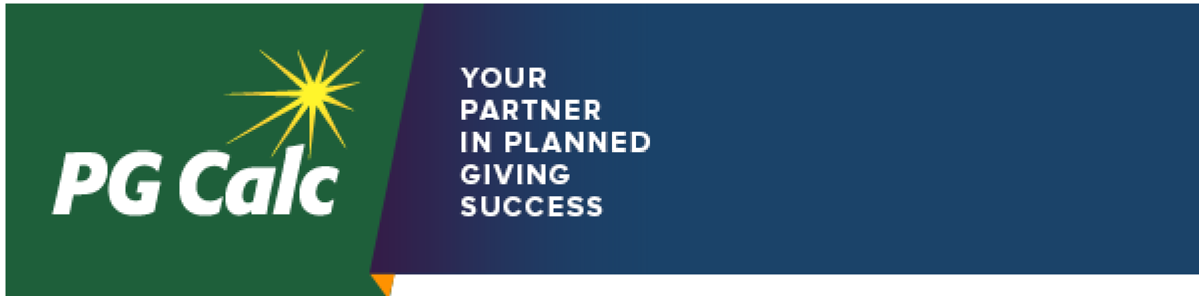

Tax Aspects of Gift Annuities

PG Calc Featured Article, August 2019

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After the bequest and beneficiary designation, the gift annuity is the most popular planned gift vehicle. Donors like them because they are easy to understand, offer reliable payments at attractive rates, and help them support the causes they love.

While often touted as the "simplest" planned gift, it may be hard to explain to prospects and donors the nuances of how gift annuities work. The easiest explanation is that an annuitant is entitled to a payment for life of a percentage of the amount donated. That payment percentage is determined by the age of the annuitant and the number of annuitants. A single annuitant, age 75, is entitled to a 6.8% annuity rate. A gift of $10,000 would entitle the annuitant to payments of $680 a year. Simple, right? Not so fast.

Gift annuities can be funded with cash, appreciated securities, or a combination of the two. This article will discuss the tax consequences to a donor and annuitant of a gift annuity funded both with cash and securities.

The Donor's Income Tax Charitable Deduction

The income tax charitable deduction for a gift annuity is less than the amount of the gift donated. That makes sense when you consider only part of the gift annuity is a gift to your charity. Some of the gift annuity is the donor's non-charitable right to receive income. The non-charitable portion is not deductible.

You'll often hear that a gift annuity is a "bargain sale." Say what? Who is buying what from whom? The donor is buying an annuity contract from your charity equal to the non-deductible portion of the gift. The rest of the gift is wholly charitable and therefore deductible.

The division between the deductible and non-deductible portions of a gift annuity determines how annuity payments are taxed in the hands of the annuitant. The income tax deduction will be the same for a gift funded with long-term appreciated property, cash, or a combination of the two.

Taxation of Annuity Payments Funded Exclusively with Cash

When funding a gift annuity exclusively with cash, the entire non-deductible portion of the gift is returned to the annuitant tax-free. How can that be? Think of it this way. If you withdraw money from an ATM, are you taxed on that transaction? No. Likewise, as the non-deductible portion of the annuity is paid to the annuitant, it's as if the donor is getting her own money back. She already paid tax on that money! Therefore, that return of her purchase price is tax-free.

Now, that tax-free portion is not a free ride. The non-deductible portion of the annuity is returned to the annuitant over her life expectancy. Therefore, once the non-deductible portion of the annuity is paid to the annuitant, that tax-free portion becomes ordinary income. It makes sense that the tax-free portion of the payments runs out at that point because the annuitant has then received all of the original gift amount upon which tax has already been paid.

Example: *Ms. Palmer, age 75, contributes $100,000 cash for a gift annuity. The charity to which she makes the gift uses the American Council on Gift Annuities rate of 6.8%, and the IRS discount rate is 2.8%.*

Non-Deductible Portion of Gift (Cost of the Annuity Contract)	***Deductible Amount***
A *$53,808*	*B* *$46,192*

Annual payment $6,800

A. *$53,808 is the price Ms. Palmer paid for an annuity paying $6,800 for life. Ms. Palmer already paid tax on the cash used to purchase the annuity contract. Ms. Palmer will receive the $53,808 of after-tax dollars as tax-free income. This income will be spread over her projected life expectancy as of the day she made the gift.*

B. *$46,192 is the amount by which the $100,000 contribution exceeds the $53,808 she paid to buy the annuity contract. This "excess" is the income tax charitable deduction.*

According to IRS tables, Ms. Palmer's life expectancy is 10.5 years. The annual tax-free portion of the $6,800 is computed by dividing the cost of the annuity contract, $53,808, by her life expectancy: $53,808 ÷ 10.5 = $5,125. This portion of her annual payment is tax-free. The balance of her annuity payment, $1,675, is taxed as ordinary income. At the end of her life expectancy, she will have received her entire tax-free purchase price. If Ms. Palmer lives past her projected life expectancy of 10.5 years, her entire annuity payment will become fully taxable as ordinary income going forward.

Taxation of Gift Annuities Funded with Long-Term Capital Gain Property

To review, why does a gift annuitant receive tax-free income? Because the annuitant has already paid taxes on a portion of each payment from the gift annuity. But what if the gift annuity is funded with property upon which taxes have not been paid?

When property that has appreciated in value, such as stock, is donated to charity, there is no capital gain tax due. Likewise, if appreciated stock funds a gift annuity, the portion of the capital gain that is attributable to the tax-deductible portion is not taxed. This is just like an outright contribution of appreciated stock to a charity.

But that leaves us with capital gain that is attributable to the non-deductible purchase price of the annuity. The capital gain attributed to the non-deductible portion of the annuity is subject to tax. The only question is when.

In most cases, capital gain can be reported in one of four ways:

1. The capital gain is spread out over the life of the annuitant if the donor is the only annuitant.
2. If it is a two-life annuity, the donor is the primary annuitant, and it is funded with the donor's separate property, the gain will be reported over the life expectancy of the donor/annuitant.
3. If a husband and wife fund the annuity with jointly-owned or community property, and the annuity payments are made to them jointly and then to the survivor, the gain can be reported over their joint-life expectancy.
4. If the annuity payments are paid to someone other than the donor, then the gain attributable to the non-charitable portion of the annuity (the purchase price) must be reported by the donor in the year of the gift.

Any gain unreported at the death of the sole or surviving annuitant is not taxed because it is part of the residuum that belongs to the charity.

Example: *Instead of contributing $100,000 cash for the gift annuity, Ms. Palmer contributes stock with a fair market value of $100,000 and a cost basis of $40,000. If Ms. Palmer sold the stock she would have to report $60,000 of capital gain income. Her $40,000 cost basis is treated like the cash in the example above. Tax has already been paid on the cost basis, so it is returned to her tax-free. How is the capital gain divided between the charitable and non-charitable portions of a gift annuity?*

Purchase Price of the Annuity $53,808		***Charitable Deduction $46,192***	
Tax-free cost basis	***Capital gain attributed to purchase***	***Gift cost basis***	***Capital gain attributed to gift***
$21,523	*$32,285*	*$18,477*	*$27,715*

The fraction of Ms. Palmer's contribution that is deductible drives how the capital gain is allocated between the gift and purchase price of the annuity. Since our total contribution is a nice round $100,000, the division of these amounts is simple.

53.808% of Ms. Palmer's capital gain is reportable because that is the percentage attributed to the purchase price of her annuity. 53.808% of $60,000 of capital gain is $32,285. That is the amount of capital gain Ms. Palmer must report, spread in equal installments over her 10.5-year projected life expectancy.

46.192% of Ms. Palmer's gain is attributable to the deductible portion of her gift. 46.192% of $60,000 is $27,715. Ms. Palmer doesn't have to report this gain because it is as if she made an outright gift to charity of $46,192 that includes this $27,715 of gain. As with all outright gifts of long term appreciated property to a public charity, the capital gain is forgiven.

For the duration of her life expectancy, Ms. Palmer's payments will be taxed as follows:

Tax-Free	($21,523 ÷ 10.5) =	$2,050
Capital Gain	($32,285 ÷ 10.5) =	$3,077
Ordinary Income (the balance of the payment)		$1,673
		$6,800

If Ms. Palmer lives 10.5 years, her projected life expectancy at the time of the gift, her entire purchase price will have been returned, and her entire taxable gain will have been reported. Thereafter, the annuity payments will be fully taxable as ordinary income.

If she were the donor and another person – her brother, for example – were the successor annuitant, the capital gain would be reported over her projected life expectancy only. However, if she were to die sooner than 10.5 years after making the gift, her brother would continue reporting a portion of his payments as capital gain until it has all been reported. Only if he also were to die before 10.5 years have elapsed would the unreported capital gain be forgiven.

Conclusion

You don't have to be an expert at the taxation of gift annuity payments. Nonetheless, familiarity with the taxation of cash annuities as partly tax-free and partly ordinary income will help you promote and discuss gift annuities. Plus, remember that an annuity funded with appreciated property triggers a different tax treatment than a cash gift. At a minimum, it is important to ascertain whether a donor is considering funding a gift annuity with cash or appreciated property, as the answer may affect significantly the taxation of the annuity.