

Sarah MacEachern - Tue, 11/20/2012 - 00:00

Funding a charitable gift annuity (CGA) with a retained life estate (RLE) in a personal residence or a farm can be an excellent gift from a charity's standpoint. It can also be a wonderful way for a donor to continue living in a place he or she has come to call home while using the home's value to generate a stream of payments for life.

However, with the discount rate attributable to Section 7520 of the Internal Revenue Code continuing to be ultra-low, those interested in pairing a RLE with a CGA should pay careful attention to a few issues unique to the current environment. Of course, even in more "normal" times the intricacies associated with this potentially attractive combination of planned giving vehicles will merit some special scrutiny.

Quick Overview of RLEs and CGAs

RLEs are a well-established yet not very common gift arrangement. They work as follows. The donor deeds a personal residence or farm to the recipient charity, while retaining the right to use the home or farm for life or, less commonly, a term of years. The donor receives an income tax deduction and pays no capital gains tax on any appreciation, but remains responsible for upkeep, taxes, and other expenses for the duration of the arrangement. When the life estate ends, the property becomes the charity's to keep or, more likely, sell. Exactly a year ago, the featured article in the eRate provided a solid orientation to RLEs. [That article](#) remains a helpful resource for anyone not already familiar with the many considerations associated with RLE gifts.

CGAs, by contrast, are a mainstay of many planned giving programs. Typically they are funded with either cash or publicly-traded securities. The donor receives an income tax deduction for part of the value of the assets contributed, and some of any gain in long-term appreciated assets completely avoids taxation. The annuitant (whether the donor or someone else) receives payments for life backed by all of the charity's unrestricted assets, and the payments are taxed favorably for many years. The older the annuitant at the time payments begin, the larger the fixed amount paid by the charity.

Marrying One Technique with the Other

Even though CGAs are in fact usually funded with cash or highly liquid assets, donors can sometimes contribute relatively illiquid assets such as real estate. Often when a gift annuity is funded with real estate, the entire property is contributed. In the case of a RLE-CGA combination, however, what's contributed is the remainder interest in the donor's residence. The donor retains the life interest, or life estate.

Thus, the charity needs to be willing not just to issue a CGA in exchange for a donation of real estate, but also to accept a particular kind of real estate gift. Whereas a charity that receives complete ownership of a property is free to sell that property or manage it to produce income (or use the property for its own charitable purposes), when it receives a remainder interest in a home or farm still being used by the donor, it must wait until the life estate terminates before it can do anything with the property.

To be sure, a remainder interest in a residence or farm has value, and owning that interest has a positive impact on the charity's balance sheet. Nevertheless, the charity should not count on being able to liquidate its interest readily, or even at all for the time being. Rather, it should be prepared to hold the interest until the life estate ends, recognizing that the value in question will fluctuate each year. Moreover, all the while it will have an annuity payment obligation, the present value of which will need to be shown as a liability on its books. That liability will decrease somewhat each year, although it will not reach zero until the end of the annuity.

From the standpoint of administering the CGA, if the charity must maintain a CGA reserve account in compliance with the laws of one or more states, it should be aware that not all states consider the remainder interest in a piece of real estate to be a permissible asset in terms of ensuring that the account balance is sufficient. Accordingly, the charity may need to transfer to its reserve account some of its unrestricted assets and then keep in that account all or a portion of what was transferred until the annuity obligation ends. Regardless, the charity will need to draw on unrestricted assets to make the CGA payments, as its remainder interest in the residence or farm will not be generating any income.

Selecting an Appropriate Annuity Rate in an Era of Low Discount Rates

For tax purposes, the law is clear about how to value the remainder interest in a personal residence or a farm. With the right information, PG Calc's *Planned Giving Manager* can make the calculations instantly. Specifically, a qualified appraisal

obtained by the donor must establish not simply the overall value of the property, but also how much of that value is attributable to the dwelling and other “improvements” made on the land in question, what the useful life of those improvements is, and what their salvage value will be at the end of that useful life. In addition, the calculation involves the age of the life tenant (or the number of years the life tenancy will remain in effect, if it is not to last for the full life of the life tenant), along with the all-important IRS discount rate.

When the IRS discount rate is very low, as it is currently and can be expected to remain for a while, the present value of the remainder interest in a residence or farm is unusually high. Here are the numbers associated with different IRS discount rates in the case of a life estate that would last for the lifetime of a person now age 80. Assume a residence valued at \$400,000, with the improvements accounting for \$250,000 of that value and having a salvage value of \$15,000 at the end of a 45-year useful life:

IRS Discount Rate	Present Value of Remainder Interest
5.0%	\$249,232
4.0%	\$265,978
3.0%	\$284,691
2.0%	\$305,680
1.0%	\$329,309

While most charities that offer CGAs wisely adhere to the maximum rates suggested by the American Council on Gift Annuities (ACGA), a charity is always well advised to consider offering a lower rate whenever something other than cash or highly liquid assets is contributed. How much the rate should be reduced depends on a number of factors, including especially the nature of the assets being contributed. Generally, a reduction of 10 to 20 percent is warranted when real estate is donated. That is, your charity might offer an 81-year-old donor a 6.3% annuity rate rather than the ACGA rate of 7.0%. When all the charity is receiving is a remainder interest in the real estate, the rate offered should reflect this additional consideration.

What’s more, when the calculated value of the remainder interest is likely artificially high due to the very low IRS discount rate required by law to be used, reducing the annuity rate further still may well be justified. For instance, looking at the numbers in the table above, were the charity’s hypothetical remainder interest valued in May

2011 (the last time the discount rate was 3.0%) rather than in November 2012 when the discount rate is only 1.0%, that interest would be assigned a 13.5% lower value. Again, this difference is attributable strictly to the variation in discount rates, as opposed to any characteristic of the underlying real estate.

Finally, it is indeed the annuity rate – not the present value of the remainder interest – over which the charity has discretion. By way of example, despite the fact that offering the ACGA rate but reducing the present value of the remainder interest by, say, 18% would produce the same annuity amount as reducing the ACGA rate by 18% and applying that rate to the present value of the remainder interest, the latter approach is the correct one. In practical terms, once you have used *Planned Giving Manager* to calculate the present value of the remainder interest, you enter the result as the value of the asset used to fund the gift annuity. You can then make an appropriate adjustment to the annuity rate in the Gift Options screen.

Tax Aspects of the CGA Element

If instead of funding a CGA with the remainder interest in a personal residence or farm, a donor were to contribute the life income interest in a charitable remainder trust (CRT), many commentators contend that in valuing the life income interest one must use the discount rate for the month in which the contribution is made. This is because the CRT income interest is a property right that already exists at the time it is exchanged for a CGA. In the case of a RLE-CGA arrangement, however, the remainder interest in the residence is created at the same time the CGA is established. Therefore, in order to determine the tax deduction and the taxation of payments in connection with the CGA, one must determine the present value of the remainder interest created simultaneously.

On the one hand, this means the donor can select the discount rate from among the rates associated with the month of the gift or either of the immediately preceding two months. On the other hand, the same rate must be used for both calculations. The donor cannot use one discount rate for one purpose and another discount rate for another purpose.

In light of the foregoing, before the gift is completed the donor and the charity should study the results of RLE and CGA calculations made using each possible discount rate. Even though the lower the discount rate the lower the deduction associated with a CGA, the increase in the present value of the charity's remainder

interest in the RLE attributable to a lower discount rate may completely offset this consideration. Moreover, the charity might be willing to reduce the annuity rate somewhat less if the donor uses a somewhat higher discount rate. In short, there can be a total of three interrelated variables: the discount rate, the value of the remainder interest, and the annuity rate offered by the charity.

Presumably, the personal residence or farm will have increased in value during the years the donor has owned it. Accordingly, the portion of the property's cost basis attributable to the charity's remainder interest in the residence or farm will need to be taken into account in calculating how much capital gain will be recognized as a result of the annuity being established. Assuming the donor is also the annuitant, that gain can be prorated over life expectancy. In addition, if the property is the donor's principal residence (as opposed to a vacation property), the exemption from taxation of capital gain upon the sale of a principal residence provided for by Section 121 of the Internal Revenue Code will be available to the donor (or, if applicable, the donor and spouse). The reason for this is that a CGA is a form of bargain sale.

Provided the exemption is greater than or equal to the taxable gain, the donor should structure the gift in a way that results in recognition of all of the gain in the year of the gift and then use the exemption to offset the gain. (This forced recognition of gain can be accomplished either by having the CGA agreement permit assignment of the annuity or by having the charity purchase its remainder interest in the RLE for cash, with the donor then using that cash to fund the CGA.) If, however, there is more gain than there is exemption, the exemption will need to be used over time as annuity payments are made. It appears this can be done by taking either of two approaches. One would be to use a prorated portion of the exemption during each year capital gain is reportable, in which case there will be some taxable capital gain to report each year. Alternatively, the donor-annuitant could use each year as much exemption as there is taxable capital gain until the exemption has been used completely, in which case there would be no capital gain to report for many years, followed by a few years during which all of the remaining prorated capital gain would need to be reported and taxed.

Finally, if the personal residence or farm is subject to a mortgage, then using a remainder interest to create a CGA will result in a two-dimensional bargain sale, regardless of whether the charity assumes the mortgage debt. This makes the tax calculations more complicated.

Conclusion

Complexity and potential pitfalls notwithstanding, funding a CGA with a RLE can be a suitable gift from a charity's standpoint and an attractive way for a donor to continue living in his or her home while using the home's value to generate a stream of payments for life. The arrangement can even be used on a testamentary basis by a donor who wants to provide for the well-being of a surviving relative, particularly a spouse. As with each of these gift techniques by itself, combining the two techniques will likely be most attractive to older donors, those perhaps age 75 and above. Moreover, with the ACGA's annuity rates being quite low and with a good measure of the inflation in real estate prices having disappeared in the last few years, now could be an especially realistic time for a charity to promote such gifts. And so much the better for the charity if in the coming years real estate values escalate.

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