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Most donors choosing to establish gift annuities want to benefit the charity while also creating a certain stream of payments for themselves. Nevertheless, annuity payments can be made to any one or two persons regardless of their relationship to the donor(s).

### **Just Who Is the Donor Anyway?**

**The charity should be clear on the identity of the donor.**

For starters, the charity should be clear on the identity of the donor. For example, gift annuities are frequently established by married couples using jointly-owned or community property. Sometimes, however, an asset that two spouses regard as being owned by both of them turns out to be owned by only one, meaning that he or she alone is the donor (unless measures are taken to transform his or her separate property into property owned jointly).

Conversely, one spouse may not be aware that an asset he or she considers separate property is really owned jointly with the other spouse (although, once again, the two spouses can change the ownership if they wish). Furthermore, a donor claiming to want to donate “his” real estate in exchange for a gift annuity may need a reminder that the property is owned by a limited liability company or some other entity in which the donor has an ownership interest. In short, “donors” sometimes claim to own assets that are either not theirs at all or owned along with others.

### **Typical Non-donor Annuitant Scenarios**

Once it is clear who owns the assets to be used in establishing an annuity, a gift planner may learn that the donor has been providing supplemental financial support for an aged parent who has limited income. Other donors may regularly subsidize siblings who are struggling financially, and still others might like to provide for an employee or a friend.

Usually people who subsidize a parent, sibling, or other individual must do so with after-tax dollars. For example, a person who is subject to a 33% tax rate and is sending an aged parent \$500 per month must earn \$746 in order to provide that \$500 check.

In these cases, it can be advantageous to establish a gift annuity and name the parent, sibling, etc. as the beneficiary of the payments. With this arrangement, the donor retains the money that would otherwise be used to make gifts to the other person. The donor also receives a charitable deduction that may reduce current income taxes.

The tax paid by the annuitant will likely be minimal because a portion of the payments will be tax-free. Moreover, the taxable portion of the payments may be taxed at a low rate, depending on the annuitant's overall taxable income.

### **Possible Transfer Tax Implications**

The large gift and estate tax exemptions that have prevailed since 2011 remove gift and estate taxes (as well as the generation-skipping transfer tax) from play in the case of almost all donors. The gift planner must still keep in mind the threshold (\$5.34 million for each of the three types of taxes currently and adjusted for inflation in the years to come, recognizing that there is effectively a single threshold of \$5.34 million for gift tax and estate tax combined) in order to spot situations in which one or more transfer taxes will be an issue.

Some sort of default warning along the lines of "there may be gift and estate tax consequences for you, so please consult with your own advisors" is advisable, because a gift planner is seldom privy to all aspects of a donor's tax and financial situation. Ideally, the gift planner should make this known well before the time at which the donor is ready to proceed with establishing a gift annuity for the benefit of someone else.

When a donor's level of wealth makes it apparent that transfer taxes will definitely be an issue, the question of whether an annuitant is a member of the donor's family becomes significant. A particularly important distinction is whether an annuitant is the donor's spouse. Transfers to a U.S. citizen spouse enjoy an almost unlimited exemption from gift and estate taxes, the exception being that a lifetime gift of a future interest to a citizen spouse does not qualify for a gift tax marital deduction. Even with a present-interest transfer to a *non-citizen* spouse made during life, the

donor can take advantage of a special annual exclusion amount (\$145,000 for 2014 and indexed for inflation in the years to come). Somewhat more complex considerations apply in the case of a transfer to a non-citizen spouse upon death. Finally, different degrees of kinship can become relevant in connection with the generation-skipping transfer tax.

### **Common Cures for Gift Tax Ills**

**A properly structured gift annuity can help donors skirt gift tax issues.**

Fortunately, a properly structured gift annuity can help donors skirt gift tax issues. The solution is to include in the gift annuity agreement language that says, in essence, the gift of payments for life is not actually “complete.” The donor simply retains the power (presumably never exercised) to revoke the annuitant’s right to payments. If the donor predeceases the annuitant without ever having exercised the power, then the present value of future annuity payments (calculated as of the date of the donor’s death) is included in the donor’s estate, at which point estate tax might be owed.

Legally speaking, retention of the power to revoke payments transforms a one-time gift of the present value of a stream of lifetime payments into a series of much smaller gifts made one by one. So long as the total of the payments made in a calendar year is less than the standard gift tax annual exclusion amount (\$14,000 for 2014 and indexed for inflation in the years to come), no gift tax will be owed *and* none of the donor’s lifetime gift tax exemption will have been used.

Consider the following scenario:

*Bob contributes \$100,000 cash to his favorite charity to establish a gift annuity for his older sister, Opal, and the charity agrees to pay the immediate annuity rate of 8.4% suggested by the American Council on Gift Annuities for a person Opal’s age, which is 88. As a result, she will be entitled to receive \$8,400 each year for life in monthly installments of \$700 at the end of each calendar month. The present value of this annuity is \$39,198, calculated using a federal discount rate of 2.4%. Assume that Bob otherwise does not provide anything else of monetary value to Opal.*

*If Bob does not retain the power to revoke Opal's right to the annuity payments, he makes a one-time \$39,198 gift to her, although \$14,000 of this is offset by the gift tax annual exclusion, making the net amount of his gift only \$25,198.*

*If he does retain that power, however, he makes a gift to Opal of \$8,400 each full calendar year (and probably something less in the first and final years of the annuity arrangement, as they are likely to be partial years). Because \$8,400 is less than \$14,000, the gift annuity, by itself, does not result in Bob making a taxable gift during any of the years that Opal receives payments.*

*Note that if Bob were instead to have contributed only \$25,000 (i.e., one-fourth of \$100,000) for a gift annuity, there would be no need to retain a power of revocation for gift tax purposes because even the present value of the annuity (\$9,799.50, which is one-fourth of \$39,198) is less than the \$14,000 annual exclusion amount.*

*Of course, because the annual exclusion applies only to gifts of current interests, that exclusion is not available to offset the present value of the payments associated with a deferred annuity. For this reason a donor will normally retain a right of revocation in the agreement for a deferred annuity, even when the amount contributed is quite modest.*

## **Capital Gains Tax Implications**

If a gift annuity is to be funded with capital gain property, a gift planner must keep in mind that the taxable portion of the gain can be spread only over the life expectancy of any donor or donors receiving the annuity payments initially. This means that if a husband and wife establish a gift annuity with capital gain property they own jointly but annuity payments are made to only one of them initially, half of the taxable gain will be realized in the year of the gift.

Conversely, if a spouse uses his or her separate capital gain property to establish a gift annuity for the benefit of both himself or herself and the other spouse, the gain can be spread only over the donor spouse's life expectancy (assuming all of the gain can be paid out over that period). Thus, in such a situation, the annuity is best structured so that payments are made initially strictly to the donor spouse and then to the other spouse if he or she survives the donor.

In the case of an annuitant of a one-life gift annuity who is not the donor's spouse, or in the case of any two-life gift annuity in which payments are not made solely to the

donor initially, all of the taxable capital gain will be recognized by the donor in the year of the gift. This makes it worthwhile for a gift planner to work with the donor and any advisors to determine the extent to which the charitable deduction will be able to offset the capital gain recognized.

## **A Few Cautions**

In certain instances, the spirit of generosity that motivates a donor to establish a gift annuity for another person's benefit can lead to complications. One possible problem area is Medicaid eligibility. When a gift annuity is established to make payments to someone other than the donor, the annuitant's eligibility for Medicaid based on asset level is not going to be affected unless he or she retains a portion of the payments over time. By contrast, the annuitant's eligibility based on income level can be affected as soon as the first payment is made.

Accordingly, whenever a potential annuitant's Medicaid eligibility is known to be relevant, an elder law attorney representing the annuitant should be consulted before a gift annuity is established. The same holds true with respect to eligibility for other types of government assistance, such as subsidized housing.

In addition, when a gift annuity is established to benefit a current or former employee, some of the annuity payments can be categorized as employee compensation and therefore subject to withholding. For this reason, the donor (whether an individual or an entity, such as a corporation) should consult with a knowledgeable employment law attorney.

## **Conclusion**

A gift annuity can be a great way for a donor to provide support for another person. Being aware of potential tax issues, along with other considerations, will help gift planners talk things through with donors in an informed manner. Finally, keep in mind that both PG Calc's [\*Charitable Gift Annuities: The Complete Resource Manual\*](#) and our [\*Planned Giving Manager\*](#) software are sources for sample gift annuity agreements, many of which pertain to scenarios where the donor and the annuitant are not the same person.

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