitable Gift Annuity

- Although the compounding rate during the deferral period is modest (4.5% today, 4.0% as of July 2011), it is guaranteed. The post-flip CRUT payments will depend on trust investment performance, which could be better or worse than the deferral period compounding rate.
- There is complete deferral of payments until the payment starting date. The charitable unitrust must make distributions in any year it earns net income.
- With a flexible gift annuity, the annuitant has more control over when payments begin than with a flip unitrust.

Conclusion

In some instances, the choice between a gift annuity and a CRT will be clear:

- The amount to be contributed is below the minimum required for a CRT.
- Your charity is not registered to issue gift annuities in the state where the donor lives.
- The donor wants to name three or more payment beneficiaries.

- Given the ages of the beneficiaries, the vehicle would fail to satisfy a legal requirement, such as the 5%-probability-of-exhaustion test that is applicable to CRATs only.
- The donor wants to retain influence over investment decisions.

In other cases, the donor will be able to choose either a CRT or a gift annuity. The donor's decision will be based on factors that may include:

- The amount of payments
- Taxation of payments
- Size of charitable deduction
- Perceived importance of security of fixed payments versus potential for income growth
- Type of asset to be contributed
- Setup cost and complexity of arrangement
- Timing of contribution and desired starting date of payments

By becoming familiar with a donor's goals and concerns, you will be able to help the donor decide whether a gift annuity or a CRT, or some other gift arrangement, will work best for her.