Gifts That Keep Giving

By using an annuity to fund a life policy, clients can make charitable gifts that keep their heirs involved and the tax collector at bay.

By Roccy DeFrancesco

CHARITABLE GIVING SOUNDS SIMPLE. Just give your property or money away, receive a deduction, and provide wealth replacement for the heirs using a death benefit—and everybody is happy. Yet there are many ways for a client to make a gift, including a charitable remainder trust (CRT), charitable remainder annuity trust (CRAT), charitable remainder unitrust (CRUT), charitable lead trust (CLT), charitable gift annuity (CGA), and family foundations.

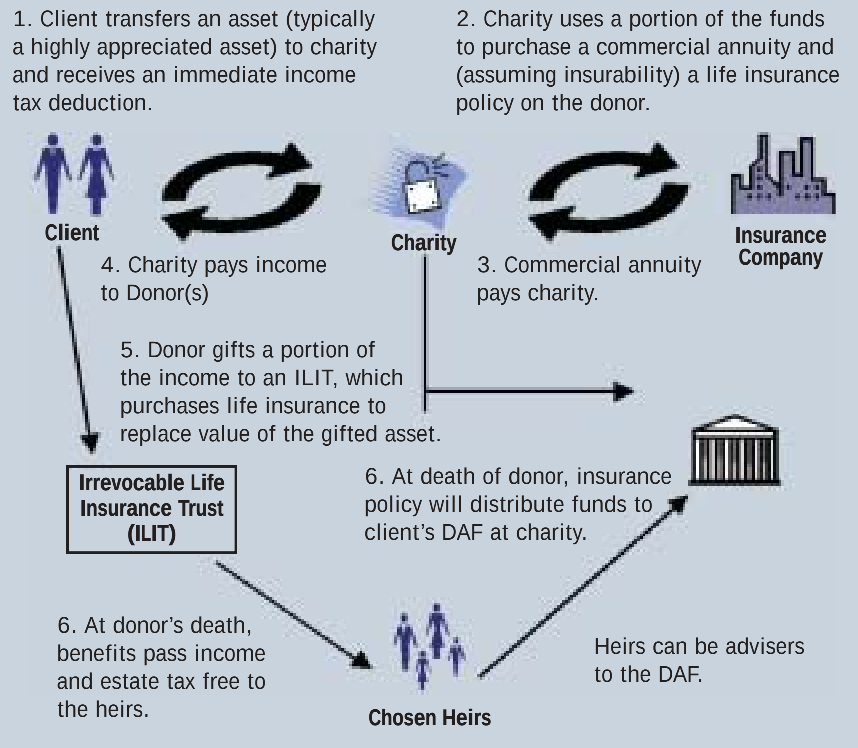
What is the best way for advisers to decide on the appropriate vehicle? In this article, I'll describe a concept that uses the CGA in an advanced fashion. To my knowledge, only a few charitable planning firms know how to incorporate a donor-advised fund with a CGA. This strategy can be a powerful tool for clients not only to give something back to their community, but also to help them learn what charitable giving is all about.

First, some quick facts about CGAs and how they work are necessary to set the stage for the discussion:

- A CGA is a contract between a qualified 501(c)(3) public charity and a donor. The donor makes an irrevocable gift to the charity in exchange for the promise of receiving lifetime income.
- Typically, the lifetime income is paid to the donor or to the donor and a spouse (joint and survivor). The charity pays the donor for life (monthly, quarterly, or annually) at an agreed-on rate.
- Once any reserve or reinsurance requirements to make donor payments have been satisfied, the charity then uses whatever remains from the original gift for its charitable purposes. Some charities allow a portion of this charitable remainder from the CGA to pass into a donor's donor-advised fund (DAF).
- A CGA can provide a donor with a lifetime income stream at a high rate that is guaranteed by the charity and an immediate tax deduction.

When entering into a CGA contract, most donors want to make sure that the

How the CGA Works



charity has a safe method of protecting the funds that ultimately will be used to make their lifetime income payments. Charities are required to maintain certain reserve requirements, and they may also be mandated to invest funds according to strict parameters, depending on state-by-state requirements.

Despite the reserve requirements, it is still vitally important to work with a reputable charity that understands how to implement a CGA. Financial advisers have to be sure that the charity can be trusted to manage the money properly, since it will be used in part to pay a guaranteed income to the donor or the heirs. Most commonly, a charity will choose to use a single premium immediate annuity for the life of the donor from a highly rated commercial insurance carrier. In essence, this allows the charity to pass interest rate, investment, and mortality risks to an insurance company.

Once a charity has met its all of its payment obligation to a donor, it is free to use the remainder of the gift from the donor for its charitable purposes. Some charities may allow all or a portion of this remainder to be designated for a DAF that is typically funded at the death of the donor. This permits the donor (or the heirs if funded at the death of the donor) to have some say in an advisory capacity as to how the charitable funds are actually used and provides an excellent method of establishing a legacy.

In other words, the charity will purchase some type of a life insurance policy on the donor (sometimes a second-to-die policy for a greater death benefit) with much of the remaining funds that are ultimately supposed to stay with the charity. Life insurance is used so that a large guaranteed death benefit will then pass to the charity.

Many high-net-worth clients today want their children and their grandchildren to learn firsthand what charitable giving is all about. A good way for them to do that is be using a CGA, where the charity will allow a portion of the death benefits from a life insurance policy purchased with the proceeds from the gift to the charity to be directed into a DAF. By setting up a DAF well in advance, a client can be assured the death benefits will be used in a charitable manner.

With this type of a setup, the children and grandchildren do not receive the money directly, of course. Instead, they get to see how such a gift is used to help those in need as they get involved in the managing the DAF.

From a tax management perspective, there are three primary ways that a CGA can be helpful. First, when passing the ownership of a highly appreciated capital asset (marketable securities, real estate, business interests, etc.) to a charity in exchange for a CGA, the donor doesn't realize a lump-sum capital gain. The capital gain is reduced significantly and then amortized over the donor's life expectancy. As a result, a portion of the donor's CGA income will be taxed at the lower capital gains rate.

Second, the donor receives an immediate and substantial income tax deduction, which he or she can then use to offset current income taxes up to a certain amount, based on adjusted gross income. Any surplus deduction can be carried over for up to five additional years. The amount of the upfront tax deduction is based on the projected value of the ultimate gift to the charity.

Third, passing an asset into a CGA removes the asset from the donor's taxable estate, which can greatly reduce any potential estate taxes. And in some cases, depending on the type of asset, passing an asset to a CGA can also avoid income with respect to a decedent (IRD) taxation at the time of estate settlement.

Many clients who aren't charitably inclined won't look at a CGA. For those who are on the fence, one way to help rationalize using a CGA is to implement a "wealth replacement" strategy.

Wealth replacement is a fancy term for buying life insurance with some or all of the income stream that flows to the donor from the CGA. The theory is that a client can give away a $500,000+ asset to a charity, get a current income tax deduction, and use the stream of income from the charity to buy a $500,000+ life insurance policy inside an irrevocable life insurance trust (ILIT). This policy would typically be purchased inside an ILIT so that the death benefit will pass

Beyond the Family

Why CGAs can be a better solution than a family foundation

Many experts recommend a family foundation as the tool of choice for their high-net-worth clients with charitable planning needs. Why? Too often it's prompted by the fact that an attorney setting up a family foundation will typically charge $10,000-$15,000. In contrast, a client would not even have to hire an independent attorney to use a charitable gift annuity (CGA).

Still, there are some valid reasons why clients like family foundations:

Control of the money gifted to the charity. While a client's heirs can have significant input on how a CGA is distributed (which is done through a donor-advised fund), a family foundation gives the family total control over the assets.

Ego. Family foundations seem to appeal to people who want their name on something that will create a legacy for the family. Almost all clients can accomplish the same charitable goals with a CGA and do so in a more tax-favorable manner—but the family legacy wouldn't live on in name.

Passing wealth to the children. Charities are supposed to benefit their causes and people in need, not the donor's children financially. Yet one common sales pitch to clients for family foundations plays up the fact that the children get to run the foundation and draw a salary, and they can hold an annual board meeting in a nice vacation spot like Hawaii. I believe these "benefits" abuse both family foundations and the tax laws.

So what are the most important differences between a family foundation and a CGA? The main one is the cost. The setup costs of a CGA are negligible, while a family foundation can run $10,000 and up.

More important, when a client contributes to a family foundation, there are additional limits on the deductions that he or she can take against personal income. Those limits currently are set at 30% of adjusted gross income for a cash gift and 20% of adjusted gross income for gifts of property or securities. Those limits are much lower than the 50% ceiling for cash gifts and 30% limit for property and securities available in a CGA.—*RD*

income and estate tax free to the heirs.

Here's an example of how the strategy works. Assume that Dr. Smith has an estate of $5 million at the age of 60. The $5 million estate is made up of a home worth $1 million, a $1.65 million brokerage account, an IRA of $1.5 million, a vacation condo worth $350,000, and a rental property worth $500,000. That rental property now has a basis of $100,000. Dr. Smith still works as a surgeon, making $400,000 a year.

Dr. Smith and his wife would like to leave something to charity and also to teach their three children about charitable giving via a DAF. A wealth replacement strategy that uses a CGA would work as follows:

1. Dr. Smith gifts the rental property to a charity, which sells it for $500,000 (the charity pays no capital gains).

2. Dr. Smith receives an income tax deduction of $60,925, which saves him $24,370 in income taxes on his current year's tax return. This deduction could be increased substantially if he waited to receive income payments from the CGA. Also, if Dr. Smith was older when making the gift, the income tax deduction would be larger. In our example, the deduction would be $89,890 if Dr. Smith was 65 years old.

3. The charity then buys a single premium lifetime annuity on Dr. Smith and starts paying him $28,000 in income each year until his death. The first year, $14,515 of the payment is taxable to Dr. Smith as long-term capital gains, while $13,216 is treated as ordinary income and $269 is tax free. The taxable consequences of CGA payments to Dr. Smith change during his lifetime. (The formulas are complicated; I won't go into them in detail here for brevity's sake.)

4. The charity also buys a $500,000 second-to-die life insurance policy on Dr. Smith and his wife that will fund the DAF at the last spouse's death.

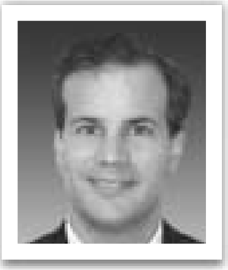
5. Dr. Smith takes $4,500 from the income he receives from the CGA each year and gifts it into an ILIT, where a $500,000 second-to-die life insurance policy is purchased, ensuring that the death benefit will pass to Dr. Smith's heirs income and estate tax free.

6. When Dr. Smith and his spouse die, $500,000 will pass to their heirs free of income and estate tax, thus "replacing" the $500,000 piece of real estate that would have passed to the heirs if not for the charitable gift.

7. The DAF is funded when Dr. Smith's spouse dies. That money is then used in the DAF for various charitable purposes, with the help and direction of Dr. Smith's heirs.

Take a look at the multiple benefits that this arrangement provides. First, Dr. Smith helped a charity by gifting it a $500,000 asset. Second, he received an immediate deduction for his current income taxes. Third, his heirs didn't lose the asset because a $500,000 life insurance policy in an ILIT was purchased with the income from the CGA. Fourth, Dr. Smith was able to remove a $500,000 asset from his estate for estate tax purposes. And fifth, after the death of Dr. and Mrs. Smith, the couple's heirs got involved in charitable giving by managing a DAF that was created via a life insurance policy owned by the charity.

Should you be using CGAs in your firm? Keeping things as simple and low-cost as possible is a good way to make sales to the high-end client. And CGAs do cost less than family foundations, another tool for your charitably-minded clients. (See "Beyond the Family" at left.) CGAs can be an ideal way to help clients meet their charitable giving goals, encourage heirs to do likewise, and provide wealth replacement. That's a winning situation for all involved. **FP**



Roccy DeFrancesco, J.D., is a partner in TriArc Advisers, which provides education on advanced planning and wealth management to financial and legal professionals. He can be reached at www.triarcadvisors.com or 269-469-0537.

To take the CE Quiz online, go to www.Financial-Planning.com