25th ANNUAL
THIS YEAR IN NONPROFIT LAW

December 7, 2015

When is a CGA Better than a CRT?

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1. Summary

2. The CGA as a solution to associated debt

Suppose a donor is moving to a continuing care retirement community and owns a small rental residential property she can no longer manage. The property has a small balance due on the original purchase mortgage. The donor must sell, and wants to consider the possibility of a charitable gift. Unless the donor pays off the mortgage with other assets, the property cannot be contributed to a charitable remainder trust ("CRT") because of the prohibition of section 4941[1] as discussed below, but it can be contributed to a charitable gift annuity ("CGA").

2.1 The two tests for a CGA

Somewhat confusing, there are two different tests for whether an annuity is a qualified charitable gift annuity. An annuity can be a qualified CGA for purposes of the donor's tax reporting even if it is not a qualified CGA for purposes of the charity's tax reporting, and probably vice versa.

2.1.1 The donor's test

Regulation section 1.1011-2(a)(4) specifies the requirements for a qualified CGA from the donor's perspective. There is no cross-reference, other linkage or necessary logical connection to section 514(c)(5), which controls the treatment of the CGA from the charity's perspective. If the requirements of regulation section 1.1011-2(a)(4) are met, the donor should be entitled to annuity reporting even if the charity cannot satisfy section 514(c)(5).

Regulation section 1.1011-2(a)(4) requires that (i) the annuity be unassignable, or assignable only to the issuing charity, (ii) the only annuitants are the donor or the donor and one or more designated survivor annuitants and (iii) the donor is entitled to a deduction under section 170. Section 170 in relevant part requires (i) that the value of the property transferred (after considering adjustments for disallowances) meaningfully exceeds the

[1] Unless otherwise specified in context, references to sections are to sections of the Internal Revenue Code of 1986, as amended. References to regulation sections are to sections of the Treasury regulations promulgated with respect to the Internal Revenue Code.

value of the property received and (ii) the donor does not have a retained property right in the property transferred or in its income.[2]

If the annuity does not satisfy the requirements of regulation section 1.1011-2(a)(4), the donor is taxed on the fair market value of the annuity in the first year, probably at ordinary gains rates. This would be bad.

2.1.2 The charity's test

As a matter of economic theory, the obligation to pay an annuity is similar to the obligation to repay a loan. When a charity earns income from borrowed proceeds it earns unrelated business taxable income ("UBTI") on which it must pay unrelated business income tax ("UBIT"). Similarly, if charity earns income from the proceeds of an annuity it can potentially have UBTI. If the annuity does not satisfy the requirements of section 514(c)(5), the outstanding fair market value of the annuity (this number changes every year) is treated as acquisition indebtedness, and the charity must pay tax at 35% (39.6% if the charity is formed as a trust) on the proportion of its investment income attributable to the deemed debt. While not as bad as the adverse outcome for the individual donor noted above, it materially increases the probability that the contract will go "under water."

Fortunately, section 514(c)(5) creates an exception for a qualified charitable gift annuity. A qualified CGA (i) will have a value of less than 90% of the consideration provided, (ii) is payable over no more than 2 lives, (iii) will not have a minimum or maximum number of payments and (iv) is not tied to the income produced by the transferred property. In addition, the purchase price paid for the annuity must be the "sole consideration" for the issuance of the annuity, a point discussed further below. If the requirements of section 514(c)(5) are met are met, the charity should avoid UBTI even if the donor is not entitled to annuity reporting under regulation section 1.1011-2(a)(4).

2.2 Sole consideration

In material part, section 514(c)(5) provides as follows:

> "(5) Annuities. For purposes of this section, the term "acquisition indebtedness" does not include an obligation to pay an annuity which—

[2] An annuity is a general obligation of the charity, and the purchase price passes into the general assets of the charity. The donor has no property right in the income from the transferred purchase price itself. This seemingly modest point is critical for a large number of tax purposes. As but one example, see Rev. Rul. 80-281.

(A) is the sole consideration (other than a mortgage to which paragraph (2)(B) applies) issued in exchange for property…."

Two different paragraphs of section 514(c) are relevant here. Section 514(c)(2) provides as follows:

"(2) Property acquired subject to mortgage, etc. For purposes of this subsection —

(A) General rule. Where property (no matter how acquired) is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.

(B) Exceptions. Where property subject to a mortgage is acquired by an organization by bequest or devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of the acquisition. If an organization acquires property by gift subject to a mortgage which was placed on the property more than 5 years before the gift, which property was held by the donor more than 5 years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift. This subparagraph shall not apply if the organization, in order to acquire the equity in the property by bequest, devise, or gift, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor.

(C) Liens for taxes or assessments. Where State law provides that—

(i) a lien for taxes, or

(ii) a lien for assessments,

made by a State or a political subdivision thereof attaches to property prior to the time when such taxes or assessments become due and payable, then such lien shall be treated as similar to a mortgage (within the meaning of subparagraph (A)) but only after such taxes or assessments become due and payable and the organization has had an opportunity to pay such taxes or assessments in accordance with State law."

2.2.1 Qualified debt

In the case of the real estate owner described at Paragraph 2 above of this outline, the debt is qualified debt. The donor will only receive the annuity in exchange for the transfer to the charity, but for tax purposes the donor must report the amount of the mortgage as immediately received gain. The charity will probably want to calculate the annuity on the estimated amount to be realized rather than the fair market value. This increases the amount of the charitable deduction, which is based on fair market value. From a purely economic

standpoint, in almost all cases the donor would be better off selling and keeping the proceeds rather than creating a CGA, but if the donor does have a genuine charitable intent, the combined tax benefits of an enhanced charitable deduction and the deferral of the remaining gain over the donor's life expectancy are not small.

2.2.2 Non-qualified debt

Section 514(c)(2)(A) provides that if property encumbered by debt is transferred to a charity, the charity is deemed to have incurred the debt even if it does not assume or agree to pay the debt. This provision gives one rule, but does not directly answer a much more important question. Clearly, the proportion of the income the charity earns from the annuity purchase price represented by the encumbering debt will be UBTI. But does the transfer of the debt mean that the donor received "consideration" in addition to the annuity itself? If the donor put the debt on the property, the release of the debt probably constitutes additional consideration. In that case, the annuity is not a qualified CGA, and the charity earns UBTI on all earnings financed by the annuity (a fatal result).

But what if the debt is non-recourse debt in a partnership where the donor is a limited partner? Property encumbered with debt that does not fit within the safe harbor of section 514(c)(2)(B) cannot be used to purchase a charitable gift annuity unless substantial amounts are involved. If substantial amounts are involved that may justify incurring significant legal fees, however, it may be possible to satisfy the "sole consideration" rule by careful structuring. Without going deeply into this very challenging topic, the following authorities may be useful: Rev. Rul. 76-95, PLR 201012050, PLR 8526015, PLR 200150040 and PLR 9110012.

3. The CGA as the solution to the self-dealing problem

3.1 Brief introduction to section 4941

Section 4947 of the Internal Revenue Code of 1986 (the "tax code") provides that section 4941 applies to all charitable remainder trusts ("CRTs"). Section 4941 prohibits self-dealing between CRTs and "disqualified persons", essentially donors and trustees and the respective families of each.

In its simplest form, self-dealing is a transaction between a trustee and a trust, for example, when the trustee personally buys an asset from the trust. In a marketplace transaction, both the buyer and the seller must freely agree to a price. Both buyer and seller subjectively

accept the price as "fair," and economic theory posits that the results of many such transactions converge on a price that objectively sets "fair market value" – a tremendously important social good. But when buyer and seller are the identical, the potential for abuse is obvious. Consciously or unconsciously, the trustee will tend to get the better of such bargains, to the detriment of the trust.

Congress passed the Tax Reform Act of 1969 amendments to the tax code, which included sections 664 and 4941, in reaction to abuses of charitable giving by wealthy individuals. Critically, section 4941 does not apply to public charities. Congress expressly assumed that charities that are maintained by broad public support will be policed by the need to raise support from the general public. As applied to private foundations and CRTs, however, section 4941 is very broad. On the one hand, the traditional concept of self-dealing was expanded to include indirect self-dealing, and on the other hand, the prohibition was expanded to include not only the families of donors and trustees, but also businesses, trusts and other entities in which donors and trustees have a significant interest.

"Greenmail" is a classic example of indirect self-dealing. Suppose a wealthy donor owns a number of shares of company X. Some years ago the donor created a CRT for which the donor received a tax deduction and other tax benefits. The donor causes the CRT to purchase a significant number of other shares of company X. The donor then threatens company X with a proxy fight unless it buys his shares at a higher than market price. Because of the size of the combined block of shares owned by the donor and the CRT together, the proxy fight threat is powerful. In this instance, indirect self-dealing occurs when the company buys the donor's shares at a higher than market price. The donor has used the assets of the CRT to realize a personal benefit, and yet no transaction has occurred between the donor and the CRT.

Similar indirect self-dealing can occur when a donor and CRT invest through the same broker and the broker gives both clients an aggregate volume discount. In such circumstances, the entire volume discount must be given to the CRT.

The thorniest analytical problems can arise when a CRT owns a small part of a closely held business in which disqualified persons have a significant interest, even if the business is conducted as a C corp. An interesting early article written by someone who had some role in writing the regulations notes that it is unclear whether such a business can pay a dividend

or pay salaries without running afoul of section 4941.[3] While this concern is generally treated as purely theoretical in ordinary operations, it is a useful reminder that when large transactions are contemplated it can be very difficult, and in many cases impossible, to give comfort that a transaction involving a CRT and a closely held business will not violate section 4941.

Section 4941(d)(2)(A) appears to create a safe harbor for the transfer of property with debt similar to section 514(c)(2)(B). In all but the simplest circumstances, however, the web of contractual arrangements typically surrounding debt make this safe harbor effectively unavailable once the full reach of indirect self-dealing is understood. Typical loan documents will have a variety of cross-collateralization clauses that make it impossible to disentangle the gifted property from other retained property. Contiguous properties may have related easement rights. Partnership management agreements may call for contributions based on rent rolls assessed in arrears. Private letter ruling 200420029 is a good example of the steps that must be taken to avoid self-dealing under § 4941, although it deals with a private foundation and a disqualified person planning to invest in the same business from the start, rather than the possibility of some easily over-looked string inadvertently connecting a property to gifted from property to be retained.

3.2 Common self-dealing problems potentially cured by a CGA

3.2.1 Co-investing

As noted, PLR 200420029 addresses the case where the charity and the donor both knowingly invest in the same business where section 4941 applies. One of the basic concepts in analyzing self-dealing is that all benefits that are obtained by the co-investment, such as a volume discount on fees, must entirely accrue to the private foundation. Other protective rights given the private foundation include the right to withdraw without penalty and to take distribution of assets in kind upon withdrawal. In almost every case where third party investors are involved, it will not be possible to insert the principles of PLR 200420029 into an ongoing business, even if an immediate sale is contemplated. As a result, section 4941 can spring out of the background with devastating consequences if the planners overlook some hard to spot issue.

[3] Alvin J. Geske, *Indirect Self-Dealing and Foundation's Transfers for the Use or Benefit of Disqualified Persons*, 12 Hous. L. Rev. 379 (1974-75).

A public charity issuing a CGA is not subject to section 4941. The charity will want to take a number of protective steps before accepting a closely-held business interest, but with this caveat, practical business negotiation can get the transaction done.

3.2.2 Salary continuation and covenants not to compete

Although technically covered by the item above, salary continuation agreements and covenants not to compete are the most visible forms of self-dealing in common business disposition charitable planning cases. If a CRT is contemplated, section 4941 absolutely prohibits either form of consideration to the donor or any relative of the donor by the closely held business in which the CRT receives an interest. If a CGA is contemplated, the relevant test is the excess benefit rule of section 4958. With appropriate planning, the excess benefit standard can be definitely satisfied.

3.2.3 Remote environment risks

No charity should ever accept an interest which carries any meaningful degree of environmental risk. But real estate practice has adapted to a world in which it is impossible to avoid all environmental risk. Some risks, such as minor petroleum residue run-off from a nearby parking lot, may be so remote that they are often just ignored. At some hard to define point, however, a risk moves from very remote to just very unlikely. At that point, a CRT becomes more problematic. If an environmental cost does arise, often both the donor and the CRT would be liable, and the donor would have to pay the cost even if the CRT had insurance which covered the risk.[4] With a CGA, the donor and the charity could come to a reasonable business decision about the risk. If the cost of any remediation, if required, would likely be comparatively inexpensive, the donor and charity could simply agree to adjust the size of the annuity.

4. The CGA and recapture

4.1 Brief review of recapture

The tax code permits a deduction for depreciation and amortization. When property on which depreciation or amortization has been taken is sold, gain on the sale up to the amount of depreciation or amortization previously allowed is “recaptured,” meaning it is taxed under special tax provisions. Gain over the amount of depreciation or amortization previously

[4] As an asset of the CRT, none of the proceeds of the policy can be used to give any benefit to a disqualified person under section 4941.

allowed is taxed under other generally applicable rules. For our purposes here, recapture can be divided into two types: section 1245 recapture and section 1250 recapture.[5] As a simplification, section 1250 recapture applies to buildings and their structural components, and section 1245 recapture applies to any other form of property.

As a matter of practical tax administration, the Internal Revenue Service ("IRS") will generally accept transaction terms agreed upon at arms'-length by a buyer and seller. This position is based on the fact that in most cases, a benefit to a seller is a detriment to a buyer, and vice versa. For example, a buyer would prefer to pay more of the purchase price in the form of a covenant not to compete to a seller and less in exchange for assets. This produces ordinary tax deductions as the payments are made, and avoids increasing the amount that must be depreciated over time. The seller would prefer to have more of the purchase price paid in the form of capital gains taxed at a lower rate, and less as a covenant not to compete taxed as ordinary income.

The positions of buyer and seller are not exactly parallel, however. A seller must recognize section 1245 recapture immediately, even if the purchase price is paid in the form of an installment sale. The buyer does get a benefit from the allocation of the purchase price to section 1245 property, but only over time. Accordingly, a rational buyer and seller would tend to reduce the price paid for section 1245 property to the lowest reasonable amount (sometimes zero) and pay an equivalent amount in the form of a covenant not to compete. Even where this substitution is not available, however, most transactions place a low value on section 1245 property even if the replacement cost would be substantial.

For individual sellers, section 1250 recapture is taxed as capital gain but at a 25% rate. The gain can be deferred under an installment sale, but all of the section 1250 recapture is reported and taxed before any of the regular long term capital gain is taxes.

4.2 Differences between a CGA and a CRT for recapture purposes

4.2.1 Section 1245 recapture

The tax differences between how a donor reports section 1245 recapture under a CRT and a CGA are considerable. A CRT allocates all of the 1245 recapture gain to the

[5] I am using technically imprecise terms for clarity's sake. "Section 1250 recapture" is a term technically reserved for some of the gain on the sale of section 1250 property that special rules require treating as ordinary income. While more common in the past, this is comparatively rare today. Here I use section 1250 recapture to mean what is technically described as unrecaptured section 1250 gain.

ordinary income layer. All of the distributions from the CRT will be taxed at ordinary income tax rates for a lengthy period. The recent increase to ordinary income tax rates can make this consequence expensive. While conclusive authority for this proposition cannot be found, the correct approach appears to be that (i) the section 1245 recapture, (ii) the remaining long term capital gain and (iii) the recovery of basis is reported ratably as part of the exclusion amount.[6] As a result, the effective tax rate on CGA income is much lower than a CRT, at least during the period of time represented by the adjusted return multiple (a period of time roughly equivalent to life expectancy using annuity tables rather than whole population tables).

4.2.2 Section 1250 recapture

The tax differences between how a donor reports section 1250 recapture under a CRT and a CGA are much smaller, but a charity is more likely to encounter section 1250 property recapture. The section 1250 gain fills up a special layer of the CRT. While the section 1250 layer must be exhausted before any regular long term capital gain is reported, significantly, qualified dividends are distributed before the section 1250 gain is distributed. Depending upon the CRT's investment strategy, this can dilute the adverse effect of the section 1250 gain. The rule for a CGA is essentially the same as the rule for section 1245 recapture.

5. Putting the economics together

5.1 The BIG downsides to a CGA

5.1.1 The possible return of inflation

5.1.2 All ordinary income after the expected return multiple

5.1.3 Very low payouts at younger ages

5.2 The advantages to a CGA

5.2.1 Sometimes the only available choice

5.2.2 Lower costs

The obvious costs are tax return preparation and possible trustee fees. If the donor or the charity acts as the trustee, most of this cost disappears. A less visible difference

[6] Section 1245 requires that all recapture gain be *recognized* upon disposition of 1245 property. Under regulation 1.1011-2(a)(4) "any gain [on the annuity] is to be *reported"* using the general annuity rules of section 72. Regulation 1.1245-6(d), promulgated before the installment sales rules were changed, provided that section 1245 gain could be reported on the installment sale, which is good authority that the distinction between recognition and reporting applies to section 1245.

is that larger charities invest at institutional funds rates, while stand-alone CRTs typically pay retail rates.

5.2.3 Better tax treatment during the life expectancy period

A CGA reports basis, recapture and LTCG proportionately during the life expectancy of the donor(s). A CRT frontloads the income taxed at a higher rate. This effect is especially pronounced in the case of section 1245 gain.

5.2.4 A guarantee

5.3 The actuarial considerations

As a general rule, in the present environment, a CGA tends to do better and better as the age of the donor increases.