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## **Charitable Gift Annuity (CGA)**

High income and high net worth clients by nature seem to be more giving people than the general public (mainly because they have the extra money to give).

There are many different ways for a client to gift money to charity, i.e., Charitable Remainder Trust (CRT), Charitable Remainder Annuity Trust (CRAT) Charitable Remainder Unitrusts (CRUT), Charitable Lead Trust (CLT), Family Foundations, Charitable Gift Annuities and the list goes on and on.

Since this web-site is not a client's guide to charities, we decided to discuss the solution we believe is hands down the simplest, least expensive, and most beneficial way to fund a client's charitable goals, i.e., the Charitable Gift Annuity (CGA).

### **CGA Quick Facts (the client is the donor)**

-A charitable gift annuity is a contract between a donor and a qualified 501(c)(3) public charity.

-The donor makes an **irrevocable gift** to the charity in exchange for a **promise of lifetime income**.

-Typically, the lifetime income is paid to the donor or to donor and spouse (joint and survivor).

-The charity pays the donor(s) for life (monthly, quarterly, or annually) at an agreed upon rate.

-Once reserve or reinsurance requirements to make donor payments have been satisfied, the charity uses whatever remains from the original gift for its charitable purposes.

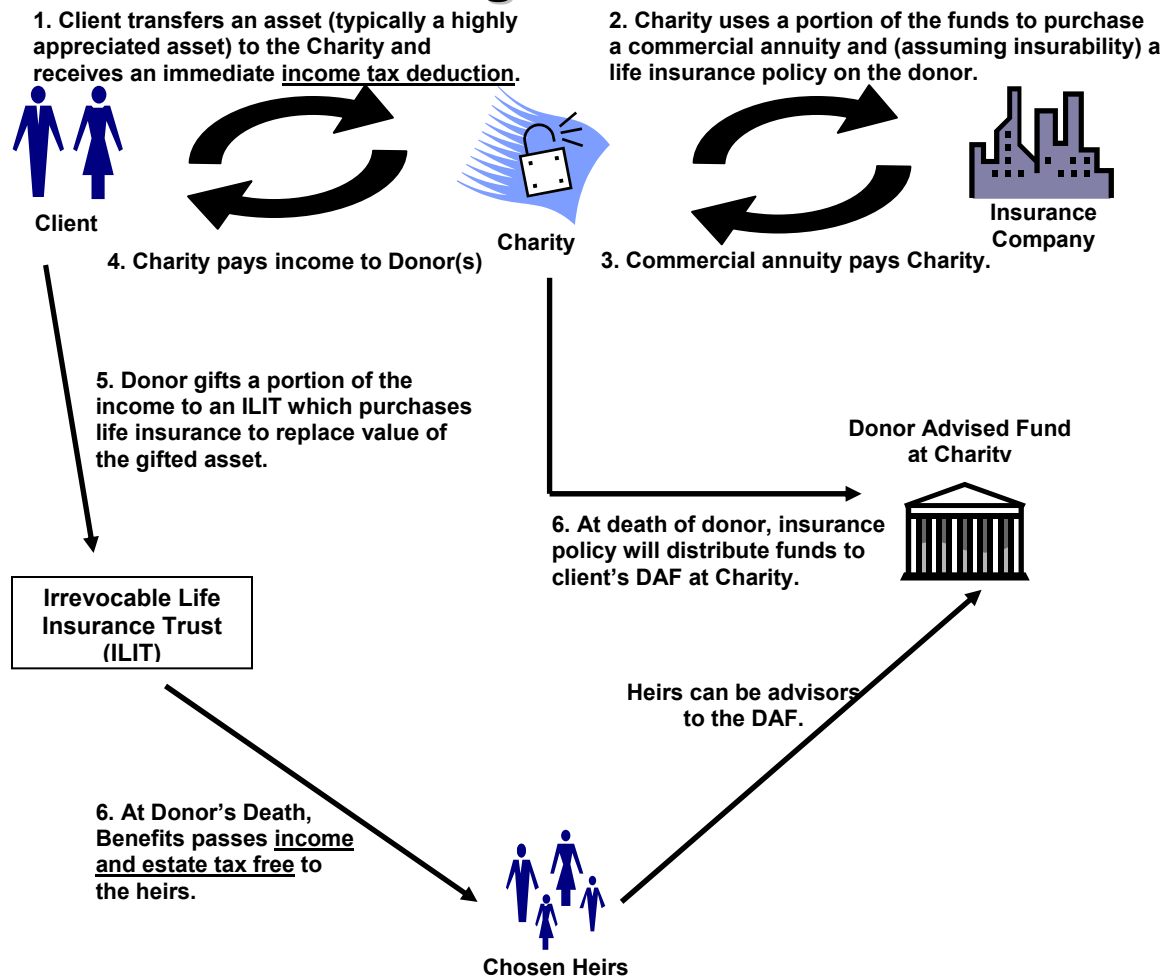
-Some charities allow a portion of this "charitable remainder" from the CGA to pass into a client/donor's Donor Advised Fund (DAF).

-A CGA can provide **lifetime income** at a high rate that is guaranteed by the charity and **an immediate tax deduction** for the donor.

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The following is a schematic for how the CGA works.

## CGA Program Overview



### Charitable Benefit

Once a charity has met its payment obligation to a donor (fund an investment to pay the donor the agreed upon annuity payments), it can use the remainder of the gift from the donor for its charitable purposes. Some charities allow all or a portion of this remainder to be designated for a Donor Advised Fund (DAF) which is typically **funded at the death of the donor(s)**. 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 used and provides an excellent method of establishing a legacy.

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

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By using a DAF, the children and grandchildren do not receive the money but instead are there to see the money used to help those in need. The theory is that such a charitable setup is good to help build the moral foundation of the children and grandchildren by getting them involved in the DAF at the charity.

### **Substantial Tax Benefits**

There are three primary ways in which a CGA can assist in tax management. First, when transitioning 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 **does not** realize a lump sum capital gain. The **capital gain is reduced significantly** and then amortized over the donor's life expectancy.

Second, a substantial **immediate income tax deduction is given**, which can be used to offset current income taxes up to a certain amount based on adjusted gross income.

Third, transitioning an asset to a CGA **removes the asset from the donor's taxable estate**, which can greatly reduce potential estate taxes.

### **Wealth Replacement**

Many clients who do not have a charitable intent will not look at the CGA. However, for those who are on the fence, one way to 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 purchase a \$500,000+ life insurance policy inside an irrevocable life insurance trust (ILIT). This policy would typically be purchased inside an ILIT so the death benefit will pass income and estate tax free to the heirs.

#### **Example:**

Assume that Dr. Smith age 60 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 brokerage account worth \$1.65 million, an IRA of \$1.5 million, a vacation condo worth \$350,000, and a rental property worth \$500,000. The rental property has a basis of \$100,000. Assume Dr. Smith still works as a surgeon where he makes \$400,000 a year.

Dr. Smith has three children and five grandchildren, and he and his wife would like to leave something to charity so they can teach their children about those who are less fortunate by having them involved in charitable giving through the DAF.

Dr. Smith decides to implement a CGA, and it would work as follows:

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

2) Dr. Smith receives an income tax deduction for his tax return of \$60,925 (saving Dr. Smith \$24,370 in income taxes on his current year's tax return). This deduction could be increased substantially if Dr. Smith waited to receive income payments from the CGA.

3) The charity buys a single premium lifetime annuity on Dr. Smith and starts paying Dr. Smith \$28,000 in income each year until his death. The first year, \$14,515 of the payment is taxable to Dr. Smith at the long term capital gains rate, \$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 and are not discussed for the sake of brevity.

3a) 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.

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

5) When Dr. Smith and his spouse die, \$500,000 will pass to their heirs income and estate tax free (thereby replacing the \$500,000 piece of real estate that would have passed to the heirs if it were not for the gift).

5a) The DAF is funded at the second spouse's death and that money will then be used in the DAF for charitable purposes with the help and direction of Dr. Smith's heirs.

Benefits of the above example:

Dr. Smith helped a charity by gifting it a \$500,000 asset; Dr. Smith received an immediate deduction for his current income taxes; Dr. Smith's heirs did not lose the asset due to the fact that a \$500,000 life insurance policy in an ILIT was purchased with the income from the CGA; Dr. Smith removed a \$500,000 asset from his estate for estate tax purposes; and at Dr. and Mrs. Smith's death, the heirs became involved in the DAF that was funded with a life insurance policy that was purchased and owned by the charity.

## **Conclusion**

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Charitable giving sounds simple—just give your property or money away, receive a deduction, and provide wealth replacement for the heirs via a death benefit and everyone is happy. The reality is that setting up a charitable giving program is similar to buying life insurance. If you use the wrong advisor, the chances are significant you will be setting up a plan that is in your advisor's best interest instead doing what is best for you and the charity your are trying to benefit.

It is our opinion that, if you are looking for a simple way to fund your desire for charitable giving, you should consider a CGA. You can remove a low basis asset from your estate and pass an equal amount of wealth to your heirs, while at the same time funding a charity your heirs will be able to work with to help others who are less fortunate.

If you would like help determining if a charitable solution is right for you, please feel free to contact our firm.