**FINANCIAL STRATEGIES**
For estate planning and planned giving.
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UNIVERSITY OF ROCHESTER

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# ACGA Announces New Gift Annuity Rates

At the recent 29th Conference on Gift Annuities in New Orleans, the American Council on Gift Annuities announced new suggested maximum gift annuity rates to take effect July 1, 2010. The new rates reflect a small adjustment upward in most rates since the last set of suggested rates became effective February 1, 2009.

This is the first general increase in suggested rates by the ACGA since March of 1997. There have been six reductions to those suggested rates since that time prior to the new rates just announced. The new rates are based on the same assumptions used by the ACGA for some time now with some minor adjustments.

**Immediate Payment Gift Annuities.** The rates are calculated on the assumption that a contribution for an immediate gift annuity will produce a 50% residuum at the time the annuity is anticipated to terminate. That is, the charity will still have 50% of the original contribution left at that time.

During the term of the annuity, it is assumed that the annuity will be invested in a model portfolio of 40% equities, 55% in 10-year Treasury bonds, and 5% in cash or cash equivalents based on the return on the three-month Treasury bill. For equities, the return is expected to be the historic average return on equities since 1926 less 1%, and the return for the 10-year Treasury bond and three-month Treasury bill is the average of the last three months prior to the adoption of the rate schedule.

After accounting for an assumed annual expense factor of 1% of the original contribution, the assumptions above result in a net 4.5% assumed rate of return during the term of the annuity based on the most recent returns for each component. This is up from 4.25% for the net return assumed in the rates currently in effect. Most of the difference is in the return on the 10-year Treasury bond.

One small change in the assumptions was in the area of life expectancy. The new rates continue to assume mortality based on the 2000 annuity tables, but with a two-year setback from the female life expectancy instead of a 1½ year setback. Also, the new rates assume quarterly payments rather than semi-annual payments.

These assumptions produce the following representative one-life and two-lives immediate payment suggested maximum rates:

| ONE-LIFE RATES | | | | TWO-LIVES RATES | | | |
|---|---|---|---|---|---|---|---|
| Age | Current Rate | New Rate | Difference | Ages | Current Rate | New Rate | Difference |
| 50 | 4.4 | 4.8 | +0.4 | 50-50 | 3.8 | 4.2 | +0.4 |
| 55 | 4.8 | 5.0 | +0.2 | 55-55 | 4.1 | 4.6 | +0.5 |
| 60 | 5.0 | 5.2 | +0.2 | 60-60 | 4.6 | 4.9 | +0.3 |
| 65 | 5.3 | 5.5 | +0.2 | 65-65 | 4.9 | 5.1 | +0.2 |
| 70 | 5.7 | 5.8 | +0.1 | 70-70 | 5.2 | 5.4 | +0.2 |
| 75 | 6.3 | 6.4 | +0.1 | 75-75 | 5.6 | 5.7 | +0.1 |
| 80 | 7.1 | 7.2 | +0.1 | 80-80 | 6.1 | 6.3 | +0.2 |
| 85 | 8.1 | 8.1 | 0.0 | 85-85 | 7.0 | 7.1 | +0.1 |
| 90 | 9.5 | 9.5 | 0.0 | 90-90 | 8.3 | 8.3 | 0.0 |

(*Note:* Rates at younger ages have been adjusted from the pure rates that would follow from the assumptions to ensure that annuities meet the requirement that the deductible value of a gift annuity be more than 10% of the amount of the original contribution and have also been adjusted for older ages to account for a tapering down to a maximum suggested rate at age 90 and above.)

This new schedule has rates slightly higher at most ages at which gift annuity transactions typically take place. For example, the current rate for a one-life annuity with a beneficiary age 65 is 5.3% and the new suggested maximum rate is 5.5%. Similarly, at age 75 the current rate is 6.3% and the new rate is 6.4%. The difference is greater at younger ages—the current rate at age 50 is 4.4% and the new rate is 4.8%. However, there are relatively few gift annuity transactions with a beneficiary of that age and many charities have a minimum qualifying age for their gift annuity programs.

**Deferred Gift Annuities.** The ACGA is recommending a change in the interest rate credited during the deferral period from the current 4.25% to 4.5%. This is effective for a deferral period of any length.

The *Explanation of the ACGA Gift Annuity Rates Effective July 1, 2010,* notes that a different, lower compound interest rate had been used at times in the past for deferral periods in excess of 20 years. The ACGA also cautions charities issuing deferred annuities to be sure to check that the rate for annuities with relatively long deferral periods does not exceed the maximum allowable rate in certain states, notably New York and New Jersey.

**Changes Coming?** The rates paper did suggest that changes may be coming in the methodology in calculating rates in the future. The rates paper noted that the previous ACGA surveys have determined that gift annuitants live longer than the general public. In making its recommendation on rates, the rates committee also recommended that the ACGA undertake another study of actual gift annuitants in 2010 and 2011 to determine if the current method of assuming a two-year setback from female life expectancy in the 2000 annuity tables is sufficient to account for this longer life expectancy.

The rates paper also indicated that the rates committee had begun a serious review of whether or not a 50% residuum should continue to be the assumption on which the rates are built or whether it would be more appropriate to move to a present value concept. Under the current method, the ultimate benefit for the issuing charity is the same—50% of the amount of the original contribution—regardless of the age of the annuitant or annuitants at the time the gift annuity is issued.

The ACGA points out that a $10,000 gift annuity for the life of a 60-year-old and a $10,000 gift annuity for the life of an 80-year-old would have the exact same residuum value—$5,000. However, if each of the two annuitants lived his or her exact life expectancy, the charity would have to wait almost 15 years longer to have access to that residuum in the case of the 60-year-old annuitant.

The obvious conclusion is that the residuum in the annuity for the 80-year-old has a significantly higher present value than that of the 60-year-old. The rates committee confirmed that it has been studying whether or not it would be more appropriate for rates to be built on an assumption that the present values of all annuities—regardless of the age of the annuitant—be substantially similar. The rates committee ultimately determined that a move to present value may be appropriate in the near future, but they wanted to conduct further study and analysis and invite input from the charitable community.

## Long Arm of EGTRRA Raises Questions for CRTs

The Economic Growth and Tax Relief Reconciliation Act of 2001 set in motion a wide range of sweeping tax-law changes, including the eventual repeal of the federal estate tax in 2010. Many, if not most, thought that Congress would take

## Who Should Consider Converting to a Roth IRA? A person who …

- Can afford to pay the conversion tax and do so from sources other than the IRA. Otherwise, the whole purpose of the conversion is defeated.
- Does not expect to be in a lower tax bracket in retirement.
- Will probably not need to touch the Roth for living expenses until much later, if ever.
- Is younger, although this could work well for an older person in good health.
- Wishes to provide for beneficiary(ies) who will stretch benefits over life expectancy(ies).

action long before the estate tax went away to continue it at some level. That has not happened, and currently there is no estate tax—although it is scheduled to come back in 2011 at levels dictated by pre-**EGTRRA** law.

In addition to repealing the federal estate tax, **EGTRRA** instituted a one-year back-up plan for federal gift tax in what is currently in the **Internal Revenue Code §2511(c)**, which states:

> **Treatment of Certain Transfers in Trust—**Notwithstanding any other provision of this section and except as provided in the regulations, a transfer in trust shall be treated as a transfer of the property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.

This language is applicable to gifts made after December 31, 2009, and before January 1, 2011.

Charitable remainder trusts are not treated as wholly owned by the donor (or the donor's spouse) and, therefore, could be deemed to come within the purview of **IRC §2511(c)**. The question is, "Is that what Congress really intended?"

Such a reading of that Code section would lead to some seemingly unintended consequences. For example, if a donor D created a charitable remainder unitrust, retained a 5% annual unitrust interest, and directed the remainder to charity C, it would seem to follow from the literal reading of the section this transaction would be treated as a gift of the property.

Has the donor made a taxable gift to himself or herself? It seems highly unlikely that would have been the intent of Congress. A technical correction to the original language of **EGTRRA** did clarify that marital and charitable deductions would continue to apply to affected transactions. Does that mean that an income interest transferred to a spouse would qualify for a deduction but would be taxable if retained by the donor?

**IRC §2511(c)** also targets gifts that prior to and after 2010 would be treated as incomplete gifts and deems them completed gifts for this year. A typical situation in the charitable realm would be for donor D to retain an income interest in a charitable remainder trust, give third-party T a survivorship interest in that income interest but retain the right to revoke that interest by will, and direct the remainder to charity C.

But for **IRC §2511(c)**, the survivorship interest of T would be deemed to be incomplete for gift-tax purposes since D retained a right to revoke by will. However, a literal reading of the section could lead to the conclusion that the gift is complete—and taxable—for gift-tax purposes in regard to T and, as noted above, even for the value of D's interest.

**IRC §2511(c)** is intended to address transactions that would not typically be subject to gift tax but would be subject at some point to federal estate tax during this period when there is no federal estate tax—generally because the gift is deemed to be incomplete. It also has the effect of reducing the attractiveness of income shifting for income-tax purposes.

Charitable remainder trusts would seldom be used for income-shifting purposes or to circumvent the gift tax during this time in which the estate tax is temporarily repealed. The annual distribution from a charitable remainder trust is taxable to whoever receives the distribution according to a four-tier system that determines the character of distributions. To the extent the trust has realized each component, distributions are treated first as ordinary income, then capital gain, then other income, and finally return of principal.

The **IRS** has guidance related to **IRC §2511(c)** in **Notice 2010-19; 2010-8 IRB 1.** The notice reiterates the application of the section to transfers in trust not deemed to be wholly owned by the donor or the donor's spouse. Although several leading advisors have appealed to the **IRS** to issue further guidance clarifying that the section does not apply to charitable remainder trusts, no such guidance has been forthcoming as yet.

## Discussion Lists for Gift Planners

- **ABA-TAX** A tax-law Internet discussion group sponsored by the American Bar Association Tax Section. Participation is limited to practitioners, law professors, and law students. http://www.abanet.org/tax/lsinfo.html
- **ABA-PTL** Sponsored by the Probate Division of the Real Property, Probate & Trust Law Section of the American Bar Association, intended primarily for the use of Section members and related professionals so they can discuss estate-planning and administration issues by e-mail. http://mail.abanet.org/scripts/wa.exe?SUBED1=aba-ptl&A=1
- **Yahoo! Groups—Planned Giving** An open list for discussion of gift-planning topics. http://groups.yahoo.com/group/plannedgiving/
- **GIFT-PL** Partnership for Philanthropic Planning members-only discussion list for all issues and queries related to gift planning. http://www.pppnet.org/members/gift_pl.asp

## Treasury Completes Report on Charity-Owned Life Insurance

The Pension Protection Act of 2006 (**PPA**) mandated a study by the Department of the Treasury on tax-exempt organizations' use of certain life insurance contracts for the purpose of sharing the benefits of the organizations' insurable interest in individuals insured under such contracts with investors and on whether such activities are consistent with the tax-exempt status of such organizations. That report was submitted to Congress this spring.

The mandate for the study grew out of concern about several versions of a plan under which charity-owned life insurance (**ChOLI**) contracts were obtained as part of a structured plan to acquire a pool of such contracts with the bulk of the cost of procuring the policies borne by private investors. In a typical plan, investors loan funds to charities to purchase the policies and the investors then receive a large proportion of the death benefits in addition to interest on the funds loaned.

According to the report, "In general, the investors in a **ChOLI** arrangement are seeking the profit potential that actuarial arbitrage can provide but that is otherwise inaccessible due to the insurable interest requirement." The Treasury had hoped to acquire a substantial amount of information from new notification requirements created by **PPA** for charities entering into the described contracts. Through December of 2009, the **IRS** had received fewer than ten submissions of a new Form 8921 designed for that purpose.

Consequently, the report focuses more on the tax implications and policy issues involved rather than hard data. One key area of analysis is the requirement under **IRC §501(c)** that a charity operate exclusively for exempt purposes. Without coming to a firm conclusion, the report points out that facilitating the investment by private investors in life insurance contracts may run afoul of that requirement.

The report also explores the question of whether any aspect of the plan results in private inurement for noncharitable persons or entities. Again, without stating a formal conclusion, the report suggests that despite the greatly disproportional allocation of death benefits there is not a compelling case for private inurement—unless, of course, officers or other insiders of the charity materially participate as investors.

Such arrangements also raise the issue of unrelated business taxable income (**UBTI**). If charities borrow money to purchase the policies, this would seem to give rise to debt-financed income. Absent debt-financing, **UBTI** would include gross income from such arrangements only if it constitutes an "unrelated trade or business" that is "regularly carried on." That, of course, would be a question of fact.

The report notes that there have been three bills introduced in Congress to create excise taxes to discourage organizations from entering into such transactions. None has been enacted into law. The report concludes by recommending adoption of the administration's fiscal year 2010 and 2011 budget proposals to revise the "transfer-for-value" rule of **IRC §101(a)** to ensure that investors in a **ChOLI** arrangement do not inappropriately benefit from the gross income exclusion for death benefits from a life insurance contract in circumstances when those investors have purchased an ownership interest in the underlying policies.

***Financial Strategies*** *is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep philanthropic planners up to date on developments in estate planning as they relate to testamentary and lifetime plans of support of qualified charities.*

UNIVERSITY OF ROCHESTER

590 Mt. Hope Avenue
Rochester, New York 14620
(585) 273-5930
toll free (800) 635-4672

*Edited by André R. Donikian, JD, and Robert L. Coffman, JD*