

CGAs

MOVING BEYOND THE BASICS AND INTO THE FUN STUFF!

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CGAs: Moving Beyond the Basics and Into the Fun Stuff!

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The ever popular charitable gift annuity is typically funded with either cash or marketable securities. But, it has become increasingly important for the gift planner to be able to expand the conversation beyond the basic funding assets when appropriate. Find out if commonly owned assets such as life insurance and commercial annuities can be used effectively.

Part 1: Funding a CGA With Life Insurance

After months of discussing funding a \$200,000 CGA with cash, the donor says, "I have this old life insurance policy that I don't need for my family's protection anymore. I'd like to give it to you. It's worth about \$500,000 and the cash value is \$200,000. Can I use this for the CGA instead of writing a check?"

Where do you turn for help? First, look to your gift acceptance policy. Are there any prohibitions against using life insurance to fund a CGA? If not, be sure to check the section on outright gifts of life insurance. If there are restrictions there, it may well be that your organization won't want to accept life insurance for a CGA.

Next check with your gift acceptance committee. Before approaching the committee, do a little homework about what type of life insurance policy it is, how much it is worth, etc. Ask the donor to provide you with a copy of the actual life insurance policy, the last annual statement, and if possible, an up-to-date policy illustration.

Your charity's risks of accepting life insurance for a CGA

Your charity should consider several risks beyond the normal CGA risks. One is that your organization will have to find another source for making the annuity payments since you wouldn't want to access the cash value of the insurance policy to make the payments. That would eventually cause the policy to lapse.

Another risk is the strength of the life insurance policy itself. *If* you plan to keep the policy as an investment, then you have to look at how the policy has performed in terms of interest earnings and expenses and what it might earn in the future. Consider how much interest you anticipate will be added to the policy until the time of the donor's death, when the donor will die (you can't know this), and how much it will cost between now and then to own this policy (you can't know this).

Another consideration is how well the policy has been funded. For any policy other than term and pure whole life, there is a range of premiums that can be paid; the thinner the premiums, the more the risk of the policy lapsing and vice versa. The worst-case scenario for your organization would be accepting a life insurance policy and then having to use your organization's own funds to dump additional premiums into it just to keep it from lapsing.

Compare the future estimated (projected) interest earnings to what your investment committee might be able to earn. Recall that CGAs should be invested with a 4.25% (net) per year earnings projection. Can your organization do better than the life insurance company?

Another risk to your charity is the strength (or lack thereof) of the insurance company that issued the policy. If the insurance company isn't financially sound, the insurer could go under, leaving

your policy exposed to bankruptcy. Be sure to perform due diligence on the insurance company if your organization wants to keep the policy as an investment. *Consider obtaining your due diligence information from unbiased or independent sources.*

Life insurance isn't an investment. It is insurance to protect against the risk of someone dying prematurely. If your donor dies before his/her life expectancy, you will probably make more net money on the policy if you keep it. However, if the donor lives beyond his/her life expectancy, your investment committee may easily do better financially if you surrender the policy right away and invest the cash from the surrender. The trouble is—you don't know when the donor is going to die. Do you need insurance for a premature death? If so, keep the insurance. If not, your board members should consider its ability to invest on their own.

Are there other options? Yes, another option exists besides surrendering the policy to the insurer: the option is a controversial segment of the life insurance industry, called life settlements, in which a policy owner sells a policy to a third party investor for more than the current cash value, but less than the face amount. The insured does not need to be terminally ill. If your institution is considering this, check into it thoroughly and consult independent sources to discover all the pro's and con's before proceeding.

Illustrations/tax issues

For example, Bob has a whole life policy with a fair market value of \$290,000 and a death benefit of \$500,000. His cost basis is \$215,000. To run a CGA illustration, enter the fair market value for the amount of the donated policy. Do not enter the face amount of the life insurance policy.

When you enter that information into the computer program to calculate the CGA deduction, be sure to enter Bob's cost basis into the correct field. The cost basis is the total premiums paid to date, less any dividends the policy owner received in cash from the insurance company and less any partial surrenders (it is rare that policy owners take their dividends in cash). This does not include dividends that were used to increase the cash value.

There is no taxable event to the donor when he/she transfers the ownership of the life insurance policy in exchange for a gift annuity. This is unlike the situation where a commercial annuity is transferred to a charity.

With a life insurance policy as the CGA funding asset, there will be only two taxation tiers for the payments: ordinary income and tax-free return of principal. No part of the CGA payment is taxed as long-term capital gain.

As an alternative, could the donor surrender the policy for cash before funding the CGA?

If Bob surrenders the insurance policy, he will have a taxable event equal to its value minus the cost basis, or in this case, \$75,000. But, his income tax deduction is \$33,228.75 higher with the cash gift (\$128,484.50 - \$95,255.75). His CGA payments will be taxed more favorably with the cash gift because of the higher cost basis than the life insurance gift -- he receives \$3,188.69 more in tax-free income. He would need to live 13.1 years to receive enough tax-free income from the CGA to offset the taxable income from cashing in the life insurance. See Table 1.

Table 1: Using Life Insurance or Its Cash Proceeds to fund a CGA

	Bob uses life insurance to fund a CGA	Bob surrenders life insurance for cash to fund a CGA
Asset donated to fund CGA	Life insurance: \$500,000 face amount; cost basis: \$215,000; fair market value: premium paying whole life valued at interpolated terminal reserve plus unearned premium	Cash: \$290,000 from surrendering life insurance
Taxable event from surrender of the life insurance policy	NA	\$75,000.00
CGA payment rate (applied to \$290,000)	6.1%	6.1%
Income tax charitable deduction assuming quarterly payments and 3.4% CMFR	\$95,255.75 (based on lower of fair market value or cost basis)	\$128,484.50 (based on \$290,000)
CGA payment taxation	(based on \$215,000)	(based on \$290,000)
Income tax-free	\$9,141.15	\$12,329.83
Long-term capital gain	\$0	\$0
Ordinary income	\$8,548.85	\$5,360.07
Total annual payment	\$17,690.00	\$17,690.00
After 13.1 years, the entire payment is taxed as ordinary income.		

Appraisal/Receipt

If the deductible portion of the gift is worth more than \$5,000, an appraisal will be required for the life insurance policy. Where do you get a qualified appraisal? The IRS will not recognize an IRS Form 712 Life Insurance Statement from the issuing life insurance company as a qualified appraisal. Check third-party businesses that perform these appraisals for charitable gifts of life insurance.

Provide the typical receipt for a CGA, but describe the policy in detail. For example: Prudential Life Insurance Company; whole life policy; policy #AJX738949; face amount of \$500,000; cash value of \$278,000; issued 9/1/1990; insured, John A. Doe; policy owner, John A. Doe. Be sure

your receipt does NOT say, “No goods or services were given in exchange for this gift.” “No goods or services other than the charitable gift annuity payments will be given in exchange for this gift,” is acceptable. Also provide IRS Form 8283 where appropriate.

Part 2: Funding a CGA With a Commercial Annuity

People purchase commercial annuities from life insurance companies as investments for future retirement income. With the recent economy, many annuity purchasers have been disenchanted with low-interest earnings on their annuities. If they decide to cash in these poor performing assets, taxable events occur if the annuities are worth more than what they paid for them. Both of these situations lead to commercial annuities being frequently proffered as a charitable gift.

Just what is a commercial annuity anyway?

A commercial annuity is an investment made via a contract between the annuity owner and the insurance company. Commercial annuities are usually purchased by people over the age of 50. There is no magic number about age 50. It’s just that younger generations have little if any interest in purchasing retirement income products with after-tax dollars.

Is it better for a donor to use the annuity to fund a CGA, or cash in the annuity and use the cash to fund the CGA?

Let’s say Jack would like to give his commercial annuity in exchange for a charitable gift annuity. It’s worth \$55,000 and his cost basis is \$30,000. Jack will complete the change of ownership/beneficiary forms with the insurer holding the commercial annuity. The insurer will reissue the commercial annuity with your institution as the new owner and beneficiary. What are Jack’s tax consequences? The insurance company will send Jack an IRS Form 1099-R, which will indicate he has a \$25,000 taxable event.

The effective date of the gift is normally the date the donor signs the change of ownership forms with the insurance company. Therefore, for processing a gift annuity, that will be the gift date.

The key is that the CGA payments are based on a cost basis of \$55,000.

It really doesn’t make any difference if Jack decides to cash in the commercial annuity and give the cash proceeds in exchange for the gift annuity. In fact, it is probably much simpler if Jack does it this way. If Jack surrenders the commercial annuity (he completes a surrender form from the insurance company and they will issue a check for the surrender value to Jack), he has a taxable event equal to the difference between the cash surrender value and his cost basis—in this case, \$25,000 of ordinary income. The taxation of the gift annuity payments remains the same. See Table 2.

Table 2: Using a Commercial Annuity or Its Cash Proceeds to fund a CGA

Asset donated to fund CGA	Commercial deferred annuity: \$55,000 value (cost basis \$30,000)	Cash: \$55,000.00 from surrendering the commercial annuity
Taxable event – taxed as ordinary income; taxed as ordinary income	\$25,000.00 (for transferring ownership of annuity to charity in year of gift)	\$25,000.00 (for cashing in the annuity worth \$55,000 and a \$30,000 cost basis)
Charitable deduction calculated for CGA based on quarterly payments and a 3.4% CMFR (based on \$55,000)	\$24,683.45	\$24,683.45
Amount of commercial deferred annuity used to calculate CGA payments	\$55,000.00	NA
CGA payment rate on \$55,000	6.3%	6.3%
CGA payment taxation (based on \$55,000)		
Income tax-free	\$2,446.29	\$2,446.29
Long-term capital gain	\$0	\$0
Ordinary income	\$1,018.71	\$1,018.71
Total annual payment	\$3,465.00	\$3,465.00
After 12.4 years, the entire payment is taxed as ordinary income.		

Although a majority of charitable gift annuities are funded with cash or marketable securities, creative strategies exist to fund gift annuities with other assets commonly owned by prospective donors. Life insurance can be a useful asset to use but the gift planner and professional advisors need to analyze the policy's values and the donor's tax situation to determine whether the donor's benefits are stronger if the actual insurance policy is the funding asset or if it makes more sense for the donor to first surrender the policy and donate the cash proceeds. On the other hand, commercial annuities create taxable events when donated and should typically be surrendered for cash before funding a gift annuity.