

**Tax Considerations in
Creating Life Income Gifts
for Others**

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overview

three scenarios

1. gift annuity f/b/o sibling
 - gain recognition, gift completion
2. remainder trust f/b/o child
 - gain deferral, flexibility
3. testamentary unitrust as IRA "stretch"
workaround

scenario one

- Richard sets up immediate gift annuity f/b/o sister Jane, age 67
- funding noncash 100x, basis 25x
- ACGA rate effective 07/01 is 4.4 pct.
- expected return multiple 18.4 years
- July 7520 rate 0.6 pct.
 - two-month lookback rate 0.8 pct.
- present value annuity stream
- exclusion ratio

quid pro quo

- Rev. Rul. 67-246
 - value transferred exceeds value received
 - intention that excess be gift
- *American Bar Endowment*, 477 U.S. 105, 106 S.Ct. 2426 (1986)

the bargain sale

the sale of property to a qualified charity at less than fair market value

section 514(c) (5)

- exception to acquisition indebtedness rule
 - present value of annuity less than 90 pct. of amount transferred
 - no guarantee re number of payments
 - no adjustment to annuity payout based on income generated by transferred property
 - "or any other"

appreciated property

- section 1101(b)
 - adjusted basis allocated betw. sale and gift elements
 - compare pre- TRA '69
- reg. section 1.1011-2(c) examples
 - ex. 1, basic principle
 - sale price 4k, FMV 10k, adj. basis 4k
 - gift element 6k
 - allocate basis 4/10 to sale element
 - $.4 \times 4k = 1.6k$, from 4k is 2.4k gain

appreciated property, cont'd

- reg. section 1.1011-2(c) examples, cont'd
 - ex. 2, ordering rule
 - long-term gain property
 - no step-down election
 - third tier after cash
 - in the particular case,
 - gain element recognized immediately
 - deduction carried forward

appreciated property, cont'd

- reg. section 1.1011-2(c) examples, cont'd
 - ex. 4, etc., reduction rule
 - short-term gain property
 - reduction applied pro rata
 - again, 10k FMV, adj. basis 4k
 - if sale price is 2k,
 - basis in sale element is 800
 - gain is 1.2k
 - gift reduced to 3.2k

valuing the annuity stream

section 7520(a)

- annuitant's life expectancy per tables
- prevailing rate of interest determined, per section 1274(d)(1), w/ ref. to avg. market yield on mid-term Treasuries
- two-month "lookback" per reg. section 1.7520-2(a)(2)

taxation of annuity payout

section 72(b)

- investment recovered ratably over "expected return multiple"
- the balance of each payment taxed as ordinary income

- if annuitant outlives life expectancy, further payments entirely ordinary income
- if she dies early, itemized deduction[*] for unrecovered investment
 - ref. section 72(b)(3)

[*] not subject to two pct. floor

taxation of annuity payout, cont'd

- per reg. section 1.1011-2(a)(4)(ii),
 - gain recovered ratably if
 - annuity not assignable, except to issuing charity, and
 - payable only to transferor or transferor and one survivor

[not our case here]

gift annuity f/b/o nonspouse

- if funded w/ appreciated property,
 - transferor recognizes gain immediately
 - not pro rated over expected return multiple

- if present value of annuity stream exceeds annual exclusion,
 - transferor may render gift incomplete by retaining power to revoke
 - but if power not released more than three years prior to transferor's death, estate tax inclusion per 2038/2035

the numbers

- 100x noncash, 25x basis,
annuitant age 67, ACGA rate 4.4 pct.
- w/ 7520 rate at .06 pct.
 - present value residuum 32.38x [deduction]
 - present value annuity stream 67.62x
 - basis allocated to sale element
 $67.62/100 \times 25 = 16.91x$
 - recognized gain $67.62 - 16.91 = 50.71x$
 - expected return multiple 18.4 years
 - exclusion ratio 83.5 pct.
 - ordinary taxable 0.73x per year

the numbers, cont'd

- 100x noncash, 25x basis,
annuitant age 67, ACGA rate 4.4 pct.
- w/ 7520 rate at .08 pct.
 - present value residuum 33.70x [deduction]
 - present value annuity stream 66.30x
 - basis allocated to sale element
 $66.3/100 \times 25 = 16.58x$
 - recognized gain $66.3 - 16.58 = 49.72x$
 - expected return multiple 18.4 years
 - exclusion ratio 81.9 pct.
 - ordinary taxable 0.80x per year

the numbers, cont'd

- 100x noncash, 25x basis,
annuitant age 67, ACGA rate 4.4 pct.
- side by side
 - deduction 32.38x vs. 33.70x
 - recognized gain 50.71x vs. 49.72x
 - ordinary taxable 0.73x vs. 0.80x per year

Q&A scenario one

scenario two

- Jane sets up charitable remainder trust
f/b/o daughter Sarah, age 50
- five pct. unitrust
- life expectancy 33.1 years
- funding noncash 100x, basis 25x
- July 7520 rate 0.6 pct.
two-month lookback rate 0.8 pct.
- present value remainder [deduction]

the partial interest rule

section 170(f), exceptions include

- split-interest trust paying fixed annuity
or unitrust amount
- remainder after legal life estate in
residence or farm
- pooled income fund

the charitable remainder trust

- irrevocable trust
 - inter vivos* or testamentary
- "income" to noncharitable beneficiary
- remainder to qualified charities

- fixed annuity or
- unitrust
 - straight or
 - net income
 - w/ makeup or
 - w/out

"income" interest

- at least five pct. but not more than fifty pct. of
 - initial corpus (annuity trust)
 - corpus revalued annually (unitrust)

- distributed to one or more beneficiaries
 - at least one of whom is not a section 170(c) org.
 - lives in being or term of years not more than twenty

ten pct. remainder

present value of remainder at least ten pct.

life expectancy per tables

- prevailing rate of interest determined, per section 1274(d)(1), w/ ref. to avg. market yield on mid-term Treasuries

- two-month "lookback" per reg. section 1.7520-2(a)(2)

net income unitrust

- pays lesser of unitrust amount or current net fiduciary accounting income
- if "w/ makeup" (NIMCRUT), pays net income in excess of unitrust amount to make up for shortfalls in previous years
- further variants
 - "flip" trust, "spigot" trust

qualified contingency

section 664(f)

- trust instrument may provide for early termination on occurrence of contingency, accelerating remainder to charity
- contingency does not factor into valuation of income or remainder interests

[e.g., divorce, remarriage, leave school, etc.]

remainder trust f/b/o third party

nonspouse, immediate

- "income" interest eligible for gift tax annual exclusion, but
- if present value exceeds 15k, settlor may want to render gift incomplete
- reserved power to revoke
- if exercisable inter vivos, would trigger "grantor" trust status, disqualifying see, section 674(b)(3)

f/b/o third party, cont'd

nonspouse, immediate, cont'd

- but reserved testamentary power will cause estate tax inclusion per section 2038 (or 2035 if released w/in three years)
- inclusion only partly offset by deduction for charitable remainder
- incremental tax must be paid from other sources, see Rev. Rul. 82-128

the numbers

- 100x noncash, 25x basis, income bene age 50
 - w/ 7520 rate at .06 pct.
 - present value remainder 26.06x [deduction]
 - present value unitrust stream 73.94x
 - w/ 7520 rate at .08 pct.
 - present value remainder 26.10x [deduction]
 - present value unitrust stream 73.90x
- gain realized w/in exempt entity, distributed over at least twenty years

some observations

- if net income w/ makeup,
 - precontribution gain not allocated to "income" in year of sale
- flipCRUT as default model
- compare gift annuity payout 3.3 pct.
 - portion excluded as return of investment
 - balance taxed as ordinary income

some more observations

- if annuity trust
 - min. five pct. annuity trust would exhaust in just over 21 years
 - w/ 7520 rate at 0.6 pct., min. age CRAT paying five pct. is 77 years
 - qualified contingency per Rev. Proc. 2016-42 could salvage,
 - but cf. reg. section 25.7520-3(b)(2)(v)

Q&A scenario two

scenario three

- H.R. 1994, SECURE Act
incorporated into H.R. 1865 spending bill
- RBD now age 72 rather than 70-1/2
 - no age limit on deductible contributions
 - but contributions after age 70-1/2 will reduce QCDs dollar for dollar
 - complete distribution w/in ten years regardless of participant's pay status
 - except "eligible" designated beneficiaries

death of the "stretch" IRA

what were the rules before

- if participant dies before required beginning date (RBD),
 - payable over life expectancy of "designated beneficiary," or
 - w/in five years of death
- spouse may roll over, per reg. sec. 1.408-8, Q&A-5

death of "stretch" IRA, cont'd

former rules, cont'd

- if participant dies after RBD,
 - payable over life expectancy of "designated beneficiary," or
 - of participant (as of date of death) i.e., "ghost" life expectancy
- again, spousal rollover

death of "stretch" IRA, cont'd

spousal rollover

- reg. sec. 1.408-8, Q&A-5 says
 - spouse must be sole beneficiary w/ unlimited right to w/draw
- cf. letter rulings under UICL 408.06
 - designation to estate
 - spouse as executor
 - sole heir/legatee or
 - authority to make non- pro rata distributions

death of "stretch" IRA, cont'd

trust as "designated beneficiary"

- per reg. sec. 1.401(a)(9)-4, Q&A-5
 - trust valid under state law
 - irrevocable as of participant's death
 - all beneficiaries identifiable
- documentation to administrator by October 31 year after death

death of "stretch" IRA, cont'd

trust as "designated beneficiary," cont'd

- all benes are identifiable individuals
- payable over life expectancy of oldest
- separate trusts w/ separate designations must already be in place
- determination as of September 30 of year following participant's death
 - reg. sec. 1.401(a)(9)-4, Q&A-4

death of "stretch" IRA, cont'd

trust as "designated beneficiary," cont'd

- determination as of September 30, cont'd
 - distribute to nonqualified benes
 - disclaimers
- e.g., PLR 201901005
 - bene designation to trust f/b/o child and grandchildren
 - disclaimers across the board
 - spouse as sole heir

death of "stretch" IRA, cont'd

trust as "designated beneficiary," cont'd

- conduit
 - reg. sec. 1.401(a)(9)-5, Q&A-7
example 2
- accumulation
 - reg. sec. 1.401(a)(9)-5, Q&A-7
example 1
 - contingent remaindermen taken into account
in determining shortest life expectancy

the new regime, per SECURE Act

"eligible" designated beneficiaries

- surviving spouse
- minor child during minority
 - reg. sec. 1.401(a)(9)-6, Q&A 15
- chronically ill or disabled bene
 - defn. cross ref. sec. 7702B(c)(2)
- bene not more than ten years younger
than participant (typically sibling)

workarounds

- testamentary charitable remainder trust
 - income tax exempt at trust level
 - net income unitrust w/ or w/o makeup
 - cf. state law re "wasting" asset
 - min. ten pct. remainder value
 - no encroachments

workarounds, cont'd

- testamentary gift annuity
 - zero setup, lower administrative expense
 - no five pct. minimum stated payout
 - fixed payout
- PLR 200230018
 - no realization event, but
 - no "investment" to recover

Q&A scenario three

Russell A. Willis III, J.D., LL.M.

<https://www.plannedgiftdesign.com>

314.566.3386

rawillis3@plannedgiftdesign.com

<https://www.linkedin.com/in/russ-willis-plannedgiftdesign/>
<https://twitter.com/rawillis3>
