RETIREMENT PLANNING
WITH
CHARITABLE REMAINDER UNITRUSTS
AND
DEFERRED CHARITABLE GIFT ANNUITIES

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RETIREMENT PLANNING WITH CHARITABLE REMAINDER UNITRUSTS AND DEFERRED CHARITABLE GIFT ANNUITIES

Many donors do not need current income but are interested in strategies which will allow them to receive income in later years – often in retirement, when they no longer have income from compensation. Deferred charitable gift annuities, spigot charitable remainder trusts, and FLIP charitable remainder unitrusts in some ways resemble retirement plans – yet they are not subject to minimum distribution, mandatory coverage or other rules that often limit the usefulness and attractiveness of qualified retirement plans.

I. Charitable Remainder Trusts

A charitable remainder trust ("**CRT**") makes regular distributions to one or more beneficiaries for their lives or for a set term of 20 years or less. The distributions must equal at least 5% of the value of the CRT but no more than 50%. When the CRT terminates, the remaining assets in the CRT pass to one or more charities. The present value of the remainder interest that will ultimately pass to charity must be at least 10% of the value of the CRT at the time of funding.

The CRT is a tax-exempt trust so can sell appreciated assets with no taxable capital gains. The individual beneficiaries realize and pay tax on the CRT's ordinary income and capital gains over the years as they receive distributions from the CRT. Thus, for example, the capital gains tax the donor would otherwise become liable for on the sale of a low basis asset is deferred and paid over several years. In the meantime, the net proceeds of the sale by the CRT are available to be invested within the tax-exempt CRT.

II. Types of Charitable Remainder Trusts

A. Charitable Remainder Annuity Trust

A charitable remainder annuity pays the income beneficiary a fixed percentage of the initial value of the charitable remainder annuity trust ("**CRAT**"). The pay-out never goes up or down, and additional assets cannot be transferred to the CRAT. The value of pay-out decreases due to increases in the cost of living. CRATS appeal primarily to older donors who like the fixed regular distributions. If income is insufficient, the shortfall is paid from principal. No additions to a CRAT can be made after the initial funding.

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B. Standard Pay Charitable Remainder Unitrust

A standard pay charitable remainder unitrust pays the individual beneficiary a set percentage of the value of the charitable remainder unitrust ("**CRUT**") as determined annually. Distributions are made first from income and then from principal.

C. Net Income Charitable Remainder Unitrust

A net income charitable remainder unitrust ("**NICRUT**") pays the individual beneficiary whichever is less of (i) a fixed percentage of the value of the NICRUT, which is determined annually or (ii) all of the net income of the trust. The percentage pay-out must be 5% or more. If the NICRUT has no income, the individual beneficiary receives no distributions.

D. Net Income with Makeup Charitable Remainder Unitrust

A net income with makeup charitable remainder unitrust ("**NIMCRUT**") is the same as a NICRUT except that the trustee keeps track of the difference between the specified percentage pay-out and a lesser amount of income actually available for distribution. This make up "account", for example, would reflect a 2% shortfall if the NICRUT had a pay-out of the lesser of 5% or the actual net income and the actual net income was only 3%. With a NIMCRUT, when an illiquid asset is sold, a makeup payment, equal to capital gains from appreciation after the inception of the NIMCRUT, is made to the income beneficiary.

E. FLIP Charitable Remainder Unitrust

A Flip CRUT converts from a net income or net income with makeup charitable remainder unitrust to a standard pay unitrust. It is usually the best option if a CRUT is to be funded with real estate, an interest in a family business, or any other illiquid asset and is discussed at length below.

III. Taxation of CRUT Distributions

The CRUT itself is tax exempt, so its income (other than unrelated business taxable income) is not taxed until distributed to the individual beneficiary. Characterization of income in the hands of the individual beneficiary is on a worst in – first out basis.

For years, it was tiered as follows:

Tier 1: Ordinary income of current year and undistributed from prior years.

Tier 2: Long term capital gains of current year and undistributed from prior years.

Tier 3: Tax exempt income of current year and undistributed from prior years.

Tier 4: Return of principal.

With the addition of the 3.8% tax on net investment income, and differences in income taxation of qualified and nonqualified dividends, the worst in-first out tiering has become far more complicated. Now, within each tier, there are sub-tiers so that income taxed at a higher rate within a tier is deemed to come out before income in that tier that is taxed at a lower rate. Income accumulated before January 1, 2013 is completely grandfathered from being included as IRC Section 1411 net investment income. Starting with net investment income earned in 2013, it is factored in, and the income beneficiary pays tax on it at higher rates. See **Exhibit A** for the current tiers.

IV. Flip Unitrust Retirement Planning

A. Flip Unitrusts

Treasury Regulations under IRC Section 664 (Section 1.664-3(a)(1)(i)(c) issued in 1998) permit a charitable remainder unitrust ("CRUT") to begin as a net income or net income with makeup unitrust and convert, or "flip", to a standard pay unitrust upon the occurrence of a "triggering event" specified in the trust instrument.

1. Prior Law

Before 1998, it was nearly always necessary to utilize a net income CRUT (typically with makeup provisions for any deficiencies) when the trust was funded with an illiquid asset. Otherwise, it would be difficult to meet the periodic distribution requirements of a standard pay trust. The disadvantage of a net income CRUT, however, is that distributions must come solely from income, typically defined either in the trust

instrument or under state law as rents, dividends, interest and royalties. Trust income represents the yield in an investment. A portfolio that seeks to maximize yields is likely to be heavily concentrated in fixed income instruments, including bonds, notes and certificates of deposit. While providing reasonable income, the portfolio will enjoy little growth, if any. In a market where yields are low and growth high, the returns will be adversely affected. Thus, the price of investing for current income is loss of substantial appreciation of the corpus.

A standard pay CRUT has the disadvantage of requiring distributions, even if the trust assets are illiquid. But, when practical under the donor's circumstances, a standard pay unitrust is likely to show the greatest overall return, with the least risk, since it can invest in a more balanced and diversified portfolio consisting of equities and fixed instruments. Distributions can be made from income (such as interest and dividends), realized gains and principal. In most cases, a portfolio that grows in value will return a better unitrust amount to the individual beneficiary than a portfolio that is fixed in value. Since the individual beneficiary receives a pay-out equal to a fixed percentage of the value of the unitrust, as determined annually, the individual beneficiary receives more over the long run if the value of the corpus appreciates. Recognizing the advantages of a standard pay arrangement, some donors were willing to use this type of trust, even though the primary contribution was illiquid, and to add cash or publicly traded securities in order to have sufficient cash for the mandatory distributions.

2. Flip Defers Pay-outs

Using a flip trust, a donor may contribute an illiquid asset (such as real estate or closely held stock) to the CRUT without the pressure of a forced sale or the necessity of contributing additional cash or other liquid assets with which to make the pay-out distribution. When the illiquid asset is sold, or at some specific date outside the control of the settlor, the trustee or the individual beneficiary, the proceeds may be reinvested in a broad, balanced portfolio from which distributions may be made. The ability to use the settlor's retirement age as the triggering event makes the flip unitrust suitable for retirement planning.

B. Flip Design

1. Triggering Event

Under the final regulations, a net income or net income with makeup CRUT may convert or "flip" to a standard pay CRUT upon the occurrence of certain conditions. The trust must provide that it will use the "income only" method until the occurrence of a permissible triggering event. The flip event must be stated in the governing instrument and triggered on a specific date or by a single event the occurrence of which is outside of the control of the donor, the income beneficiary or the trustee. Examples of permissible triggering events include (i) the sale of an unmarketable asset; (ii) a birth or death; (iii) a marriage or divorce; or (iv) a date certain, such as the date of the donor/individual beneficiary's 65th birthday. It is unclear whether, for example, the date of the donor's retirement could be used, since this is arguably within the donor's control for purposes of these rules.

Impermissible events relate to occurrences that are within the discretion of some person. For instance, the sale of an unregistered security for which there is no available exemption permitting public sale is a sale of an "unmarketable" asset and a permissible triggering event. However, the sale of publicly traded stock is not a permissible triggering event, because the stock is readily marketable and the decision to sell is within the discretion of the trustee. A request by the income beneficiary or by the income beneficiary's financial advisor is likewise not a permissible event.

2. Multiple Triggers

Planners should consider the creation of multiple flip triggers in a trust document, which should provide that the trust would no longer be subject to the net income limitation at the earlier to occur of two or more events. Multiple flip triggers are anticipated in the examples contained in the regulations under section 664.

> **Example:** Assume that the primary source of funds for the living expenses of a husband and wife is the salary earned by the husband. The plan is to establish a NIMCRUT funded with appreciated publicly traded securities, with distributions deferred until the husband's income drops following his planned retirement at age

70. However, should he die before that time, the wife will need the increased income sooner. The flip provision in the trust might provide that the net income limitation will end on the earlier of the death of the husband or the husband's attaining age 70.

3. Forfeiture of Makeup Amount

The unitrust pay-out must convert exclusively to a fixed percentage of the trust assets (standard pay) on January 1 of the calendar year following the year in which the triggering event occurs. Any makeup amount is forfeited when the trust converts to a standard pay unitrust. Therefore, if there is a substantial deficiency account, a triggering event early in the year will be preferable because it will permit all or some of the makeup amounts to be distributed before the flip occurs.

4. Relationship Between Flip Trigger and Fiduciary Accounting Income

The flip unitrust may have a deficit account at the time the triggering event occurs because the net income in prior years was less than the unitrust amount. The planner must consider whether the triggering event (such as the sale of an unmarketable asset) will, by itself, generate fiduciary accounting income that will be distributed from the deficit account. While this may be consistent with planning objectives, an alternative objective might be for the trust to convert to a standard unitrust without distributing the deficit account. In this case, it would be better if the triggering event generated no fiduciary accounting income, or at least less of it.

Example: A flip unitrust holds an interest in an investment partnership between the trust and its grantor. The trust document provides that the trust will convert from a net income unitrust to a standard unitrust in the first year following the sale or exchange of all, or any part, of the trust's interest in the partnership (an unmarketable asset under the regulations). The gain realized by the trust from the sale of an interest in the partnership (the triggering event) would normally be allocated to principal (subject to the power of a non-beneficiary trustee to reallocate). This would mean that no fiduciary accounting income would be

generated in the year of the triggering event, with the deficit account effectively left in trust. On the other hand, if, in the year of the triggering event (presumably prior to the sale), the trust receives a distribution from the partnership equal to its deficit account, this distribution will be allocated under the normal rules to income, not principal. In this case, the distribution from the partnership would in turn allow distribution of the deficit account to the income beneficiary.

V. Retirement NIMCRUTs

A non-flip NIMCRUT can also allow the deferral of distributions of cash to the income beneficiary until the donor requires the cash. Until that time, interest, dividends, capital gains, and other investment returns can be held for reinvestment in the tax-exempt environment of the CRT. To effectively achieve this objective, it is necessary to have a means by which fiduciary accounting income can be controlled, since the NIMCRUT will not be required to make distributions unless and until it realizes receipts allocated to income under the fiduciary accounting system.

The choice of investments by the trustee provides the means by which fiduciary accounting income may be controlled. Although other investment vehicles have been tried by trustees over the years, the planning community has settled on two as the most effective: (i) variable annuity contracts issued by insurance companies and (ii) interests in investment partnerships.

A. Revenue Procedure 97-23

In April 1997, the IRS issued Revenue Procedure 97-23 to expand the areas in which rulings will not be issued to include the following:

> "Whether a trust that will calculate the unitrust amount under §664(d)(3) qualifies as a §664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, trustee or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under §643(b) and income

for federal income tax purposes for the benefit of the unitrust recipient."

The revenue procedure explained that the IRS and Treasury will study whether creating or using net-income unitrusts to control the timing of the trust's receipt of trust income causes the trust to fail to function exclusively as a charitable reminder unitrust, a pre-requisite for qualification as a CRT. In the years since the issuance of Revenue Procedure 97-23, nothing further has been heard of the study that was to be conducted, leading cynics to suggest that the IRS never intended to conduct a study, but instead accomplished its objective by creating uncertainty in the minds of donors and their advisors considering the use of partnership interests or variable annuity contracts as devices to time the receipt of fiduciary accounting income by a NIMCRUT. While planners were encouraged by the Technical Advice Memorandum (TAM) discussed below, at least in the case of variable annuities, the revenue procedure nevertheless continues to cause concern.

B. Variable Annuity Contract

The device most commonly used to time the income of a retirement NIMCRUT is a deferred annuity contract purchased by the trustee from an insurance company. The CRT will not realize fiduciary accounting income unless and until the trustee elects for the trust to receive a withdrawal from the annuity contract. Variable annuity contracts are not only a reliable device for timing the realization of income, they typically allow for investment within the contract in a variety of portfolios with different investment objectives. However, after years of experience with this device, planners have recognized some limitations with use of the annuity contracts to time the income of NIMCRUTs.

1. Withdrawals Are Ordinary Income

All withdrawals from an annuity contract are ordinary income, filling tier 1 of the CRT and, therefore, characterizing all distributions from the NIMCRUT as ordinary income until tier 1 is exhausted. This can have the negative effect of converting long-term capital gain into ordinary income, reverse alchemy in the world of tax planning, in situations where most of the investment return within the annuity contract results from realized capital appreciation rather than interest or dividends.

2. Limitation on Investments

The insurance company issuing the annuity contract may also limit the types of investments that may be purchased within the annuity contract. As investors and their advisors have become more sophisticated, they increasingly seek alternatives to publicly traded stocks and bonds, such as real estate, hedge funds and private equity opportunities that are typically not offered by the insurance companies providing these annuities.

3. TAM 9825001

Following Revenue Procedure 97-23, there was considerable anxiety in the advisor community that the investment of NIMCRUT assets in a variable annuity contract might disqualify the trust. These advisors were also concerned, based on internal IRS training materials, that this type of investment might constitute self-dealing. Both issues were raised in Technical Advice Memorandum 9825001, involving a classic retirement NIMCRUT invested in variable annuities. These issues were apparently raised in an examination of the tax returns of either the donor or the trust, and technical advice from the IRS national office was requested. The TAM analyzed the self-dealing issue at length before concluding that this type of investment, *even if done for the purpose of creating a device to time the realization of fiduciary income*, did not constitute self-dealing. It dealt with the qualification issue more summarily, merely concluding:

> "The purchase of the deferred annuity contracts does not adversely affect the trust's qualification as a charitable remainder unitrust under section 664 of the Code and the current regulations thereunder."

Planners who had been hesitant to recommend retirement NIMCRUTs after the release of Revenue Procedure 97-23 were once again encouraged to do so after the apparent change of thinking within the IRS just six months later, in the context of a real-life fact pattern raised in the TAM.

C. Partnerships

Another widely used NIMCRUT investment device to control the timing of fiduciary accounting income is a partnership interest. In the simplest variation, the trustee of the trust forms a partnership with the donor. NIMCRUT assets are contributed to the partnership, which then buys, sells, and holds investments. The underlying concept, now codified in the Uniform Principal and Income Act, is that the NIMCRUT will not have fiduciary accounting income except when, and only to the extent that, the trust receives distributions from the partnership. In some ways, the partnership is a more flexible income-timing device than the variable annuity contract.

1. Long Term Gain Characterization

The partnership is a conduit for tax purposes, with taxable income flowing through to the partners under IRC Sections 701-702, whether or not distributed. The important point is that the income retains its character when passing through the conduit, so that long-term capital gains realized by the partnership go into tier 2 of the NIMCRUT. Unlike a NIMCRUT that invests in a variable annuity, a NIMCRUT that invests in a partnership interest is able to distribute long-term capital gains.

2. Investment Flexibility

The unitrust partnership also allows more investment flexibility than the annuity contract since there is no insurance company or other third party setting guidelines or restrictions on allowable investments. The partnership is free to invest in private equity, hedge funds, real estate, or other investments that might not be allowable in a variable annuity, limited only by the prudent investor rules.

Notwithstanding this greater flexibility, the use of a partnership as a NIMCRUT income-timing device raises other issues that planners must consider, including the following.

3. Incomplete Deferral of Income

The deferral of income that is a key element of retirement NIMCRUT planning will necessarily be incomplete. For example, if the partnership is between the trust with a 99% interest, and the donor with a 1% interest, only 99% of the income of the

partnership will be deferred. Moreover, since distributions from the partnership are contrary to the objective of deferral, the individual holding the 1% interest may be in the position of recognizing taxable income without receiving from the partnership any distribution of funds that could be used to pay the tax on that income.

4. Type of Partnership

Some planners have recommended a limited partnership as the investment vehicle for deferral of NIMCRUT planning. However, the same valuation adjustments that have resulted in discounting the fair market value of limited partnership interests for gift and estate tax purposes could have a negative impact in the case of NIMCRUT planning. The trustee (or qualified appraiser if the trustee is the income beneficiary) might be forced to discount the value of the limited partnership interest when calculating the unitrust amount, thus slowing the growth of the deficit account from which distributions may be made in the future. The valuation discounts, an accepted principle of tax planning, have led some NIMCRUT planners to instead focus on general partnerships that would result in smaller discounts.

D. Limited Liability Companies

One problem with the unitrust partnership is that the deferral of taxable income is incomplete: There is “leakage” of phantom income to the extent of the percentage interest held by a taxable person or entity. One alternative that eliminates this problem is a limited liability company (LLC) organized under the law of a state that allows single member LLCs. A single member LLC has some obvious attractions.

1. Complete Income Deferral

The deferral of income is complete since all LLC income flows through the conduit to the NIMCRUT as the sole member.

2. No Tax Return

Unlike a partnership, no separate tax return is required for the single member LLC since its existence is ignored for tax purposes.

One area of concern which has restrained many planners from recommending a single member LLC as an income-timing device for a retirement NIMCRUT, is that this type of entity is ignored for federal income tax purposes. Even though the entity may have a separate existence under state law – for example, to protect the CRT from liability – the concern is that the IRS might disregard its existence, making deferral impossible since income recognized by the LLC would be deemed recognized by the NIMCRUT.

VI. Deferred Charitable Gift Annuities

A. Charitable Gift Annuities

A charitable gift annuity ("**CGA**") is a contract established with a charity that allows a donor to transfer assets to the charity in return for a partial income tax charitable deduction and a fixed income for the donor's lifetime. After the donor dies, the charity keeps the remainder of the gift. CGAs can often be established for as little as $10,000.

1. Donor Profile

A CGA is an effective option for individuals who require income and want to support only one charity by donating easy-to-liquidate assets, such as cash or publicly traded securities. Retired donors like the reliable fixed amount of the annuity payments, which are often higher than what they could get from a savings or money-market account, particularly in a low-interest environment. Younger donors are far less likely to invest in a CGA because inflation will decrease the value of the annuity payments over time.

2. Income Tax Deduction

If the donor itemizes his or her deductions, the donor can claim a federal income tax charitable deduction for a portion of the amount transferred to the charity in exchange for a CGA. The deduction is equal to the amount of the contribution less the present value of the payments that will be made to the annuitant(s). The present value of the payments is determined using life expectancy tables and assumed earnings prescribed by the IRS.

3. *Taxation of Annuity Payments*

If the donor funds a gift annuity with cash, part of the payments will initially be taxed as ordinary income and part will initially be considered tax-free. If the donor funds the gift annuity with appreciated securities or real estate owned more than one year, part of the payments will be taxed as ordinary income, part as capital gain, and part may be tax-free. In most instances, the payments will eventually be taxed as ordinary income.

4. *Pros and Cons*

Criteria	Characteristic	Details
Tax efficacy	Limited	Due to income received from annuity, deduction is limited and generally equal to amount of the contribution minus the present value of payments to be made to the donor during his or her life. Donating appreciated assets can provide additional tax advantages.
Cost	Low	Minimal costs.
Control	Minimal	The donor chooses an organization to receive the donation; then the charity controls the assets/ decision-making.
Distribution to charity	Restricted	Limited to one organization, which the donor chooses.
Legacy options	Some	At death or end of the annuity contract, the remaining assets go to the sponsoring charity.
Recognition v. anonymity	Some flexibility	Can remain anonymous to public but not to the sponsoring organization.

B. Popularity of CGAs

The American Council on Gift Annuities (ACGA) has recently released its report of the 2017 survey of Charitable Gift Annuities (CGAs). One interesting trend revealed by the data is that the number of CGA contributions has increased steadily every year since 1994. This is probably due in part to the fact that the past five years have been

a period of historically low interest rates, and CGAs are often more attractive to donors in a low interest rate environment.

1. Security

Another important reason donors prefer CGAs is security. Unlike a trust, where the life income beneficiary depends on the assets of the trust and the yield generated from those assets for payment of the income stream, a CGA represents a direct obligation of a charitable institution that the donor knows and trusts. A gift annuity pays the income beneficiary a fixed annual amount, so the annuitant need not be concerned with the investment results obtained by the charity. Moreover, unlike a trust, where the principal may be exhausted if the income distribution exceeds the yield derived from trust assets, an annuitant is not concerned that the annuity will terminate earlier than planned. The annuity payments will continue for the life or lives of the named annuitant or annuitants, backed by the full credit-worthiness and required reserves of the issuing organization.

CGAs are subject to regulation by state insurance commissioners that require sponsoring charities to maintain sufficient reserves to make the annuity payments to the donors and to invest their annuity funds prudently.

2. Simplicity

The popularity of CGAs has increased over the past 15 years, in part because they are also very popular with charities. One reason for this popularity is that donors and charities have found that it can be expensive to develop and document a charitable remainder trust. For this reason, charitable remainder trusts are often reserved for larger life income gifts. A CGA is often preferred by a donor over charitable giving vehicles utilizing a trust, such as a pooled income fund or charitable remainder trust, for a variety of reasons. The first, and often the most important, is simplicity – the donor does not need to read through or pay for a long and complicated trust instrument. A CGA is usually documented with a very short (one-or two-page) contract.

Current representative ACGA recommended rates for single life and joint and survivor annuities are attached as **Exhibit B**. A sample gift annuity contract is attached as **Exhibit C**.

C. Popularity of Deferred CGAs

A deferred gift annuity is a contract under which a funded gift annuity does not commence making annuity payments for several years. The ACGA 2017 Survey Report confirms that the vast majority of gift annuities commence payments to the annuitants immediately. However, the percentage of total annuities that are deferred gift annuities has grown steadily from 5.8% in 1994 to 12% in 2017.

One reason for the increase may be that as donors reach the age at which many deferred gift annuities are funded – around 60 – many are focused on retirement saving as their principal financial planning objective. These donors are confronted with the relatively low limits for contributions to qualified retirement plans like IRAs and 401(k) plans. Contributions to fund deferred CGAs may be viewed as an attractive way to supplement retirement income while making a charitable gift in the process.

One of the few negatives of a deferred gift annuity as a supplement to other retirement income is that most people cannot accurately predict in advance when they will retire. The flexible deferred gift annuity allows an annuitant to decide later when to start payments, rather than requiring the donor to select a payment starting date at the time of the contribution. The longer the annuitant waits, the larger the annuity payments will be.

The survey reveals that 32% of the responding charities had completed a flexible deferred annuity – up from 5% in the 1999 survey. Private Letter Ruling 9743054 first approved the flexible deferred annuity in 1997, and PLR 200449033 issued in 2004 reinforced the earlier ruling, demonstrating that the position of the IRS had not changed.

D. Deferred CGAs for Retirement Planning

A deferred charitable gift annuity offers flexible retirement planning to donors. The same benefits to the donor and charity of a CGA are available with a deferred charitable gift annuity ("**DCGA**"), in which the starting date for payments to the annuitant is deferred to some point in the future. Creative gift planners and financial planners may use the DCGA to achieve a broader range of philanthropic and financial planning objectives of a donor.

The standard charitable gift annuity, with payments beginning immediately, addresses a financial planning objective that is very common to the older donors typically served by a planned giving program – a predictable and secure income stream. By addressing different financial planning objectives – all of which involve the timing of an income stream to a requirement that is likely to occur in the future – the DCGA is often appropriate for donors younger than those who are typically considered planned giving prospects.

1. Tax Aspects of Deferred Gift Annuities

Deferring the starting date of a gift annuity affects the tax consequences of the gift for the donor. On the positive side, the charitable contribution deduction is typically greater since enjoyment of the benefit from the charity is delayed. On the other hand, a smaller portion of each payment under a DCGA may be excluded from gross income, since the exclusion ratio for a DCGA is typically less than the ratio for a standard gift annuity.

> **Example:** Max, age 50, received in January of this year a bonus from his employer of $100,000 in recognition of his outstanding performance last year. He has no current need for additional income but would like to provide increased income for retirement at age 65, while making a gift to his alma mater. The college agrees to pay Max an annual annuity of $7,500 beginning at age 65 in exchange for a contribution of $100,000. Max will be entitled to claim a charitable deduction this year of $32,867, which is the value of the gift to the charity. Of payments in the amount of $7,500 annually, $4,126 will be ordinary income and $3,374 will be tax-free recovery of Max's investment in the annuity contract.

The DCGA is addressing a similar financial objective to that typically addressed with a standard gift annuity – funding a source of retirement income. The difference is that, unlike the annuitant of a standard annuity, Max is not yet ready to retire. As a younger donor, his financial planning objective is slightly different - to fund a source of retirement income when he needs it at his anticipated retirement age. A description of the procedure for calculating deferred gift annuity rates is at **Exhibit D**.

E. DCGA Retirement Plan Supplement

It is a basic principle of financial planning that the best way to save for a future financial objective, such as retirement, is to initiate a methodical system of savings and investment. The DCGA can be the basis for a retirement savings plan for charitably inclined individuals. The DCGA compares favorably with other types of retirement savings when one takes into account the limits on contributions (and deductibility of contributions) to IRAs and the limits on contributions to other retirement plans, including employer-sponsored 401(k) plans.

1. Serial DCGAs

The DCGA retirement plan supplement is intended to achieve the same financial planning objective Max had in the example above – purchasing a DCGA today to provide retirement income beginning at some distant point in the future. The difference is that, instead of purchasing a single large DCGA, this program anticipates annual purchases of smaller DCGAs, corresponding to the amount that the donor is capable of setting aside each year toward the goal of funding retirement income. Each DCGA contract would provide for payments to be deferred until the anticipated retirement years. This use for DCGAs is illustrated in the following example:

> **Example:** Ann is the planned giving officer for a nonprofit hospital system. She has taken on the task of developing planned gifts from members of the hospital medical staff. A common complaint from the doctors is that one of their primary financial planning objectives is to provide for a secure retirement. They find it difficult to set aside enough to provide the income they will need at retirement if they are forced to save with after-tax dollars. This is exactly what they are told by many of their financial advisors if they have "hit the ceiling" on pension contributions. Ann designs a DCGA retirement supplement plan based on annual contributions. Each year's contribution to the plan will be used to buy a DCGA from the hospital. Each DCGA will provide payments to begin when the participating doctor reaches retirement age. She comes up with a plan that can be easily presented to the entire medical staff, in which the majority of contributions are tax deductible. She first presents the plans to Dr. Kathy, a successful surgeon who is 45 years old. Dr. Kathy has learned that she

can no longer make deductible contributions to her retirement plan or IRA, yet she would like to continue to set aside funds for retirement at age 65. Ann proposes to establish a five-year plan (that may be extended at Dr. Kathy's option) to methodically set aside funds used to purchase DCGAs that will be payable over Dr. Kathy's retirement years. Dr. Kathy feels she can afford to set aside $25,000 per year for each of the next five years.

Ann has shown Dr. Kathy a system for setting aside $125,000 toward retirement, over a period of five years, the majority of which will be tax deductible. If this system is followed, Dr. Kathy will create for herself retirement income of $11,000 per year, payable during her life and backed by the full financial strength of the hospital system. Dr. Kathy is impressed, but she wants to know how the DCGA retirement plan supplement compares with setting the same amount aside each year in a traditional savings and investment plan. She wants to start the plan right away when Ann tells her she would need to earn substantially more after tax on her investments to achieve the same retirement income. With the DCGA retirement plan supplement, the account is also protected from Dr. Kathy's creditors as it accumulates, as with a multi-participant qualified retirement plan. This offers an advantage over a SEP-IRA or other single member plan often used by doctors and other professional sole practitioners.

2. Elective Starting Date DCGA.

One problem with saving for retirement is that most people don't know exactly when they will end up wanting to retire. While the example of Dr. Kathy demonstrates the financial benefits of using a DCGA as a retirement plan supplement, it would be even better if the donor/annuitant could retain the right to elect the commencement date of the payments under the annuity contract. The feature of an elective starting date adds tremendous flexibility to the DCGA being used as retirement plan supplement.

3. In PLR 9743054, the IRS approved a deferred annuity in which the donor does not have to choose in advance the starting date for payments. That decision can be made later, depending on circumstances. The older the donor (or other annuitant(s)) when payments begin, the larger the payments.

Example: On July 1, 2019, Allen, who is age 50, contributes $25,000 for a flexible deferred gift annuity. The gift annuity agreement allows him to start his quarterly payments on March 31 of any year not earlier than 2024 (age 61) nor later than 2034 (age 71). The amount of payments is based on the year in which payments begin per the following schedule.

Date Payments Begin	Age	Annual Payment Amount
3/31/24	61	$1,100
3/31/25	62	1,125
3/31/26	63	1,125
3/31/27	64	1,150
3/31/28	65	1,175
3/31/29	66	1,200
3/31/30	67	1,200
3/31/31	68	1,225
3/31/32	69	1,250
3/31/33	70	1,275
3/31/34	71	1,325

The IRS has ruled that such a contract meets the definition of a gift annuity as described in IRC Section 501(m)(5), that issuance of gift annuities of this type will not result in income from an unrelated trade or business as defined in IRC Sections 511 through 513, and that the investment of annuity funds will not be unrelated debt financed income under IRC Section 514.

The request for a private letter ruling proposed claiming the smallest charitable deduction that would result from any beginning date, and this was approved.

Planned giving software programs that now include the flexible deferred gift annuity calculations provide the following information:

- A schedule of payments based on ACGA rates (or others entered by the user).
- The charitable deduction (which is the lowest deduction that would result from a deferred gift annuity with any of the possible starting dates).
- A schedule of how payments would be taxed for each of the possible beginning years. This schedule should be kept on file by the Gift Annuity Administrator, for the information will eventually be needed to complete the Form 1099R.

4. The Amount of the Deduction.

As with other charitable gift annuities, the donor will be entitled to deduct the difference between the value of the property transferred to the charity and the value of the annuity contract received in return. The only difference in this situation is that this calculation might yield a lower deduction at some starting dates than at others. This might happen, for example, if the charity wanted to offer an elective starting date DCGA to be funded with $100,000 by a donor/annuitant currently age 50. Referring to the rates recommended by the American Council on Gift Annuities effective July 1, 2017, the charity determines that if the annuitant elects to start the annuity payments at age 65, the charity is willing for the annuity obligation to be $7,500 and if the annuitant wants to wait and begin receiving payments at age 75, the annual annuity obligation would be $12,800. But in calculating the value of the annuity contract for tax purposes, to determine the amount of the charitable deduction the donor may claim, the valuation of the annuity contract would result in a deduction of $32,867 if the earlier starting date is elected and a deduction of $51,428 if the later starting date is elected. For this reason, the donor must accept the lower deduction, since the gift is reduced by the maximum value that the annuity contract could have, determined by the starting date that could be elected. In this example, the charity’s acknowledgment to the donor should reflect a gift of $100,000 offset by an annuity contract valued at $35,855.

5. Two modifications of the typical gift annuity agreement are necessary:

The “Payment of Annuity” paragraph should reference an attached schedule on which the amount of payments for each possible beginning year is listed.

There should be an “Election of Commencement Date” paragraph with language such as the following: “To elect irrevocably the commencement date of payments hereunder, which shall be the last day of March and which shall not be earlier than March 31 [15 years from now] nor later than March 31 [20 years from now], the Donor during her life shall deliver written notice to Charity no later than ninety (90) days prior to the desired commencement date.”

6. One question that has been raised is whether the right to receive payments as of a certain date results in constructive receipt of income as of that date. Our opinion is that it does not. By analogy, the owner of a commercial deferred annuity contract has a right to elect life payments at any time but does not have taxable income until the election is made.

VII. <u>Conclusion</u>

Flip charitable remainder unitrusts, spigot net income with makeup charitable remainder trusts and deferred charitable gift annuities offer flexible retirement planning strategies for clients with highly appreciated assets, clients who don’t need immediate income, and professionals who have maxed out their retirement plan contributions.

Exhibit A
NEW CRUT DISTRIBUTION TIERS

Ordinary Income – All net investment income

Class	Tax Rate
Interest	43.4%
Net Rental Income	43.4%
Non-Qualified Dividend Income	43.4%
Qualified Dividend Income	23.8%

Capital Gain – All net investment income

Short-Term	43.4%
Long-Term	23.8%

Tax Free Income 0

Return of Principal 0

Exhibit B
AMERICAN COUNCIL ON GIFT ANNUITIES SUGGESTED MAXIMUM RATES AS OF NOVEMBER 2019

Generally speaking, the ACGA's suggested maximum rates are designed to produce a target gift for charity at the conclusion of the contract equal to 50% of the funds contributed for the annuity. The rates are further predicated on the following:

- An annuitant mortality assumption equal to a 50/50 blend of male and female mortality
- A gross investment return expectation of 4.75% (which is up from the previous return assumption of 4.25%) per year on the charity's gift annuity funds
- An expense assumption of 1% per year.

Sample rates for immediate annuities:

Single Life:

Age	Rate
62	4.8%
70	5.6%
76	6.4%
80	7.3%

Joint Lives:

Ages	Rates
50 & 55	3.8%
60 & 65	4.3%
70 & 75	5.2%
78 & 80	6.0%

Exhibit C

SAMPLE GIFT ANNUITY CONTRACT

Immediate Gift Annuity Agreement

Sacramento Region Community Foundation

One Life Immediate Payment Annuity

This Agreement is made between [DONOR NAME] (hereafter the "Donor") and a charitable organization, known as the Sacramento Region Community Foundation, 740 University Avenue, Suite 110, Sacramento, California 95825 (hereafter the "Charitable Organization").

1. Property Transfer. The Donor, as evidence of a desire to support the work of KVIE Public Television through the Sacramento Region Community Foundation and to make a charitable gift, has contributed $[GIFT AMOUNT] which is more fully described in the attached Schedule A.

2. Payment of Annuity. In consideration of the property transferred by the Donor, the Charitable Organization shall pay to the Donor, for his life an annual annuity of $[XXX] in equal quarterly payments of $[XXX] at the end of each calendar quarter. The first payment, payable on [DATE], will be a pro rata payment of $[XXX], and all future payments shall be quarterly thereafter. The obligation of the Charitable Organization to make annuity payments shall terminate either without payment if the Donor dies before the first payment or with the payment prior to the death of the Donor.

3. Birth Date, Age, Social Security Number and Address. The birth date, age to the nearest year, Social Security number and address of [DONOR] are [DOB], [Age XX], SSN [XXX-XX-XXXX] and address [XX]. If a birth date or age shall be at any time found incorrect, then any underpayment or overpayment due to misstatement or other error, with interest as may be specified in Treasury Regulations, shall be corrected by prompt distribution to the Donor or by charge against current or future payments, as may be applicable.

4. Annuity Provisions. This annuity is irrevocable and nonassignable, except that it may be assigned to the Sacramento Region Community Foundation. The Sacramento Region Community Foundation's obligation to pay annuitant under this Agreement shall terminate with the regular payment preceding the Donor's death.

5. Payout and Use Provisions. Unless the Charitable Organization is notified in writing of a change of address or another method of payment is selected by written agreement, annuity payments shall be made to the Donor's address noted in this Agreement. Annuity payments shall be made under the provisions of this Agreement and shall not be otherwise modified or commuted.

6. Uses and Purposes of Gift. Upon satisfying the Sacramento Region Community Foundation's obligation under this Agreement to pay annuitant, an amount equal to seventy-five

percent (75%) of the residuum of the gift shall be used by the Sacramento Region Community Foundation to provide direct support to the KVIE Public Television for its general charitable purposes. The remaining twenty-five percent (25%) of the residuum of the gift shall be used by the Sacramento Region Community Foundation for its general charitable purposes.

7. State Law Provisions. The assets transferred are specified under Schedule A. This Agreement shall be governed by the laws of the state of California.

This annuity Agreement shall be interpreted in a manner that is in compliance with applicable existing state law. By signing this agreement, the Donor acknowledges receipt of the Charitable Organization Gift Annuity Disclosure Statement in accordance with the requirements of the Philanthropy Protection Act of 1995.

Annuities are subject to regulation by the State of California. Payments under this Agreement, however, are not protected or otherwise guaranteed by any government agency or the California Life and Health Insurance Guarantee Association.

In addition, to the extent an amendment does not conflict with federal law, the Agreement may be amended by mutual agreement of the parties solely for the purpose of compliance with state law, with such amendment subject to approval of the Insurance Commissioner of the State of California.

IN WITNESS WHEREOF, the Charitable Organization and the Donor have executed this Agreement on [DATE], the date that the contract and assets are received by the Sacramento Region Community Foundation.

Donor:

______________________________ Date: ______________
[DONOR]

Sacramento Region Community Foundation **Incorporation Date -- 1983**

By: ______________________________ Date: ______________
Chief Executive Officer, Sacramento Region Community Foundation

Attest: ______________________________ Date: ______________
Kevin Smith-Fagan, KVIE Public Television

Gift Annuity Agreement Between
[DONOR] and
Sacramento Region Community Foundation

Exhibit D

Procedure for Calculating Suggested Deferred Gift Annuity Rates

Approved by the American Council on Gift Annuities

1. Determine the annuity starting date, which is:

    1. One year before the first payment, if payments are made annually.
    2. Six months before the first payment, if payments are made semi-annually.
    3. Three months before the first payment, if payments are made quarterly.
    4. One month before the first payment, if payments are made monthly.

2. Determine the number of whole and fractional years from the date of the contribution to the annuity starting date (the deferral period). Express the fractional year to four decimal places.

3. For a deferral period of any length, use the following formula to determine the compound interest factor:

    a. $F = 1.0375^{d}$, where
    b. F is the compound interest factor and
    c. d is the deferral period

Example: If the period between the contribution date and the annuity starting date is 10.25 years, the compound interest factor would be $1.0375^{10.25} = 1.458405$

4. Multiply the compound interest factor (F) by the immediate gift annuity rate for the nearest age or ages of a person or persons at the annuity starting date.

Example: If the sole annuitant will be nearest age 65 on the annuity starting date and the compound interest factor is 1.458405, the deferred gift annuity rate would be 1.458405 times 5.1%, or 7.4% (rounded to the nearest tenth of a percent).

Comments:

- The annuity starting date for purposes of calculating the deferred gift annuity rate will be the same as the annuity starting date for calculating the charitable deduction, if payments are at the end of the period (which is usually the case). An annuitant is credited with compound interest for the entire period from the date of contribution to the annuity starting date.

Exhibit E

CRT ACRONYMS

CRT – Charitable remainder trust

CRAT – Charitable remainder annuity trust

CRUT – Charitable remainder unitrust

NICRUT – net income only CRUT

NIMCRUT – Net income with makeup CRUT

CGA ACRONYMS

CGA – Charitable gift annuity

DCGA – Deferred charitable gift annuity