NORTHERN TRUST

HOW DO CHARITABLE GIFT ANNUITIES AND CHARITABLE REMAINDER TRUSTS WORK?

THE ADVANTAGES – AND CHALLENGES – FOR YOUR ORGANIZATION

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For some donors, an alternative to an outright cash gift will flexibly fulfill their charitable intents as well as personal financial goals. Knowing how can help you advise and guide them.

For a nonprofit, "Cash is (often) King": A donor receives a charitable deduction for an outright cash gift and the nonprofit can immediately put it to work to fund a building, a program or a project. However, a donor's long-term objectives to support a nonprofit might be better accomplished in structuring a deferred gift, such as a charitable gift annuity or a charitable remainder trust.

Each of these structures permits the sale of appreciated assets without immediate taxation (by deferring most and possibly avoiding some capital gains tax), lowering the cost of diversification and creating cash flow. Moreover, a lifetime gift reduces estate taxes as effectively as a bequest, but has the added benefit of providing gift recognition during the donor's lifetime.

WHAT IS A CHARITABLE GIFT ANNUITY (CGA)?

A charitable gift annuity is a contractual agreement between one or two donors and a charity. The donor(s) transfer assets as a gift to the charity and in return, the charity is obligated to pay a fixed annuity to one or two annuitants (recipients of the annuity), for the lifetime of the annuitant(s).

Older individuals who are interested in a secure and fixed annuity payment are ideal candidates for a CGA. Typically, the annuitant is looking for a higher income stream than income received from CDs or other lower yielding investments, and who wishes to donate to charity the value they do not use during their life.

WHAT CGA BEST PRACTICES SHOULD WE IMPLEMENT?

Establish guidelines for gift minimums, such as $10,000 or higher for a CGA and approve subsequent gift annuities by a repeat donor at a lower minimum such as $5,000.[1]

You should also establish a minimum age for immediate charitable gift annuitants – the most common being between 60 and 65 and the average hovering at 70. If the annuity is deferred, it is recommended the minimum age of the annuitant at the time payments begin be the same as the minimum age of an annuitant of an immediate gift annuity.[2]

The Philanthropy Protection Act of 1995 requires a disclosure statement must be received by the donor in advance of signing the contract to establish a charitable gift annuity. Some states require the inclusion of specific language in the disclosure statement or in the agreement. The American Council on Gift Annuities recommends the charity have the donor acknowledge in writing they have received the applicable disclosure statement.[3]

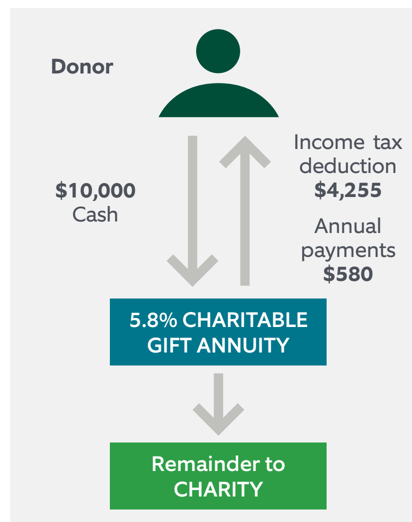
BEST PRACTICES FOR CHARITABLE GIFT ANNUITIES

- Set minimum gift amount
- Set minimum age of annuitant
- Use suggested American Council on Gift Annuities (ACGA) rates
- Comply with state regulations
- Comply with investment restrictions
- Provide donor disclosure statement

HOW DOES A CHARITABLE GIFT ANNUITY WORK?

Scenario #1: The donor is 72 years old. He is the only annuitant donating a cash gift of $10,000 in July 2018 in exchange for a gift annuity. The Charity adheres to the American Council on Gift Annuities (ACGA) recommended current rates for gift annuities. New suggested maximum rate schedules are effective on July 1, 2018.

Based on the payout rate of 5.8% from the ACGA 2018 Table and the July 2018 IRS discount rate of 3.4%, the donor will receive a charitable deduction of $4,255 in the year of the gift. The charitable deduction allowed is the difference between the cash contributed and the present value of the annuity payments. For the first 14.5 years, the annual payment will be $580 of which $396 will be a tax-free return of basis, and the remainder will be taxed as ordinary income. Afterwards, the entire annuity will be taxed as ordinary income.



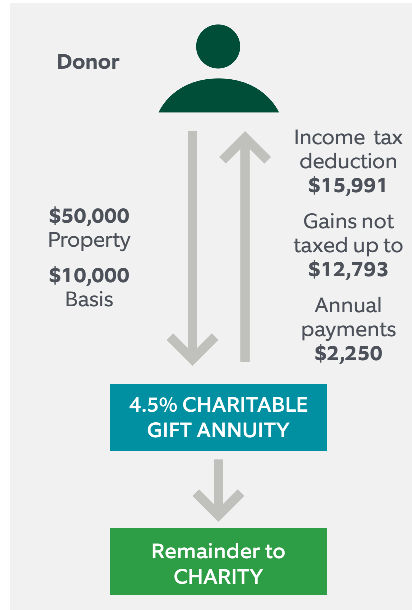
[1] "Recommended Charitable Gift Annuity Best Practices," American Council on Gift Annuities, May 2016.

[2] "Recommended Charitable Gift Annuity Best Practices," American Council on Gift Annuities, May 2016.

[3] "Recommended Charitable Gift Annuity Best Practices," American Council on Gift Annuities, May 2016.

Scenario #2: The donors are 72 and 67 years old. In October 2017, the husband and wife contributed jointly-owned long-term appreciated stock with a fair market value of $50,000 and a cost basis of $10,000. In this example, a publicly traded stock is gifted electronically to the nonprofit's brokerage account. The gift is complete on the date the shares are transferred into the charity's account. The value of the gift will be the average of the high and low prices for that date the stock is received.

Based on a payout rate of 4.5% from the ACGA 2012 Table and the September 2017 IRS discount rate of 2.4%, the donors will receive a charitable deduction of $15,991 in the year of the gift. The total reportable capital gain of $27,207 and the tax-free portion of $6,802 will be reported over 21.2 years, and the additional component of yearly distributions will be taxed as ordinary income. Afterwards, the entire annuity will be taxed as ordinary income. For the IRS discount rate used to compute the value of the charitable contributions, the donors may choose among the IRS rates for the month of the gift, or either of the two preceding months. The higher the IRS discount rate the higher the immediate charitable deduction.



	August 2017 IRS Discount Rate 2.4%	September 2017 IRS Discount Rate 2.4%	October 2017 IRS Discount Rate 2.2%
Charitable Deduction	$15,991	$15,991	$15,331

CHARITABLE GIFT ANNUITIES AT A GLANCE

	ADVANTAGES	CHALLENGES
FOR DONORS	• The contract is easy to understand and complete. • Taxpayers who itemize their deductions may take an immediate income tax deduction for the charitable gift portion of the transfer. The CGA provides a fixed lifetime income stream with some tax-free income. • If appreciated property is gifted, capital gains taxes may be allocated over the life of the annuity. • If the donor dies before the actuarially determined year, the estate can take the unrecovered investment in contract as an itemized deduction on donor's final income tax return.	• The gift is irrevocable. • If the annuitant is someone other than the donor, the donor is making two gifts: – The first is the gift of the remainder interest to the charity which is deductible for gift tax purposes – The second is a taxable gift to the non-donor annuitant
FOR CHARITIES	• It is an efficient way to administer a large number of smaller denominated gifts. • Gifts of cash or appreciated marketable securities to establish a CGA are clear and understandable. • Gift is irrevocable. • A CGA program will promote long-term relationships with donors. • Repeat gifts are likely.	• Another charity offers higher rates than the recommended ACGA rates. • The contribution is exhausted before the payment obligation ends due to an annuitant outliving his or her life expectancy or unfavorable market performance. • Gifts of other types of assets, such as real estate, are more complex and may require approval by a gift acceptance committee. • Charity has to be compliant with state registration and its regulations.

WHAT IS A CHARITABLE REMAINDER TRUST (CRT)?

A charitable remainder trust is an irrevocable trust that generates a potential income stream for the donor, or other beneficiaries, with the remainder of the donated assets going to a charity or charities.

Depending on the donor's goals and the asset gifted, there are five different variations on the charitable remainder trust:

- The charitable remainder annuity trust (CRAT) is a fixed payment trust. The amount to be paid to the income beneficiary is determined when the trust is first established. The payout percentage is applied to the value of the funding assets to determine the specific fixed payment amount.
- The standard unitrust is a variable payment charitable remainder trust. The unitrust revalues all assets annually. The fixed payout rate is applied to the value of the assets to determine the variable payment amount.
- The net income trust (NICRUT) is a charitable remainder trust that pays out the lesser of the unitrust amount or net income earned by the trust.
- The net income with makeup (NIMCRUT) is a refinement of the net income trust, which allows the unpaid unitrust amount to be paid in any later year when the net income is greater than the unitrust amount.
- The flip trust (FLIPCRUT) is a hybrid of the net income trust and the standard unitrust. These are typically used when the CRT is funded with an illiquid asset with insufficient cash flow. Prior to the sale of the original funded asset, the trust will pay out the lesser of the unitrust amount or net income. Once the asset is sold, the net income trust "flips" over to function like a standard unitrust, although the trust will continue to act like a net income trust until the beginning of the next calendar year. Note, however that the "flip" event may be the sale of a non-income producing asset, but it may be a specific date in the future, to allow the assets to grow prior to making large annual payments.[4]

Because the rules governing the creation and administration of CRTs are complex, the Internal Revenue Service has provided specimen trust agreements for the creation of such trusts. Charitable Remainder Annuity Trust ("CRAT") specimens are available in Rev. Procs. 2003-53 through 2003-60. Charitable Remainder Unitrust (CRUT) specimens are available in Rev. Procs. 2005-52 through 2005-59.[5]

MANDATORY REQUIREMENTS FOR CHARITABLE REMAINDER TRUSTS

- Required minimum payout is 5%
- Ceiling on the payout rate is 50%
- Projected remainder interest must be at least 10%
- Probability that a CRAT will be exhausted prior to the end of the term is less than 5%

[4] Forrest C. Brostrom, Planned Giving Administration: The Business Officer's Guide (Washington: NACUBO, 2005) 72-76.

[5] Ibid.

WHAT CRT REQUIREMENTS AND BEST PRACTICES SHOULD WE IMPLEMENT?

A charitable remainder trust (CRT) provides greater flexibility, allowing the donor to make more significant gifts during his lifetime than might be possible through an outright donation. A CRT is appropriate not only for highly appreciated marketable securities, but also for non-income producing or unmarketable assets. With this increased flexibility come greater costs: initially legal costs of drafting the trust agreement and appraisal fees, and then ongoing administrative costs for the trust.

The donor selects the desired payout rate, a decision that is bound by CRT requirements, influenced by the interplay between current interest rates and transfer taxes, as subject to personal charitable objectives.

To meet requirements of the Internal Revenue Code for qualification, the actuarial value of the charitable remainder interest must be at 10% of each gift. This test will likely make CRTs payable for the life of the beneficiary unavailable to very young persons, and will put a cap on the payout rate available to older individuals. Note that the payout rate cannot be below 5% and the ceiling on the payout rate is 50%. A CRAT that is structured to pay a fixed annuity (rather than a variable annuity) has the additional requirement that the probability that the trust will be exhausted prior to the end of the term is less than 5%.

Another important factor in choosing the payout rate is the effect of the IRS discount rate on the gift and estate tax charitable contribution deductions. The higher the payout rate, the lower the contribution deduction.[6]

BEST PRACTICES FOR CHARITABLE REMAINDER TRUSTS

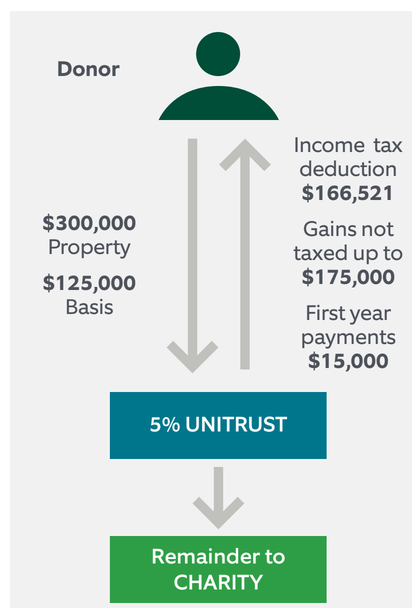
- Align the appropriate charitable remainder trust vehicle with the unique goals and circumstances of the donor
- Assess the suitability of the asset to fund the trust
- Use specimen trust agreements provided by IRS

HOW DOES A CHARITABLE REMAINDER UNITRUST TRUST WORK?

The donor is 72 years old and gifts appreciated stock into a standard charitable remainder trust. The donor will receive an income tax deduction and pay no capital gains tax on the transfer to the trust. In the first year, the beneficiary will receive a total of $15,000 in payments.

In subsequent years, the trust will be revalued each year and the payout amount will be readjusted to reflect the current value of the trust.

	Beginning FMV of Trust	Annual Annuity Payment
Initial Funding	$300,000	$15,000
Year 2	$276,450	$13,823
Year 3	$282,720	$14,136
Year 4	$311,557	$15,578



[6] Claudia B. Sangster and Steven J. Chidester, "Charitable Giving, Part II, Other Deferred Giving Techniques," American Institute for Philanthropic Studies, March 2016.

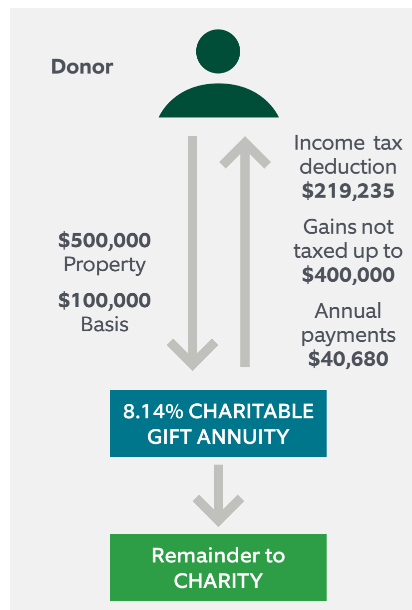
Although the trust pays no tax on its income, it records the amounts of each type of taxable income received, and passes out income of corresponding character to the individual beneficiary with each distribution. When a distribution is made to an individual beneficiary, the beneficiary will be taxed under a four-tier system using a "worst-in-first-out" methodology. Thus, a distribution will be taxable as higher tier income (including its sub-tiers) until all such current year and historic income is exhausted. Once all such income has been deemed distributed, the beneficiary will be taxable at the next lower tax tier rate. The tiers are:

- **Tier 1:** Ordinary income
- **Tier 2:** Capital gain income
- **Tier 3:** Tax-free income
- **Tier 4:** Corpus

HOW DOES A CHARITABLE REMAINDER ANNUITY UNITRUST TRUST (CRAT) WORK?

The donor is 80 years old and wants to establish a CRAT with an 8% payout for himself with property with a fair market value of $500,000. The December 2017 IRS discount rate is 2.6%. An 8% payout would result in a $40,000 annual annuity payment. However, the trust fails the 5% probability test. The trust would not qualify for charitable tax benefits because its 12.55% chance of being drawn down to zero is greater than 5%.

- **Scenario #1:** The trust will pass the 5% probability test if the payout rate is reduced to 6.8789%. The income beneficiary will receive $34,394.50 annually for their lifetime or until the trust is exhausted. The donor's charitable deduction will be $255,830.
- **Scenario #2:** The trust will pass the 5% probability test if the payout rate is reduced to 7.3226% with a 15 year term. The donor will receive a charitable deduction of $50,000. In this scenario, the donor would receive $36,613 annually for the next 15 years. After 15 years, the trust principal will pass to the remainderman beneficiary.
- **Scenario #3:** The trust will pass the 5% probability test if the terms of the trust are the shorter of the fixed term of 15 years or the income beneficiary's lifetime. The income beneficiary will receive $40,680.50 annually or 8.1361% of the initial fair market value of the trust. The charitable deduction will be $219,235.



CHARITABLE REMAINDER TRUSTS AT A GLANCE

	ADVANTAGES	CHALLENGES
FOR DONORS	• Provides a more significant gift during one's lifetime than might be possible through an outright gift. • Provides an immediate income tax deduction. • Funds with cash, publicly traded, marketable securities, closely held stock, real estate, limited partnerships, in-kind, tangible and intangible personal property, oil, gas and mineral rights. • Trust pays no capital gains tax on sale of appreciated assets; instead, taxable capital gains tax is passed out to the individual beneficiary with periodic distributions. • Deferral of tax at the trust level lowers the cost of diversification and leaves a larger investment base, thereby increasing potential investment returns. • Eliminates management responsibilities for specialty assets, such as real estate. • Removes asset from estate for estate tax purposes.	• Greater costs – a CRT requires document drafting, appraisals and fees for ongoing administration work. • For a CRUT, poor investment returns will lower the individual beneficiaries' distributions. • For a CRAT, additional contributions are prohibited and if principal declines in value, the trust could be depleted.
FOR CHARITIES	• Enhances donor and prospect cultivation. • Provides for sizable gifts to the charity. • Potential to invest CRTs in charity's endowment if a private letter ruling is issued by the IRS to commingle the assets of the CRTs with the endowment.	• Will the charity serve as trustee? • If serving as trustee, will charity require that it is the sole remainder beneficiary? • Who will administer the trust? Who will manage the investments? • Is the proposed funding asset acceptable?

WHAT'S BEST FOR YOUR DONORS?

For many donors, the most appropriate philanthropic solution will be determined by consultation with their legal counsel and tax advisors. For some, an outright gift will remain the vehicle of choice. For others, the flexibility of a charitable gift annuity or a charitable remainder trust will fulfill not only their personal financial planning goals, but their charitable intent in supporting a nonprofit for its continued success.

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