Navigating the twists and turns of testamentary gift annuities

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As a young lawyer, I didn't know anything about charitable gift annuities (CGAs). Why? Because they are relatively straightforward and simple to implement, and a perk is absence of the need for lawyers (like me) to draft complicated documents. After two decades of gift planning work, I now love CGAs and they are one of my favorite tools to share when I speak to lawyers and other allied professionals.

Why I Love Testamentary CGAs

Most of the discussion surrounding CGAs focuses on lifetime annuities created by donors for themselves and their spouses. CGAs also have a wonderful, and over overlooked, use in estate planning. These testamentary CGAs are especially good tools to provide for:

- A loyal employee or caregiver the donor wants to leave a guaranteed retirement income;
- A surviving parent the donor wants confidence will be taken care of for life if the donor dies first;
- A child whose money management skills aren't trusted but where other options (a trust, for example) don't make sense;
- A trusted friend, to provide supplementary support in retirement.

Testamentary CGAs are suited to these situations for the same reasons lifetime CGAs are good tools. They are easy to establish, the charity's payment obligation is backed by all assets of the charity, and the annuity is guaranteed for the recipient's life. For a donor who would have otherwise supported charity, the fact that the remainder will pass to charity when the annuity ends is a win-win. As well, there are other benefits – testamentary CGAs can't be sold (by a beneficiary who would otherwise quickly cash in a commercial annuity for cents on the dollar), don't require a complex trustee-beneficiary relationship (or the trustee fees that would result from it), and offer some protection to the beneficiary.

Ways to Gift a Testamentary CGA

A testamentary CGA can established by:

- a bequest in a will,
- a gift in a revocable living trust, or
- a retirement account beneficiary designation.

These documents, referred to below as estate planning documents, can provide that a testamentary CGA is funded with:

A Specific dollar gift. For example, "I give $10,000 to create a CGA for … "

A Percentage. For example, "I give 10% of my estate/trust/retirement account to create a CGA for … "

A Specific asset. For example, "I give my stock in Acme, Inc. to create a CGA for …."

Common Testamentary CGA Roadblocks

While the document establishing a testamentary CGA gets signed by the donor now, the CGA isn't created until the donor dies. Often, the charity doesn't know about the testamentary CGA until the donor is gone. A number of common roadblocks arise.

Roadblock #1: Who signs the gift agreement?

In most states, there is no legal requirement that a CGA agreement be signed. Most charities prefer a signed agreement. To accomplish this, the donor's executor (in the case of a CGA created by a bequest in a will) or trustee (in the case of a CGA created by a gift in a revocable living trust) will sign.

Testamentary CGA's created by retirement account beneficiary designation are more challenging. Ideally, the donor and charity will sign an agreement in advance that any proceeds the charity receives from the IRA upon the donor's passing will be used to fund a testamentary CGA with specific terms. If, instead, the retirement account beneficiary designation includes these details, the annuitant can sign the agreement in place of the donor agreeing that it properly reflects the donor's designation.

Roadblock #2: What information should the charity ask for?

Usually the terms of the CGA are negotiated with the donor. When the donor is not living, the charity must ask for copies of the donor's estate planning document (will, trust or retirement account beneficiary designation) creating the testamentary CGA. Not only will this document dictate the terms of the CGA, identifying the annuitant and other key pieces of information, it will also identify any gift restrictions the charity needs to be aware of. As well, the charity must get the donor's date of death.

Roadblock #3: What is the date of the CGA?

Many charities assume that the date of the CGA is the date they receive the donor's gift (from the estate, trust or retirement account). This is wrong. Instead, the CGA date is the date of the donor's death. This means other important information (the annuitant's age, the Applicable Federal Rate, and the corresponding payment obligations) is fixed by that date also.

Roadblock #4: When do annuity payments begin?

The donor's date of death is the date of the CGA. Payment obligations are triggered by that date as well. Because there is often delay between a donor's date of death and delivery of funds to the charity, unless the CGA is deferred payments may become due before funds arrive. Charities often fear that they must start to make payments before funds arrive. This is not the case. However, it does mean that past-due payments may need to be brought current immediately upon funding.

What if past-due payments relate to a prior calendar year? While there is no clear authority on this, there is general consensus in the gift planning community that the past-due payments should be reported for tax purposes in the year made.

Does the annuitant get interest on past-due payments? The answer is unclear. Because the charity did not have the funds during the period of delay, I do not typically see charities calculate and pay interest to the annuitant when they bring payments current after funding.

Roadblock #5: What if the annuitant is too young?

Many charities have an age minimum for CGA annuitants. Unless the annuitant already meets the age minimum when the donor's estate planning documents are signed, it is possible that the annuitant won't meet the minimum age at the time of the donor's death. Unless the estate plan offers an alternative, such as deferring the CGA start date until the annuitant reaches that minimum age, the charity may have no choice but to decline the gift.

Roadblock #6: What if the annuity is too large?

When a testamentary CGA is funded with a percentage of the donor's estate or a specific asset, the gift may end up being larger than the donor or charity expect. Depending upon the size of the charity's gift annuity pool, the charity may not want to accept a particularly large CGA due to the associated risks. They may prefer that a charitable remainder trust or pooled income fund be utilized to provide for the annuitant instead. Unless the estate planning documents authorize this flexibility, or local law and the annuitant permit the modifications, they may not be possible. Reinsurance may provide a solution for some large CGAs, though presents its own challenges. As with an age roadblock, if the charity cannot get comfortable accepting the large gift, it may ultimately need to decline it.

Roadblock #7: State regulation.

Some states require regular CGA filings by the charity and require the charity to maintain a gift annuity reserve fund. Should the charity report the CGA or include it in their reserve calculation in their filings after the donor's date of death even if they haven't yet received funds? My view is that the charity's obligations do not begin until it receives funds. If this situation occurs, however, a charity should seek local advice to ensure compliance with state regulations.

Overcoming Roadblocks Before They Arise

Advance planning makes navigating the testamentary CGA roadblocks much simpler. When a charity has the opportunity to provide input, these are my top tips for successfully navigating testamentary gift annuities.

Tip #1: Defer all testamentary CGAs by a minimum of one year.

By deferring the start of payments by at least one year, the odds that the charity will receive funds to create the annuity prior to the time a payment obligation arises increase. If the donor is concerned that the annuitant will need funds prior to the first anniversary of death, the donor can leave a current gift to the beneficiary to bridge the gap until the CGA payments begin.

Note: a deferred CGA should not be used if the annuitant is the donor's spouse and the estate tax marital deduction is needed.

Tip #2: Defer all testamentary CGAs until the annuitant reaches a specified minimum age.

If the estate planning documents specify that payments begin at the later of the first anniversary of the donor's date of death (see Tip #1) or the date the annuitant reaches a particular age, this will ensure that the charity can accept the gift.

Tip #3: Anticipate changed circumstances.

Because the estate planning documents that establish a testamentary CGA are often created long before a donor's death, any gift to create a testamentary CGA should be clear concerning what happens if:

- the annuitant doesn't survive the donor,
- the charity is no longer in existence at the donor's death,
- the charity cannot issue the annuity for any reason.

By giving the charity options, to designate a different charity or charities to issue the annuity for them, or to issue an annuity for some (but not all) of the gift, the donor's goals of providing an annuity and supporting a particular charity will increase.

A Word About Taxes

The entire amount used to fund a testamentary CGA is typically included in the donor's taxable estate at death. If the donor's estate is not taxable, this is of no consequence. If it does, there is a charitable estate tax deduction for the value of the charitable gift (this is the same amount that would qualify for a charitable income tax deduction if the donor were alive). To qualify for the estate tax charitable deduction, the gift must be fixed at the donor's date of death (which is why the date of death is used as the annuity date), and the CGA may not permit sale, assignment (except to the charity), or commutation. Estate tax will be due on the present value of the annuity (the benefit to the annuitant) unless the donor's estate tax exemption amount is sufficient to cover this.

I Hope You Will Love Testamentary CGAs Too

With patience, a good roadmap, and advance planning where possible, I hope that you will grow to love testamentary CGAs as much as I do, and utilize them as valuable gift planning tool for you and your donors.

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