



Gift Annuities and the 10% Deduction Requirement

PG Calc November 2010 Featured Article

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In early 2009, we started to get calls from clients who were seeing a warning message when they ran a gift annuity illustration in Planned Giving Manager (PGM). The message told them that the gift would not qualify because "the charitable portion of the gift is 10% or less of the principal donated." They wanted to know why they were seeing a message they'd never seen before and what they should do about it. A few months later, these calls abated. Now, we're getting them again. What's going on?

It's all about the IRS discount rate

The charitable portion¹ of a gift annuity is a function primarily of the annuitant's age, the annuity rate, and the IRS discount rate used in the calculation. A change in any of these values can affect the deductible value significantly. In particular, the lower the IRS discount rate, the lower the deduction available to the gift annuity donor. The table below shows how the deduction for a \$10,000 gift annuity paying 6.4% annually to a 75 year-old changes as the IRS discount rate changes.

IRS discount rate	Deduction
2.0%	\$3,850
3.0%	\$4,252
4.0%	\$4,611
5.0%	\$4,932

What early 2009 and late 2010 have in common are record low IRS discount rates. October's rate is 2.0%, repeating the all-time record low of 2.0% first recorded in February 2009.

Over 90% of charities follow the schedule of maximum annuity rates suggested by the American Council on Gift Annuities (ACGA) all or most of the time. When the ACGA announced its latest annuity rate schedule last April (the schedule went into effect July 1), the IRS discount rate was 3.2% and had been holding steadily above 3.0% for almost a year. In developing these rates, the ACGA made sure that all of its suggested rates for immediate payment gift annuities would result in a deduction of more than 10% of the annuity funding amount for IRS discount rates as low as 3.2%.

For October gifts, it is still possible to use August's IRS discount rate of 2.6%. Likewise, September's rate of 2.4% will be available through the end of November. Come December, however, 2.0% could be the highest IRS discount rate available. At 2.0%, ACGA rates for immediate payment gift annuities fail the 10% deduction requirement for one annuitant, age 59 or below, and two annuitants, both age 65 or below. There may be exceptions to these thresholds, but this is generally what we find.

Deferred annuities affected most

The situation is more acute for deferred gift annuities. This is because the ACGA suggests adjusting the annuity rate upward by 4.5% for every year of deferral, a rate that is over twice the 2.0% discount rate being applied to compute the deduction. A 55 year-old who defers payments less than 10 years will produce a deductible value under 10%. Likewise, a gift annuity for two 50 year-olds who defer payments less than 20 years will fail this test.

The length of the deferral period comes into play because of mortality, the likelihood an annuitant will die before receiving any payments. If this likelihood becomes great enough, it pushes the deduction back over 10%. Note that even at a discount rate of 2.4% or 2.6%, some deferred gift annuities that follow the ACGA rates will produce a deduction of 10% or less.

The 10% deduction requirement

There is quite a bit of confusion among gift planners over the 10% deductible value requirement as it applies to gift annuities. No doubt, this is because there is a similar requirement for charitable remainder trusts that has distinctly different consequences.²

The 10% deductible value requirement for charitable remainder trusts was introduced by the Taxpayer Relief Act of 1997 (I.R.C. Secs. 664(d)(1)(D) and 664(D)(2)(D)). A charitable remainder trust whose charitable remainder value is less than 10% of the funding amount of the trust will not qualify as a charitable remainder trust for tax purposes.

Failure of a charitable remainder trust to meet the applicable 10% test means the donor will not be allowed a charitable deduction and the trust will be taxable on all of its earned income and realized capital gain. Importantly, all of these severe consequences affect the donor, not the charity.

The 10% deduction requirement for charitable gift annuities is a different tale. If the charitable portion of a gift annuity is 10% or less, or if any of three other requirements³ defined under I.R.C. Sec. 514(c)(5) are not met, the annuity payable by the charity will be considered "acquisition indebtedness" and may give rise to unrelated business taxable income for the charity under I.R.C. Sec. 501(m). The income generated by the gift annuity would then be taxable to the issuing charity as insurance income. If this income were deemed "substantial," the charity could conceivably lose its tax-exempt status!

Unlike a charitable remainder trust, then, a gift annuity that fails the 10% deduction requirement is a problem for the charity, potentially a catastrophic one, but not for the donor. Put another way, although the donor can still take a tax deduction and enjoy partially tax-free payments, the charity would be ill-advised to issue such an annuity.

Note: If the deduction associated with a contribution to a charitable remainder trust is exactly 10% of the value of the contribution, the trust will pass the test applicable to charitable remainder trusts. In contrast, a gift annuity with a deduction equal to exactly 10% of the contribution does not pass the test applicable to gift annuities.

Options for addressing failure of the 10% deduction requirement

One option when a gift annuity fails the 10% deduction requirement is to end the gift annuity discussion and seek alternative vehicles for making the gift. You might suggest an outright gift or a bequest. An outright gift would be of immediate use to your organization, which may be gratifying to the donor as well as to you and your colleagues. A bequest would afford the donor complete flexibility to revise the gift at any time for any reason, but also enable him or her to consider a much larger gift than he or she would be comfortable making now.

Another option is to have the donor delay the gift until the IRS discount rate increases to the point where the gift annuity earns a deduction over 10%. Although it seems unlikely that the IRS discount rate will stay at rock-bottom indefinitely, it is hard to say how long the donor who pursues this strategy might have to wait. The donor may be eager to make a gift now, or before the end of the year, not at some later undefined date. You don't want to thwart that enthusiasm to make a gift by encouraging the donor to wait.

An additional possibility is to reduce the annuity rate offered to the donor enough that the gift annuity will have a deductible value over 10%. Keep in mind that the annuity rates suggested by the ACGA are *maximum* rates. The ACGA has no issue with organizations offering rates below the suggested rates. In the interest of proper disclosure, prior to the gift you should make clear to the potential donor that the annuity rate your organization can offer is lower than it would ordinarily offer, given the age(s) of the annuitant(s). If your organization will issue the annuity in a state that requires issuers to follow the ACGA rates or to file an approved schedule of rates, then making this sort of disclosure is not just good practice, it is required by the state.

Determining the annuity rate that passes the 10% test

Determining the annuity rate that will pass the 10% deduction requirement is a matter of applying some simple algebra. Here are the steps in PGM:

1. Produce the Actuarial Calculations chart using the standard annuity rate your organization would ordinarily offer, given the annuitant's age.
2. Divide 90% of the Principal Donated (usually line 2) by the Investment in Contract (usually line 9).
3. Multiply the Annuity Rate (usually line 4) by the result in (2). If you wish, round the result down to the nearest 0.1%.
4. Open the Gift Options window and enter the annuity amount determined in (3) as the *Annuity rate* for the gift annuity.
5. Re-run the illustration. The charitable deduction will be equal to or slightly greater than 10% of the funding amount. Note that the deduction must be *greater than* 10%, so if you find the deduction equals exactly 10%, you'll need to decrease the annuity rate slightly and re-run the illustration again.

For example, using the sample [Actuarial Chart](#) for a deferred gift annuity that fails the 10% deduction test, the math in steps (2) and (3) would be:

1. $(0.9 \times \$10,000) / \$9,870.90 = .91177$
2. $10.5\% \times .91177 = 9.5736\%$

Now, you're ready to re-run the calculation using an annuity rate of 9.5736%. The deduction turns out to be exactly \$1,000, or 10% of the funding amount. This means you will need to reduce the annuity rate slightly. Entering 9.5735%⁴ results in a deduction of \$1,000.10. That's all you need, although there's something to be said for rounding down to 9.5% for the sake of simplicity and a comfortable margin of error on the deduction amount (now \$1,069.20).

Note: The above process will work as long as the Investment in Contract found on the Actuarial Calculations chart produced in (1) is less than the Principal Donated. If it equals the Principal Donated (it cannot be higher), use trial and error to find an annuity rate that results in a deduction over 10% or contact PG Calc for additional help.

The ultra-low IRS discount rate isn't all bad for gift annuities

There *is* a benefit to donors who fund a gift annuity while the IRS discount rate is historically low. Although the

charitable deduction is unusually low, the tax-free portion of each payment becomes correspondingly higher. This tax-free portion continues for the annuitant's life expectancy, after which this portion becomes taxable ordinary income.

For donors who do not itemize deductions or who otherwise are not concerned about the amount of their charitable deduction, the prospect of future annuity payments subject to less tax may be especially attractive. Regardless, it is worthwhile for you to point out this benefit to every prospect who is considering a gift annuity.

Conclusion

October's extremely low IRS discount rate is causing some charitable gift annuities that feature the ACGA suggested maximum annuity rate to yield a deductible value of less than 10%. Deferred gift annuities are especially prone to this problem. Unless and until the IRS discount rate increases or the ACGA revises its suggested maximum rates downward, this situation will persist.

The concerns raised when a charity issues a gift annuity with a deductible value under 10% affect the charity, not the donor. These concerns can be very serious and charities are well-advised to avoid issuing any gift annuities of this kind. Fortunately, there are numerous ways to continue the conversation with a donor for whom a gift annuity paying the standard ACGA rate is not an option. In instances where you propose an annuity rate that is low enough to pass the 10% deduction requirement, be sure to disclose to your prospect what your organization's standard annuity rate would be and why you have reduced it.

¹ In almost all instances, the term "charitable portion" will be synonymous with the terms "deductible value" and "deduction." Occasionally, however, the amount a donor may claim as a charitable deduction for federal income tax purposes in connection with a gift annuity contribution must be reduced to something less than the charitable portion. This will be the case when the contribution consists of short-term capital gain assets or other property for which the deduction is a function of the property's cost basis, rather than its fair market value. In such a case, even if the deduction turns out to be 10% or less of the contribution, the gift annuity will nevertheless be acceptable so long as the charitable portion is greater than 10% of the contribution. Because gift annuities are typically funded with cash or long-term capital gain property (or some combination of the two), this article equates "deductible value" and "deduction" with "charitable portion."

² As with a gift annuity, the "charitable portion" of a charitable remainder trust contribution is almost always going to be synonymous with its "deductible value." For this reason, these two terms, along with the term "deduction," are used interchangeably, even though in some cases the deductible value may be less than the charitable portion.

³ The four requirements in I.R.C. Sec. 514(c)(5) are:

1. The obligation to pay the annuity must be the sole consideration (disregarding any mortgages) for the contribution and the value of the annuity must be less than 90% of the funding amount (i.e., the charitable portion must be more than 10% of the funding amount);
2. The annuity must be payable for the lives of one or two individuals;
3. The agreement must not specify either a minimum or maximum number of payments; and
4. The annuity must not be adjustable by reference to income earned by the gift property or other property.

⁴ PGM offers three options for rounding the annuity rate entered. The rounding option selected can change the entered annuity amount by a few cents, so adjusting your entered annuity rate by just 0.0001% may not change the

annuity amount applied by PGM. See *Customize – Calculation Options – Gift Annuities – Round annual annuity payment* in the PGM Menu Bar to review the three annuity rounding options.