Peaceful Surrender: Charitable Contributions of Life Interests

It may seem too good to be true, but the beneficiary of the life interest in a planned gift – if he or she is inclined to do so – is typically free to end the arrangement ahead of schedule by letting the charity become the new owner of the interest in question. Recognizing that there are potentially a number of details to be addressed (as covered in our June 2012 eRate featured article [link]), what follows is a quick review of the possibilities.

The Gang of Four

Life interests associated with these planned gifts are eligible for contribution to the charity:

- charitable gift annuities (CGAs)
- charitable remainder trusts (CRTs)
- pooled income funds (PIFs)
- retained life estates (RLEs)

Basic considerations involved with each one will be covered in turn.

Note: In many cases it is possible for the beneficiary of a life interest to terminate the arrangement without making a charitable gift. This usually results in the beneficiary receiving cash in a lump sum. Similarly, sometimes one type of planned gift can be transformed into another type. An example would be converting a CRT to a CGA. Finally, the beneficiary of a life interest will occasionally choose to surrender less than 100 percent of that interest. While in any given instance one or more such an options may be worthy of attention, none of them will be discussed in this article.

CGAs

In this instance, the life interest consists of the annuitant's right to payment of a fixed sum for as long as he or she is living. Contribution of this interest will generally be accomplished fairly simply, either by assigning it to the charity that issued the CGA or by relinquishing it in favor of the charity. If there are two annuitants, the process may be somewhat more complicated.

Although the annuitant should consult his or her tax advisor in claiming an income tax charitable deduction for the contribution, the weight of opinion is that the deduction equals the lesser of the present value of the stream of life payments at the time it is surrendered and the portion – if any – of the original investment in the contract that has not been returned in the form of payments as of the surrender date. The unreturned investment in contract is the sum of all tax-free and capital gain portions of the annuity payments that will not be distributed because of the early termination.

The *Deduction for Gift Annuity Termination* tool and *Non-Charitable Interest Dollars* chart in *Planned Giving Manager* (*PGM*) [link] can be used to determine the amount of the deduction. Full instructions on how to compute the deduction available for the gift of a life interest in a

CGA, as well as for all of the other gift arrangements this article discusses, are available in *PGM's* online Help. Look for "Income interest – Calculating the value of" in the Index.

If the deduction comes to more than $5,000, the IRS requires the donor to substantiate the deduction with a qualified appraisal of the present value of the life interest (even if it is greater than the unreturned investment in the contract).

CRTs

As with a CGA, the life interest in a CRT is the right to a stream of payments. While in the case of a CRT that right will often last for the lifetime of the beneficiary, it could be that the right exists only for a term of years (or for the lesser of a term of years or the beneficiary's life). Furthermore, what's paid by the trust might take the form of either an annuity or a unitrust amount. And whereas a gift annuity can have at most two beneficiaries of the life interest, in theory there is no limit to the number of life interest beneficiaries of a CRT. That being said, CRTs seldom have more than two such beneficiaries.

The phenomenon of multiple beneficiaries may be a factor not only with respect to a CRT's life interest, but with respect to its charitable remainder interest as well. Moreover, if the donor who established the trust retained the power to change remainder beneficiaries from time to time, this will need to be taken into account before any life interest beneficiary's payment right is surrendered. In short, contributing the life interest in a CRT "to charity" may be a much more complex matter than contributing the life interest in a CGA, although a surrender is normally accomplished by means of a simple assignment.

Fortunately, a CRT life interest beneficiary's surrender of his or her right to further payments from the trust will almost always produce an income tax charitable deduction. Exceptions will occur pretty much only if the trust has been in existence for less than a year and a day or if the life interest of the beneficiary in question is not vested. The measure of the deduction is the present value of the payments being surrendered. As with CGAs, the IRS requires a qualified appraisal to substantiate the deduction when it exceeds $5,000.

PIFs

Once again, the life interest is the right to a stream of payments. Specifically, what's paid is the person in question's pro rata share of the income earned by the PIF. As in the case of a CGA (and most CRTs), the life interest exists for the person's lifetime. As in the case of a CRT, even though there can be any number of life interest beneficiaries associated with a specific pro rata share of the fund, rarely will there be more than two.

Because a PIF is structured as a trust, issues regarding how long the right to payments has existed and whether the right is vested may require attention. Fortunately, a PIF can have only one charitable remainder beneficiary: the charity that established the fund.

The surrender of a PIF life interest is typically effected through either an assignment or a relinquishment. The resulting income tax charitable deduction is for the present value of the right

to payments as of the date of surrender, and if that value exceeds $5,000, the deduction must be substantiated with a qualified appraisal.

RLEs

In contrast to the three types of planned gifts surveyed above, with a RLE the life interest is the right to occupy a particular residence or farm, whether for the rest of the beneficiary's life or for a term of years. It is possible for this right to be shared in one fashion or another by two or more persons, but it is unusual to encounter a situation involving more than two life interest beneficiaries. As in the case of a CRT or a PIF, a life interest beneficiary's right to occupy the property should be vested and have existed for longer than one year in order to ensure that an income tax charitable deduction can be claimed.

If the life interest in a RLE is to be surrendered, it must be by means of a deed from the beneficiary of that interest to the charity that holds the remainder interest. Once in a great while the remainder interest will be shared by two or more charities, which is a factor that will complicate the situation somewhat. In addition, if a qualified appraisal is required because the present value of the remaining life interest (which is the measure of the income tax charitable deduction) exceeds $5,000, calculation of that present value should be based on a separate appraisal of the property itself, conducted by a knowledgeable real estate appraiser and suitably documented.

Getting a Qualified Appraisal

For all of the gift arrangements described above, the IRS requires a qualified appraisal of the deductible interest when the deduction exceeds $5,000. PG Calc is able to perform qualified appraisals of beneficiary interests in connection with CGAs, CRTs, PIFs, and RLEs, and does so regularly.

Who Should Pop the Question?

Quite often, a life interest beneficiary will be the one to raise the possibility of a surrender. This will frequently be so if the beneficiary and his or her advisors have examined various aspects of the beneficiary's circumstances and concluded that the beneficiary can afford the surrender. Accompanying such an analysis will be a separate determination by the beneficiary that he or she wants to accelerate the charitable purposes of the planned gift (or at least would not object to doing so).

For its part, a charity can be the one to suggest a surrender. In so doing, however, the charity should exercise the utmost care and discretion. The risk is that the life interest beneficiary (who, in the vast majority of cases, will be someone who established the planned gift in the first place) will feel alienated and/or pressured, a result no conscientious charity will desire. Still, especially when one or more persons at the charity know the beneficiary well, initiating an exploratory conversation can be feasible, especially if charity is able to assure the beneficiary that there will be no obligation and that the beneficiary's advisors will be called upon to protect his or her welfare.

In some cases, a charity may be able to take what would be essentially a “wholesale” approach, rather than the more “retail” approach just outlined. This will most likely be realistic in the case of CGAs, although PIFs and even CRTs might be involved. For example, the charity might want to send identical letters (identified as such, i.e., “we are writing you as well as certain other beneficiaries of ABC Charity’s gift annuity program”) to each member of a group of annuitants it has identified as ones for whom a surrender appears to be appropriate.

In turn, what is “appropriate” can legitimately be a function of what would be in the best interests of the charity as well as what a life interest beneficiary would find acceptable. Thus, a charity that has identified CRATs or CGAs facing a significant likelihood of exhaustion of the contribution prior to termination of the payment obligation could opt to approach selected annuitants about the possibility of terminating their CRATs or CGAs in order to preserve some benefit for the charity. Because they are invested separately, it typically is easy to recognize a CRAT that is in danger of exhaustion. This is not the case with CGAs, however. The *CashTrac* feature in PG Calc’s *GiftWrap* [link] can help you identify CGAs that are at significant risk of exhaustion. Alternatively, PG Calc can conduct a risk analysis [link] to help a charity identify troubled annuities.

Conclusion

If a life interest beneficiary contacts you about surrendering his or her interest, you can be confident the inquiry deserves further attention. Even though exploration of the situation may lead to the conclusion that a surrender is not the right choice (or at least not at this time), be sure to help the beneficiary and his or her advisors conduct a comprehensive analysis. Similarly, provided you can do so tactfully, don’t hesitate to propose a surrender to one or more income beneficiaries you think would be receptive to the idea. This will be especially worthwhile when the income interest beneficiaries are associated with life income arrangements that are at increased risk of providing less for your charity than intended.