# National Conference on Philanthropic Planning

**October 13-15, 2010 • Orlando, Florida**

## Conference Presentation Paper

Partnership for Philanthropic Planning
Charitable giving made most meaningful

Gift of an Income Interest in a Charitable Gift Annuity
Emanuel J. Kallina, II, and Elisabeth Koenig

## I. Introduction

When a donor enters into a charitable gift annuity ("CGA") contract with a charity, frequently he is the "annuitant" or "beneficiary" and is entitled to receive annuity payments for life ("income interest").[1] CGAs allow the donor to make a contribution to charity, but retain an income stream. During the term of the CGA, the donor may decide that he no longer needs the income stream and would like to give his income interest to the charity. It is well-settled that the donor is entitled to a charitable income tax deduction for this contribution of his income interest in the CGA; however, the amount of such deduction is in question, and is the subject of this article.

Conventional wisdom has been that any gain upon the sale or exchange of an income interest in a CGA is taxable as ordinary income. The gain is the amount by which the fair market value of the CGA exceeds the donor's investment in the contract ("Excess Amount"). If the donor were to gift the income interest to charity, conventional wisdom has been that the donor would only be able to deduct his investment in the contract as a charitable contribution, as amounts attributable to ordinary income are not deductible under Section 170(e) of the Code.[2] We believe the authority for characterizing the entire Excess Amount solely as ordinary income is debatable.

There is a strong argument that a portion of the Excess Amount may be properly characterized as capital gain, and therefore deductable. The rationale for this conclusion tracks as follows:

- A CGA is a capital asset under Section 1221;
- The amount of gain upon the sale or disposition of an income interest in a CGA is determined under Section 72;
- Section 72 does not characterize the nature of the gain from the disposition of a donor's income interest, and therefore one must look to case law and IRS pronouncements for the characterization of such gain;
- Relevant case law and recent IRS rulings provide that gain from the sale of a capital asset of this nature must be bifurcated into ordinary income and capital gain;
- Only that portion which constitutes a "substitute for ordinary income" will be taxed as such, while the excess will be taxed at capital gains rates; and
- A donor who contributes his income interest in a CGA to charity is entitled to deduct the amount properly attributable to capital gain.

This characterization as capital gain requires a case-by-case analysis of the source of the Excess Amount.

## II. Background

A CGA is a contract between a donor and a charity, whereby the charity agrees to pay a fixed annuity to one or two beneficiaries for one or two lives in return for the donor's transfer of cash or other property to the charity. A CGA allows a donor to contribute assets to a charity, receive a charitable deduction at the time of transfer, and also receive a stream of payments from the charity. CGAs are typically paid over one life, two lives in succession, or two lives concurrently with right of survivorship.

There are several types of CGAs, including the immediate, the deferred, the commuted, and the flexible gift annuity. In general terms, the immediate gift annuity and deferred gift annuity are scheduled to begin annuity payouts within one year or more than one year, respectively, from the date of the gift. The commuted gift annuity (also known as the College Tuition Gift Annuity Plan) is a deferred annuity, scheduled to commence lifetime payouts at a later date for the life of one or two individuals, which is "commuted" so that the lifetime payouts from a present value standpoint are squeezed into a shorter period of time. For example, a grandfather may buy such an annuity for his 3 year old grandson, with payouts scheduled to begin at the grandson's 18$^{th}$ birthday, run for 4 years, and then end. Finally, a flexible gift annuity is one which commences at a later date (and so is deferred), but the annuity starting date is chosen by the annuitant, with a corresponding adjustment in the annuity payout based on a present value computation, depending on the actual date chosen.

Regardless of the format, the annuity must be structured to leave at least 10% of the present value of the contributed assets to charity, based on interest rates and mortality tables at the time the annuity is created, for the annuity to qualify as a CGA.[3] The American Council on Gift Annuities (the "ACGA") publishes annuity rates that leave approximately a fifty percent (50%) residuum to the charity. Each individual state has the right to regulate gift annuities, and many do so through their insurance and/or securities law departments. State law compliance in terms of registration, uniform rates, reserves, permitted payouts, permitted types of annuities, etc. is tricky, and requires the services of a professional.

A gift annuity is taxed according to the same rules as a bargain sale to charity, and accordingly is governed as "part gift/part sale."[4] The transaction is bifurcated[5] into two parts: (1) the purchase of an annuity from the charity and (2) a gift to charity. The donor is treated as if he purchased the annuity for its present value, and the amount by which the fair market value (the "FMV") of the asset transferred exceeds the present value of the annuity is treated as a gift to the charity, yielding an immediate charitable deduction.[6]

For purposes of determining the amount of gain in this bargain sale, Section 72(c)(1) looks to the donor's basis, otherwise known as the donor's "investment in the contract." This amount is the consideration the donor paid or transferred in exchange for the annuity contract. As the donor receives annuity payments, his investment in the contract or basis is decreased by the portion of the annuity payments that are excluded from his gross income.[7]

Upon entering into a CGA, the donor's basis must be allocated between the gift and the sale portion, as is required for a bargain sale. The donor's basis is allocated to the annuity in the same proportion that the present value of the annuity bears to the FMV of the asset transferred to charity, with the remaining basis allocated to the gift. Section 72(c) then treats a portion of each annuity payment as ordinary income, a portion as capital gain (in cases where the donor funds the CGA with appreciated property), and a portion as recovery of basis. The ordinary income portion of the annuity payment comes from interest on the donor's initial investment. The period over which the gain is recognized and basis is recovered is calculated with reference to the life expectancy of the donor or annuitant, as the case may be.

If the donor were to purchase a CGA with cash (or unappreciated property), his basis in the annuity would be equal to its present value at the time of purchase.[8] As the donor receives the annuity payments, the portion of each payment attributed to return of investment is excluded from gross income under Section 72(b) until the donor recovers his basis in the annuity. The portion attributable to interest on the assets transferred in consideration of the annuity is included in the donor's gross income as gain,[9] which is taxed as ordinary income.[10]

If the donor initially transfers an appreciated asset to the charity in return for the CGA, the inherent gain (as with the donor's basis) is allocated between the gift and sale portions of the transaction.[11] If the inherent gain within the gift asset is long-term capital gain, Section 170 addresses its deductibility for purposes of the charitable deduction. For the purposes of recognizing the gain inherent in the sale portion of the transaction, this gain is recognized pro-rata[12] over the life expectancy of the donor if: (i) the annuity is nonassignable except back to the issuing charity, and (ii) the donor is the sole annuitant, or a joint annuitant with another person. Until the donor recovers his investment in the contract, the donor's annuity payments are divided among (1) tax-free return of basis, (2) recognition of built-in capital gain, taxed at capital gains rates, and (3) interest, taxed at ordinary income rates.[13]

After a CGA is created, a donor or annuitant, as the case may be, may decide to gift his income interest back to the issuing charity. While a charitable deduction is clearly available,[14] the amount of the deduction the gift yields is unclear. The prevailing view has been that the unreturned investment in the contract is the only amount that may be deducted, and none of the Excess Amount is deductible.[15] This view makes sense in a market where all factors have remained equal, and the Excess Amount is solely attributable to accrued interest or a growth in the value of the annuity due to earnings of the assets contributed, which are clearly ordinary income items. Frequently, practitioners have simply limited a donor's deduction to his unreturned investment in the contract. Note that this calculation includes built-in gains in cases where the donor funded the CGA with appreciated property, the deductibility of which is addressed under Section 170.

However, the prevailing view ignores the possibility that a portion of the increase in the FMV of the annuity may be attributable to factors other than the accrual of interest or a build-up in the underlying value of the annuity. For example, an annuity's FMV may increase due to lower interest rates, lower mortality assumptions, improved credit condition of the charity, or the simple conclusion that the income interest is worth more than its present value. This increase is not due to the accumulation of interest or due to any other item of ordinary income, but rather an increase in value of the underlying asset. Case law and Revenue Rulings support the proposition that a portion of the Excess Amount may be properly characterized as capital gain. For the reasons set forth below, we posit that a portion of the Excess Amount, measured on a case-by-case basis, should be treated as capital gain, thereby increasing the donor's charitable deduction to an amount greater than his unreturned investment in the contract.

## III. Type of Asset

The first step in this analysis is to look at the nature of the underlying asset, which is the CGA itself. Section 1221 defines a "capital asset" as all property of the taxpayer, subject to eight enumerated exclusions.[16] Regulations thereunder[17] further clarify that the term "capital asset" includes all classes of property not specifically excluded by Section 1221 regardless of the period for which the taxpayer held the property. Since a CGA is not one of the assets excluded under Section 1221(a)(1)-(8) from being treated as a capital asset, one may safely conclude that a CGA is a capital asset.

The Tax Court has long agreed that an annuity contract is a capital asset. The Tax court addressed the income tax consequences of the sale of an annuity contract on several occasions, consistently finding that the annuity contract itself was a capital asset. For example, in *Michael H. Katz*,[18] the Tax Court agreed with the taxpayer that an annuity contract was a capital asset under Section 1221.[19]

Using the same analysis, the IRS recently arrived at the same conclusions with respect to a life insurance contract in Revenue Rulings 2009-13 and 2009-14.[20] The IRS concluded that a life insurance contract was not listed among the assets enumerated in Section 1221, and thus was a capital asset.[21] Following this reasoning, a CGA should be a capital asset under the Code.

## IV. Amount of Gain

Section 72 requires that amounts received pursuant to an annuity contract, whether such amounts are received as annuity payments or otherwise, be included in gross income. Section 72(a) begins with the general rule that gross income includes amounts received under an annuity contract, except as otherwise provided in Chapter 1 of the Code. Section 72(e) governs when an annuitant sells or gives away his right to receive annuity payments under an annuity contract. This subsection sets forth the rules for calculation of the amount to be included in income for amounts received pursuant to an annuity contract, but not received "as an annuity." This provision governs when a donor sells his interest in an annuity, either to the issuing company or to a third party.

After payment has begun, all amounts received by the donor under an annuity contract are included in gross income,[22] but not as an annuity, unless such amounts are received in complete surrender of the policy.[23] Before annuity payments begin, the donor must include in his gross income only those amounts in excess of his investment in the contract.[24]

The timing of a gift of an income interest is important. If the donor "transfers [his income interest] without full and adequate consideration" before the annuity payments begin, the donor may have to include in his gross income the excess of the cash surrender value of the annuity over his investment in the contract.[25] However, if the donor gives away his income interest after payments begin, this provision does not apply.

While Section 72 is instructive as to the amount to be included in gross income, it does not define the character of gain to be recognized.[26] Although an individual donating an income interest in a CGA to charity does not receive consideration from the charity, he is treated as if he sold the income interest to charity at its FMV. Thus, it is important to characterize any gain for charitable deduction purposes, because Section 170(e) denies a deduction to the extent that the sale of the gifted income interest would produce ordinary income. In other words, the ordinary income portion realized upon a hypothetical sale is not deductible. The IRS acknowledges in Revenue Rulings 2009-13 and 2009-14 that Section 72 only quantifies the amount of the gain to be recognized upon sale or disposition of an annuity contract, but does not determine the nature or character of the gain.

## V. Nature of Gain

Many practitioners have interpreted the inclusion in gross income under Section 72(e) to equate to inclusion as ordinary income, but there in no authority in the Code or Regulations for this across-the-board conclusion. Instead, one must look to other Sections of the Code, IRS rulings, and case law for characterization.

The IRS has applied the "substitute for ordinary income" doctrine to characterize the gain an asset produces as capital gain and/or ordinary income, noting that the characterization of income produced by an asset does not change the nature of the underlying asset.[27] In *Roff v. Comm'r*,[28] the taxpayer sold an annuity contract to a third party before the maturity date of the annuity. The taxpayer argued that his gain should be characterized as capital gain, as the annuity contract was a capital asset. While the Tax Court agreed that the annuity contract was a capital asset, the court held that the gain was attributable to interest on the premium payments. The Tax Court reasoned that had the taxpayer held the policy to maturity, he would have recognized ordinary income. Further, the amount of the gain could be traced directly to the stated interest rate applied by the annuity company. The Tax Court held that the taxpayer could not change the character of his interest income by selling the policy before maturity.[29]

However, a capital asset is capable of producing both ordinary income and capital gain. Citing *Roff*, the court in *First Nat'l Bank of Kansas City v. Comm'r*[30] noted that the issue was not whether the annuity policy was a capital asset, but rather whether the gain represented *appreciation of* the capital asset (capital gain) or *income produced by* the capital asset (ordinary income). The Eighth Circuit held that the gain on the annuity policy in question was attributable to income earned by that asset, and not appreciation of the asset. As such, the gain was ordinary income. Particularly telling in *First Nat'l Bank of Kansas City* was the fact that the taxpayer did not argue that he would have recognized ordinary income upon the maturity of the policy. However, the court acknowledged that if the gain was attributable to appreciation of the asset, and not income produced by the asset, such gain should be taxed as capital gain.

Following the reasoning of the foregoing cases, the Tax Court in *Foy v. Comm'r*,[31] set forth six factors to be considered in determining whether a contract right must be classified as an ordinary income asset in whole or in part under the "substitute for ordinary income" doctrine:

1. how the contract rights originated;
2. how the contract rights were acquired;
3. whether the contract rights represented an equitable interest in property which itself constituted a capital asset;
4. whether the transfer of contract rights merely substituted the source from which the taxpayer otherwise would have received ordinary income;
5. whether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer; and
6. whether the contract rights primarily represented compensation for personal services.

The IRS recently clarified its application of the substitute for ordinary income doctrine in Revenue Rulings 2009-13 and 2009-14. The former ruling stated that some or all of the gain from the sale of an insurance policy may be ordinary under the "substitute for ordinary income" doctrine, even if the policy itself was a capital asset under Section 1221. Citing *United States v. Midland-Ross Corp.*,[32] the IRS stated that "property" under Section 1221 does not include claims or rights to ordinary income; that is, a "capital asset" does not include income items or accretions to the value of a capital asset attributable to ordinary income.

In Situation 2 of Rev. Rul. 2009-13, the Service concluded:

> Application of the "substitute for ordinary income" doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). ***Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the "inside build-up" under the contract, the excess may qualify as gain from the sale or exchange of a capital asset***. *See, e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960) (emphasis added).

In a similar manner, the Service analyzed a term life insurance contract (Situation 3) having no cash surrender value, and held that the contract was a capital asset and the gain on sale was capital gain.

Rev. Rul. 2009-14 involved a situation where C purchased a term life insurance policy on B's life from B with the intention of earning a profit. Once again, the Service held the contract was a capital asset since it was not excluded under Section 1221(a)(1)-(8). The Service held that neither the surrender nor receipt of a death benefit from the issuer produced capital gain, but rather, these events produced ordinary income. However, a "sale" of the contract, rather than a surrender or the receipt of death proceeds, produced capital gain and the substitute for ordinary income doctrine did not apply. [Note: We do not necessarily agree with the Service's analysis when death proceeds are received, since the transfer for value rules seem to apply, rather than the "substitute for ordinary income" doctrine.]

Applying these concepts to our facts, it is clear that any portion of the increase in value of a CGA attributable to the accumulation of accrued but unpaid interest is ordinary income. However, we believe a strong argument can be made that the appreciation of a CGA due to market factors, and not traceable to an accumulation of ordinary income, is properly characterized as a capital gain.

## VI. Example and Analysis

The discussion above can be illustrated with the following example. A donor contributes an asset to charity, in return for an immediate (fixed) lifetime annuity, with the following additional facts:

| | |
|---|---:|
| Date of Gift | 7/1/2009 |
| Age of Annuitant | 72 |
| Payment Frequency | Quarterly, End |
| FMV of gifted asset | $100 |
| Annuity Rate | 6.7% |
| Yearly Annuity Payout | $6.72 |
| CMFR | 3.2% |
| Charitable Contribution | $33.63 |

We will examine three scenarios, based on the donor having three different bases in the gifted asset. In Scenario #1, the donor's basis in the gifted asset is equal to the asset's FMV; if the donor sold the asset at its FMV instead of making a gift, he would realize no gain. In Scenario #2, the donor has a basis of $50 in the gifted asset, which is allocated between the annuity and the charitable contribution pro-rata. In Scenario #3, the donor's basis in the gifted asset is zero, and his charitable contribution and investment in the annuity contract are comprised entirely of capital gain. According to charitable calculation software, the resulting annual taxation of the annuitant in each scenario would be as follows:

| | | **Scenario #1 Basis of $100** | **Scenario #2 Basis of $50** | **Scenario #3 Basis of $0** |
|---|---|---:|---:|---:|
| **Return of Investment in Contract** | **Return of Original Basis** | $4.58 | $2.29 | $0 |
| | **Recognition of Capital Gain** | $0 | $2.29 | $4.58 |
| **Ordinary Income** | | $2.14 | $2.14 | $2.14 |
| **Total** | | $6.72 | $6.72 | $6.72 |

This simple analysis reveals several important **observations**:

1. The present value of the annuity and the amount of the annuity payout is predicated on the FMV of the annuity when the annuity is created, not the donor's basis in the annuity.
2. The ordinary income component does not change in relation to basis, as this is also predicated on the FMV of assets funding the annuity, and not the donor's basis or investment in the contract.
3. The sum of the return on investment and capital gain is the same in all 3 scenarios.

The foregoing example and observations lead to the following **conclusions**:

1. Based upon case law discussed above, the ordinary income component within an annuity ("inside build-up") can grow prior to the annuity starting date.
2. Once an annuity begins payment, the inside build-up of the annuity ceases.
3. There is an ordinary income component which is taxed to the annuitant as (in effect) imputed interest, but this amount is static with a fixed annuity in pay status.
4. Future events should not affect the ordinary income component of a fixed annuity in pay status, unless the future events can be traced to something which generates ordinary income (see the discussion of the *Foy* case above).
5. Changes in mortality rates, interest rates, the economic viability of the issuing charity, or perceptions of a subsequent buyer -- which result in the FMV of the annuity becoming greater than its present value -- are all changes in investment risk. These changes are not events traceable to an ordinary income event, but are events which are characteristic of an investment and go to the underlying value of the asset itself.

Looking more closely at Scenario #2, assume that on July 1, 2014, 5 years after creating the gift annuity, the annuitant decides to sell the annuity to a third party, and that such a sale is legally permissible. Suppose the buyer offers $72.47, $10 more than its then-present value, due to factors including lower interest rates, lower mortality assumptions, improved credit condition of the charity, or the buyer's conclusion that the income interest is worth more money. Continuing with the example above, recovery of basis was $2.29 per year for 5 years (or $11.45), so the unrecovered basis was $21.74 ($33.19 initial basis – $11.45 recovery of basis). Similarly, the donor recognized capital gain inherent in the original contributed asset of $2.29 per year for 5 years (or $11.45), so the remaining unrecognized capital gain was $21.73 ($33.18 initial unrecognized capital gain – $11.45 recognized capital gain). The donor's remaining investment in the contract on July 1, 2014 is $43.47. Thus, in tabular form:

| | July 1, 2009 (creation of annuity) | July 1, 2014 (sale of income interest) |
|---|---:|---:|
| FMV of income interest | $66.37 | $72.47 |
| Present Value of income interest | $66.37 | $62.47 |
| Remaining Basis | $33.19 | $21.74 |
| Basis Returned to Donor | $0 | $11.45 |
| Remaining Unrecognized Capital Gain | $33.18 | $21.73 |
| Recognized Capital Gain | $0 | $11.45 |

Upon a sale of the income interest in the CGA, three questions arise:

1. Is the $10 difference between the 2014 FMV and the 2014 present value taxable as ordinary income or capital gain?
2. Is the difference between the 2014 present value of the annuity ($62.47) and the donor's remaining investment in the contract ($43.47) taxable as ordinary income or capital gain?
3. Is the portion of gain due to the return of basis ($11.45) taxable as ordinary income or capital gain?

**QUESTION #1 - Is the $10 difference between the 2014 FMV and the 2014 present value taxable as ordinary income or capital gain?**
**ANSWER: Capital gain.**

Until recently, most experts would have concluded that the answers to all three questions were that 100% of the gain was taxable as ordinary income. In light of Revenue Rulings 2009-13 and 2009-14, we question this conclusion. We think the $10 difference between FMV and present value is taxable as capital gain, as in Scenario #2 of the former Revenue Ruling. Applying the "substitute for ordinary income doctrine" of *Foy* and these two rulings, one must determine whether the gain was due to an ordinary income event or was the result of investment risk. Since the annuity is fixed and cannot grow beyond the ordinary income component of each payment (which is considered "internal build-up" and taxable as ordinary income), it is difficult to ascertain how the increase in FMV constitutes a substitute for ordinary income. Given the fact that an income interest in a gift annuity is a capital asset, presumptively the appreciation is taxed as capital gain.

**QUESTION #2 - Is the difference between the 2014 present value of the annuity ($62.47) and the donor's remaining investment in the contract ($43.47) taxable as ordinary income or capital gain?**
**ANSWER: Capital gain, as long as there is no evidence that the difference is attributable to accrual of ordinary income.**

It is hard for anyone to argue that the difference in 2009 between the present value of the annuity and the donor's original basis in the annuity should be treated as anything but capital gain, as no ordinary income items had time to accrue. Indeed, the built-in capital gain in the original asset transferred to charity is allocated between the gift portion and the annuity portion of the CGA, and as the donor received annuity payments, a portion of each payment was recognized as capital gain. Further, the income interest itself is a capital asset, which if sold, would be taxable at capital gain rates on the appreciation. The 2014 sale of the income interest in the CGA should not be treated any differently. As previously stated, there is no evidence that the 2014 gain is attributable to an ordinary income event. If there were such evidence, then the portion attributable to an ordinary income item should be taxed as such upon the sale of the income interest.

**QUESTION #3 - Is the portion of gain due to the return of basis ($11.45) taxable as ordinary income or capital gain?**
**ANSWER: Capital gain.**

We need to analyze the nature of the gain attributable to the return of basis. It is clear that any gain on the sale of the appreciated asset prior to contribution in 2009 would be capital, not ordinary. The origin of the gain is capital, and there has been no intervening event in the past 5 years that is traceable to an ordinary income component, other than accrued interest of perhaps one day. The donor/annuitant recovered basis of $11.45, and there is no authority that classifies this as ordinary income.

Commentators have agreed that an annuitant who dies prior to life expectancy can claim the amount of the unrecovered investment in the contract as a loss on his final income tax return. Almost all commentators have said this is a capital loss, not an ordinary one. If this is true, then logically speaking, the gain due to a recovery of investment in the contract also should be capital, not ordinary.

**Comment:**

This analysis has interesting consequences when a gift annuity's basis has been fully recovered over the annuitant's life expectancy, and there is no longer any investment in the contract to exclude from gross income under Section 72(b)(2). Assuming that the imputed interest element still continues (that is, the $2.14 per year), the question is whether the $4.58, previously excluded as investment in the contract, is taxable as ordinary income or capital gain. Rev. Rul. 69-74[33] says it is taxed as ordinary income, but offers no authority or justification for this conclusion. Rather, the Service attempts to distinguish the opposite conclusion, reached in Rev. Rul. 239,[34] by stating that the earlier ruling was based upon different provisions of prior law. We find this bland assertion without authority, in violation of an earlier Revenue Ruling, unpersuasive.[35] We think there is a colorable argument that the previously excluded amount of $4.58 may be properly taxable at capital gains rates.

## VII. Conclusion

Normally, the present value and FMV of an annuity in pay status decreases as annuity payments are made to the annuitant over time. Similarly, the annuitant's investment in the contract decreases as he receives annuity payments. However, there may be situations in which the FMV increases or decreases at a lesser rate than the investment in the contract. For example, if the mortality tables are adjusted because people are living longer, the present value increases, thereby increasing the FMV. Also, the FMV could increase independently of present value due to market factors, such as a change in interest rates or speculation that a given donor will outlive his life expectancy. If a donor donates his income interest to charity under these circumstances, it is especially important to properly characterize the amount by which the FMV of the income interest exceeds the donor's investment in the contract. In characterizing the Excess Amount, one must look at the nature of such amount. Only that portion of the Excess Amount that is attributable to accrued but unpaid ordinary income, usually interest, is properly characterized as ordinary income. If the FMV of the annuity increases for any reason other than the accrual of ordinary income, such appreciation is properly attributable to capital gain.

We agree that an annuity which is variable in nature (and not fixed), or an annuity which is not in pay status and still appreciating in value due to income earned by the annuity, would produce ordinary income to the extent of income earned. However, growth in the underlying asset, just as growth in a bond, is not taxable at ordinary income rates, but capital gains rates.

In a number of ways, the CGA is analogous to a bond. Like the income interest in a CGA, a bond can increase in value for reasons other than the accrual of interest. For example, if interest rates drop, the credit worthiness of the issuer of the debt improves, or a third party buyer perceives the bond as having more value, the bond appreciates in value. When the bond is sold, one must bifurcate the transaction, with any gain attributable to accrued interest taxed as ordinary income and any other gain taxed at capital gains rates. No one argues that 100% of the gain on the sale of the bond in excess of accrued interest is automatically ordinary income; however, this consensus does not apply in the case of a CGA.

When a donor decides to give his income interest in a CGA to the issuing charity, he should analyze these factors contributing to the Excess Amount before assuming that the entire Excess Amount is ordinary income. If a portion of the Excess Amount is attributable to the appreciation of the annuity rather than income produced by the annuity, such portion is properly calculated as capital gain. As such, this may be included in the donor's income tax deduction under Section 170.

We clearly want to emphasize that our thoughts are contrary to prevailing thinking, and that other experts in the area, such as Frank Minton, have expressed a reasonable concern with our analysis (see the attached "Addendum"). That being said, we believe the analysis, reasoning, and conclusions are sound.

***Disclaimers***:

The material in this article has been prepared by the authors for informational purposes only; it is not, nor is it intended to be, legal advice. Further, the material in this article does not create or constitute an attorney-client relationship. The information herein is not intended to substitute for obtaining legal advice from an attorney. No person should act or rely on any information in this article; you should consult an attorney for advice specific to your situation.

**As required by U.S. Treasury Regulations governing tax practice, the reader is advised that any advice contained on this article was not written or intended to be used (and cannot be used) by the recipient or any taxpayer for the purpose of (1) avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions or (2) promoting, marketing or recommending to another party any transaction or matter addressed herein. Without our prior express written consent, no person may use any written tax advice contained in this web site in the promotion, marketing, or recommendation of a partnership or other entity, investment plan or arrangement to one or more taxpayers.**

The authors may be contacted at:

Emanuel J. Kallina, II
410-377-2170, extentsion 223
ejk@kallinalaw.com

Elisabeth A. Koenig
410-377-2170, extension 231
eak@kallinalaw.com

Kallina & Associates, LLC
1122 Kenilworth Drive, Suite 507
Towson, MD 21204

Phone: 410-377-2170
Fax: 443-797-1147

# APPENDIX

## FRANK MINTON'S ANALYSIS IN ***CHARITABLE GIFT ANNUITIES***, Chapter 20, pages 7-12, Revised September, 2010 (reprinted with permission)

### Contributing the Right to Annuity Payments to the Charity

Some annuitants, discovering that they do not need the annuity payments, are willing to forfeit their future right to them. Once they assign their right to payments, the charity's obligation under the contract will terminate, and it will be free to use the residuum. An assignment of an annuity interest raises several questions, and the answers to some of them are not entirely clear.
As indicated in Chapter 2, a gift annuity agreement will typically include language such as the following: "This annuity is irrevocable and nonassignable, except that it may be assigned to the charity." Clearly, this wording would allow an annuitant to assign his or her interest to the charity. If, however, the agreement were to say simply, "This annuity is irrevocable and non-assignable," then an assignment likely would not be possible, unless legal counsel for the annuitant and for the charity concluded that an exception permitting assignment of the annuity interest to the charity could be inferred or would at least be legally defensible.

#### *The Amount of the Gift*

The amount of the gift is the present value of the remaining annuity payments computed as of the date of assignment. This is computed by entering into a planned giving software program the original amount contributed, the annuity rate, the payment frequency, the date(s) of birth of the annuitant(s), the date of the assignment as the gift date, and the CMFR for the month of the assignment or for either of the two immediately-preceding months. See IRC Sec. 7520(a) which refers to "the value of any annuity" and "any interest for life or a term of years." The amount of the gift would be entered in the charity's contribution totals, and presumably donor recognition would be based on it.

#### *The Amount of the Charitable Deduction*

The income tax charitable deduction that can be claimed by a donor is not always the same as the amount of a gift (i.e., the benefit to a charity). Suppose, for example, that a donor on November 4, 2010 contributed stock valued at $30,340, which he or she had purchased on February 8, 2010 for $24,000. The amount of the gift would be $30,340. However, because the gain in this stock is short-term, the income tax charitable deduction would be limited to cost basis, which is $24,000.

In the case of an assignment of the right to annuity payments to the charity, the income tax deduction may be less than the amount of the gift. Most commentators appear to agree on this point, but there are differences of opinion as to how to calculate the amount of the deduction. The position taken in this manual is that the charitable deduction is the lesser of the amount of the gift and the unreturned investment in the contract. Here are the reasons for this position:

 IRC Sec. 72 states that, unless otherwise provided in this section, gross income includes any amount received as an annuity. This section then proceeds to explain that the portion of the distribution that is a return of the investment in the contract is not included in gross income, and it further says that the amount which is excluded from gross income shall not exceed the unrecovered investment in the contract.

 The key question is whether, if the annuity were exchanged for a cash settlement, the entire amount received in excess of the unrecovered investment in the contract would be ordinary income. If that is the case, then the deduction resulting from the assignment of the annuity to the charity would be limited to the unreturned investment in the contract. That is because no deduction is allowed for the portion of a contributed asset that would be ordinary income. (IRC Sec. 170(e)(1)(A)).

 It is debatable whether the right to receive payments is a capital asset that could generate gain or loss. Some would argue that the right to receive payments from an annuity is analogous to the right to receive lease payments, and they note that a lump sum paid in lieu of continuing lease payments has been ruled to be ordinary income. Moreover, in IRC Sec. 61(a), the Code section that defines gross income, annuity income is listed along with other items of ordinary income. This is also the position taken by *Tax Facts*, published by the National Underwriters which, in response to a question about the tax consequences to the seller of an annuity contract, responds, "Gain is taxed to the seller as ordinary income – not as capital gain."

### *A Contrary Position*

Some authorities contend that the charitable deduction, in some instances, could be larger than the unreturned investment in the contract. Their case rests on the conclusion that an annuity interest is a capital asset because it does not fit any of the exceptions under IRC Sec. 1221.

Proponents of this view cite certain cases dealing with the sale of an annuity interest. These cases support the conclusion that the portion of the gain attributable to income due under the contract at the time it was issued will always be ordinary gain, and that gain attributable to appreciation in value of the contract beyond this amount may be capital gain. An example is the Katz case (TC Memo case 2322573 and Appellate affirmation 2322576) where the court said: "While the policy was a capital asset, the gain realized did not result from the appreciation in value, but was due to ordinary income produced by a capital asset. The periodic increases in cash surrender value arose irrespective of any conditions that might produce an enhancement of the policy's value."

In the Katz case, the court implied that gain resulting from an appreciation in value would be capital gain. This position was supported and clarified recently in Revenue Rulings 2009-13 and 2009-14 dealing with gain from the sale of an insurance policy, where gain refers to the excess of the amount realized over adjusted cost basis.

The first of these rulings indicates that gain realized upon surrender of the contract will be taxed as ordinary income, but that gain in excess of the inside build-up under the contract may qualify as capital gain. Suppose, for example, that an insurance policy is sold on the life-settlement market for more than its cash value. The difference between the adjusted cost basis and the cash value would be taxed as ordinary income, but the excess over cash value paid by the purchaser of the policy would be taxed as capital gain.

If this principle is applied to the assignment of the annuity interest of a gift annuity, some of the gain might be ordinary and some capital gain. The charitable deduction would then be the unreturned investment in the contract (the adjusted cost basis) plus the portion of gain that is capital gain. If this position is correct, it would be necessary to bifurcate gain taxed as ordinary income and capital gain to determine the charitable deduction.

Two factors could increase the value of the annuity interest beyond the inside build-up, which, as noted, is taxed as ordinary income: They are (1) a decrease in the CMFR between the date the annuity was established and the date it was assigned and (2) issuance of new mortality tables with longer life expectancies between the establishment of the annuity and the assignment of the annuity interest.

There is indeed support for the premise of this argument, namely that an annuity interest is a capital asset. However, there are also compelling reasons to conclude that the contractual right to annuity payments is not a capital asset, and that this right is different from the income interest of a trust, which is defined in IRC Sec. 1001 as a capital asset. Even if it could be considered a capital asset, it is not at all certain that the IRS would agree that any increase in the present value of the payments would be taxable as capital gain. Even the court cases cited in support of the position that the right to payments is a capital asset did not alter the result, for they found the gain to be taxable as ordinary income. Accordingly, this manual takes the conservative position that the amount of the charitable deduction, when an annuity is assigned to the charity, is the lesser of the present value of the remaining annuity payments computed as of the date of assignment and the unreturned investment in the contract.

See Figure 20.7 for an example of how to determine the charitable deduction per the position taken in this manual.

## Figure 20.7

### Calculating the Deduction When an Annuity Interest Is Assigned

Minoru H, whose date of birth is August 13, 1935, contributed $100,000 cash for a gift annuity on October 1, 2005. The charity issued a gift annuity that would pay him $6,500 per year in quarterly installments. Based on the October 2005 CMFR of 5.0 percent, Minoru's charitable deduction was $39,518, and his investment in the contract was $60,482. Having decided that he did not need the payments from this annuity, and wanting to accelerate the gift, he assigned his right to payments to the charity, effective July 1, 2010. His last quarterly payment was made on June 30, 2010.

As of July 1, 2010, the present value of his annuity interest was $59,153. This was based on the July CMFR of 2.8%.

| | |
|---|---|
| Investment in the contract | $60,482.00 |
| Investment in the contract returned through 6/30/10 | 18,061.87 |
| Unreturned investment in the contract as of 7/1/10 | $42,420.13 |
| Since the unreturned investment in the contract is less than the present value of the annuity ($59,153 based on the July 2010 CMFR), the charitable deduction is | $42,420.14 |

## Endnotes

---

[1] Some commentators object to the term "income interest" when used in conjunction with a CGA, arguing that it is really a payment of interest, and a return of principal. We understand the objection, but are using the term within the mathematical or actuarial context, to distinguish between the present value of the annuity payments to be paid to an annuitant, and the present value of the remainder for which a charitable deduction is available.

[2] Whenever used in this article, "Code" refers to the Internal Revenue Code of 1986, as amended from time to time; "Section" refers to the Code; and "Reg." refers to Treasury Regulation Section; unless clearly indicated to the contrary by the context.

[3] Section 514(c)(5).

[4] Section 1011(b); *see also* Reg. 1.1011-2(a) - (c), Reg. 1.1011-2(c)(Ex. 8), Reg. 1.170A-4(b) - (d); Rev. Rul. 84-162, 1984-2 C.B. 200.

[5] *See* Reg. 1.170A-1(d).

[6] Subject, of course, to the rules of Section 170.

[7] *See* Section 72(c)(2).

[8] Section 1011(b).

[9] Section 72(a).

[10] Section 61(4).

[11] Reg. 1.1011-2(b).

[12] Reg. 1.1011-2(a)(4).

[13] *See* Reg. 1.1011-2(c) (Ex. 8).

[14] *See* Section 170.

[15] Thus, the prevailing view is that the deduction is limited to the donor's investment in the contract. For further explanation, see the Appendix.

[16] Section 1221(a) provides that "the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167 , or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

  (A) a taxpayer whose personal efforts created such property,

  (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

  (C) a taxpayer in whose hands the basis of such property is determined (other than by reason of section 1022 ), for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B) ;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1) ;

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A) ;

(6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless—

(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

(B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);

(7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer."

[17] Reg. 1.1221-1(a).

[18] T.C. M. 1961-270, *aff'd sub nom. First Nat'l Bank of Kansas v. Comm'r*, 309 F.2d 587, 10 AFTR 2d 5904 (8th Cir. 1962).

[19] Although the Tax Court had no trouble concluding that the annuity contract was a capital asset, this was not dispositive of whether the income was ordinary or capital gain. Courts reached the same result in *Roff v. Comm'r*, 36 T.C. 818 (1961), *aff'd* 304 F.2d 450 (3rd Cir. 1962) and *Arnfeld v. U.S.*, 163 F. Supp. 865 (Ct. Cl. 1958), *cert. denied*, 359 U.S. 943 (1959).

[20] 2009-1 C.B. 1029 and 2009-1 C.B. 1031, respectively. Both annuity contracts and life insurance contracts are governed by Section 72(e), so these Rev. Ruls. are instructive and maybe even determinative for similar transactions with CGAs.

[21] *Id.*

[22] Section 72(e)(2)(A).

[23] *See* Section 72(e)(5)(E) and Reg. 1.72-11(d)(1)).

[24] Section 72(e)(2)(B).

[25] *See* Sections 72(e)(2)(B) and 72(e)(4)(C).

[26] *See* Rev. Rul. 2009-13, 2009-1 C.B. 1029.

[27] *Id.* (citing *United States v. Midland-Ross*, 381 U.S. 54, 57 (1965) and *Comm'r v. P.G. Lake*, 356 U.S. 260 (1958) for this proposition).

[28] 36 T.C. 818 (1961), *aff'd* 304 F.2d 450 (3rd Cir. 1962).

[29] *Id.* at 825.

[30] 309 F.2d 587, 592 (8th Cir. 1962).

[31] 84 T.C. 50, 70 (1985).

[32] 381 U.S. 54, 57 (1965).

[33] 1969-1 CB 43.

[34] 1953-2 CB 53.

[35] Further, we would note that Prop. Reg. 1.1001-1(j) makes obsolete Rev. Rul. 69-74 for private annuities (not CGAs) issued after October 16, 2006. This Prop. Reg. does not address the issue of payments received in excess of basis, but presumably the “additional” gain would be taxed in the same fashion as the underlying transaction (i.e., taxed at either capital gain or ordinary income rates).