



# Advanced Planning Strategies

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June 2003

Dear Reader,

Congress was in the process of forming the “Jobs and Growth Tax Act of 2003” at the time this letter was in preparation. The House version contained \$550 billion in tax reduction, while the Senate version was limited to \$350 billion in relief. The Joint Committee on taxation hammered out the differences, and the process of compromise moved along with unusual speed. The House and Senate approved the final version within one day, with Vice President Cheney breaking a 50-50 deadlock in the Senate. The President is expected to sign the bill into law by the time you read this letter. We will provide a detailed planning summary of the legislation for you in next month’s letter.

One key component that drew the most attention is the relief from taxation of corporate dividends. The House version of the bill contained about \$245 billion of relief for excluded dividends; the Senate bill was limited to about \$80 billion (the Senate initially limited its relief to 3 years). The original budget proposed by the President provided for dividends to be excluded only for distributed earnings already taxed at the corporate level. There was language for an “excludable dividend account” that would presumably not result in simplification of corporate tax compliance.

The version of the dividend relief in the final legislation is significantly different from the President’s proposal and the House and Senate markups. Rather than a complete exclusion, dividends and capital gains will be taxed at lower rates. Dividends will be taxed at a maximum of 15 percent for several years for taxpayers in the four highest tax brackets. Taxation of long-term capital gains will be reduced to 15 percent for the upper brackets and 5 percent for the two lowest-bracket taxpayers. The dividend/capital gain relief will be eliminated after 2009. One issue that will certainly be debated is the potential fairness of the treatment of stock owned individually versus stock held in qualified retirement plan accounts, 401(k)s, or IRAs. All distributions not previously taxed from such retirement plans are subject to income taxation at ordinary rates when received by retirees or their heirs, and there appears to be no relief in the tax rate if a portion of the earnings of the retirement account includes corporate dividends or long-term capital gains.

*Knowledge is not power. Only knowledge in use is power.*

## **CHARITABLE GIFT ANNUITIES: DONATIONS THAT PROVIDE RETIREMENT PROTECTION**

### **WHAT IS A CHARITABLE GIFT ANNUITY?**

A charitable gift annuity (CGA) is a useful way for a donor to make a gift to charity while retaining an income stream that will offer retirement protection. Through an agreement signed by both the donor and the charity, the charity provides a life annuity backed by the charity's assets to the donor in exchange for a donation of cash or property. The donation qualifies for a tax deduction because the fair market value of the donated property will be in excess of the present value of the life annuity. The charity benefits because it will receive the excess value at the death of the annuitant.

A CGA is an attractive form of donation for a number of reasons. First, there are several tax advantages to the donor. Second, a CGA is relatively simple to design and administer. Finally, the donor will receive a fixed annual payment that continues for the remainder of the donor's life, providing a useful and guaranteed retirement benefit.

### **HOW IS THE ANNUITY AMOUNT DETERMINED?**

To determine the size of the promised annual payment, the American Council on Gift Annuities (ACGA) prescribes a set of annuity rates to which most charities adhere. Actuarially, the CGA rate is based on the life expectancy of the donor and the federal mid-term rate as determined monthly by the IRS. The donor can select the most favorable mid-term rate of the current or previous 2 months for his or her charitable gift. Of course, the predetermined annuity rate is not equal to what a commercial annuity would provide. The ACGA rates assume that the property that passes to charity at the death of the donor/annuitant will generally fall between 40 to 60 percent of the amount of the donated property. The ACGA publishes rates for the calculation of gift annuities. All calculations in this letter are based on the rates recommended beginning January 1, 2003.

### **WHAT IS THE TAX TREATMENT OF A CGA TO THE DONOR?**

The donor is entitled to an income tax deduction at the time of the gift, but the amount of the deduction varies with the circumstances of the CGA. After the CGA agreement is signed and the property is donated, the donor receives a current income tax deduction equal to the difference between the fair market value of the donated property and the present value of the life annuity received in return. The present value of the annuity is determined by actuarial factors prescribed by the IRS, including life expectancy (which varies according to the age of the donor at the time of the gift) and the appropriate federal mid-term rate discussed above. The size of the allowable deduction may also be restricted by a set of percentage limitations in Sec. 170 of the Internal Revenue Code. For example, the deduction is limited to 30 percent of the donor's contribution base (adjusted gross income in most instances) if appreciated property is donated. Excess amounts can be carried forward and deducted over the next 5 tax years. One tremendous advantage of a CGA donation is that appreciated property can be contributed without the immediate payment of capital gains taxes.

Although the donor receives an income tax deduction upon transfer of the cash or property to the charity, the donor must recognize income upon receipt of an annuity payment. A portion of the payment will reflect a return of principal, which is determined by dividing the donor's investment in the contract by the expected return. This results in an exclusion ratio, which shelters a portion of each annuity payment from tax. The investment in the contract is the lesser of the present value of the annuity or the fair market value of the

property transferred. The expected return is the annual annuity amount multiplied by the donor's life expectancy.

The annuity taxation rules provide for one portion of every payment to be excluded from income as a return of principal and the other portion to be included in taxable income. However, the character of the taxable portion of the annuity could result in both ordinary income and capital gains treatment if an appreciated capital asset was contributed to the charity. Although tax is avoided on any appreciation of capital gain upon transfer to the charity, a proportionate amount of the unrealized capital gain will be allocated to each payment. The result is that each annuity payment may have parts that are nontaxable, parts that are taxable as ordinary income, and parts that are taxable as capital gain. Once the annuitant lives beyond his or her life expectancy, each payment he or she receives will be entirely subject to ordinary income tax.

One tax problem that might occur involves the donation of property subject to indebtedness. The so-called bargain sale rules would apply to this type of donation. Under these circumstances, the donor could recognize some capital gain immediately at the time of the donation.

### **HOW ARE CGAs REGULATED BY THE GOVERNMENT?**

Congress responded to some challenges against CGAs by enacting the Charitable Donation Act of 1997, providing states with the temporary opportunity to enact antitrust provisions with respect to CGAs.

Many states regulate CGAs. A minority of states maintain stringent rules for charities offering CGAs. These states require that charities apply for a permit if they issue gift annuities. There are also states that regulate reserve limits and investment requirements. These regulations make it difficult for the charity to provide a moderate payout when chances are fairly good that investment performance will not yield much of a remainder interest to the charity. Since the charity backs the annuity payment with its assets when it forms the agreement with the donor, the charity may receive nothing if its investment return is insufficient or the donor lives longer than the life expectancy used in the annuity rate calculation.

In 1998, the National Association of Insurance Commissioners adopted Model Gift Annuity Regulations and Model Deregulation Acts.

### **AN EXAMPLE OF HOW IT WORKS**

Marge, age 65, has \$500,000 worth of publicly traded XYZ stock with an income tax basis of \$100,000. She wants to make a gift to her alma mater, but she needs a guaranteed income stream through retirement. The dividend yield on the XYZ stock is insufficient to provide the necessary income. Selling the XYZ stock will cause a \$400,000 capital gain (assume all long-term) and \$80,000 of federal income taxes.

She decides to give the stock to her alma mater in exchange for a CGA guaranteed for the remainder of her life. Based on calculations using a federal mid-term rate of 3.8 percent, she will receive an income tax deduction of \$130,814. Again, she will be able to currently deduct only an amount up to 30 percent of her adjusted gross income. She will receive an annual annuity payment of \$31,500 for the rest of her life based on current ACGA rates. Until Marge reaches her life expectancy (in 19.5 years in this instance), \$3,785 of each annuity payment is tax free as a return of principal. The remainder of the annual payment is divided into \$15,146 of capital gain and \$12,569 of ordinary income. If Marge lives beyond her life expectancy, all remaining annuity payments are taxable as ordinary income. The annuity payments will last as long as she lives and are guaranteed by the assets of her alma mater.

## RECENT CASES AND RULINGS

### TESTAMENTARY CHARITABLE GIFT ANNUITY (CGA) FUNDED WITH DECEDENT'S IRA

The taxpayer proposed entering into a charitable gift annuity contract with a qualified charity while he was still alive. The contract indicated that the charity would be named as the designated beneficiary of this IRA at the taxpayer's death. The CGA would provide his selected heir with an estimated \$45,000 per year based on the heir's age at the time of the taxpayer's death. The IRS ruled (Ltr. 200230018) that the IRA is included in the decedent's gross estate at the time of his death. The estate is permitted an estate tax charitable deduction for the actuarial amount of the charitable interest (i.e., the amount of the IRA at the time of death less the value of the annuity provided to the selected heir). The tax-exempt status of the charity is not affected by this transaction, and the charity will not have to incur unrelated business taxable income.

### PRIVATE FOUNDATION CAN HOLD AND PAY PREMIUMS ON A LIFE INSURANCE POLICY ON THE DONOR'S LIFE

The donor created a private foundation and was appointed as the foundation's director for life. The donor proposes contributing a life insurance policy on his life currently held by his irrevocable trust to the foundation. A noncontrolled attorney is named as a director of the foundation. The donor proposes to enter into an agreement to contribute the 20-year term premiums each year to pay for the policy premiums. The other director is vested with sole voting power with respect to all incidents of ownership for the life insurance policy. This proposal represents an excellent plan to provide for a significant foundation contribution for the postdeath period of the donor.

The IRS ruled (Ltr. 200232036) that (1) the payment of premiums by the foundation will not result in a benefit to private shareholders or other individuals and will not cause the foundation to lose its exempt status, (2) the transfer of the policy will not be an act of self-dealing, nor will the contributions for future premiums, and (3) the contribution and payment of premiums will not constitute a jeopardy investment under Sec. 4944.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients  
for the future*



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