

PLANNED GIVING T·O·D·A·Y®

THE PRACTICAL NEWSLETTER FOR GIFT-PLANNING PROFESSIONALS

SEPTEMBER 2010
Volume XXI, Number 9

A *Planned Giving Today* Landmark Issue Featuring . . .

Charitable Gift Annuities: What They Are and How They Work

BY FRANK MINTON

Mildred K admired good writing and could turn a phrase herself. That is why she dreamed of providing fellowships to students in the creative writing program at the local university. However, she needed all of her investment income for living expenses. Indeed, if she were to remain in her condominium she would soon require more income to pay for domestic help.

Her largest single asset was some 30,000 shares of stock in a financial services company. Even though the stock had recently declined in value, it still had appreciated significantly since she inherited it many

years earlier. Its current value was approximately \$600,000. Dividends, though, were only about \$14,000. After talking to a representative of the university and to her legal advisor, she contributed most of the stock for a charitable gift annuity. Her payments from the annuity were over three times the dividends she had been receiving. Moreover, she received a significant income tax charitable deduction that reduced her income tax over the next several years.

At the end of her life, the remaining portion of her contribution will be used

About This Landmark Issue of *Planned Giving Today*®

Charitable gift annuities are the most popular life-income planned gift available to donors today. More and more non-profit organizations are adding these gift instruments to their offerings. Yet, many people do not understand how these gift plans work and why they are so popular. This special issue has been designed to answer this need. In these pages, you will learn about gift annuities from the most knowledgeable person in this field, Dr. Frank Minton — a man who is widely known as Mr. Gift Annuity.

Whether you are a prospective donor, a board member, a professional advisor, or someone simply interested in charitable gift planning, Dr. Minton will take you step by step through the basics. The cartoons were provided by Lance Andrew ©2002 (www.lanceandrew.com).

The examples in this booklet are based on the rates recommended by the American Council on Gift Annuities that became

effective July 1, 2010, and on a 3.4 percent IRS discount rate (known as “the Charitable Midterm Federal Rate” or “CMFR”). The latter may fluctuate monthly and affects the size of the charitable deduction and how payments are taxed.

Note: This issue of *Planned Giving Today* is provided with the understanding that neither the publisher nor the author is engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

A limited number of extra copies of this landmark issue are available while supplies last. The issue is ideal for non-profit staff members, board members and other key volunteers, professional advisors, and prospective donors. Rates: 1 copy, \$36; 5 copies, \$75; 10 copies, \$120; 25 copies, \$200. To order, call 1-800-654-3237 or visit www.pgtoday.com.

THIS MONTH

Charitable Gift Annuities: What They Are and How They Work

TOPICS

- 2 What Is a Gift Annuity?
- 4 Rates and Payments
- 5 Taxation Matters
- 7 Charitable Deductions
- 9 Funding CGAs
- 11 Completing CGAs
- 12 Administering CGAs

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Graphics
Soundview Design Studio
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Planned Giving Today is published monthly and sent by first class mail to subscribers. Views expressed in this newsletter do not necessarily represent the opinions of the publisher or the Editorial Advisory Board. Article deadline is six weeks prior to issue date.

Letters to the Editor are due four weeks prior to issue date. The publisher assumes no responsibility for unsolicited manuscripts or other materials submitted for review.

2010 Subscription Rates

	Personal	Institutional Single Site
Print-and-online USA	\$195	\$449
Print-and-online outside USA	\$234	\$495
Online only	\$175	\$345
Print only USA	\$195	\$375
Print only outside USA	\$234	\$425

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ISSN: 1052-4770

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to establish the K endowed fellowship in creative writing. In celebration of her gift, the chair of the department brought six students to her condominium, and the students left her with samples of their work. Imagine their surprise when she gave them a manuscript of an essay she had just completed at the age of 84.

Facts About Gift Annuities

- ◆ Gift annuities in the U.S. were first issued in the 1830s.
- ◆ The average size of a gift annuity is slightly over \$43,000.*
- ◆ At the time immediate gift annuities are funded, the average age of annuitants is 79.*
- ◆ Nearly 56 percent of annuitants are female.*
- ◆ Approximately 90 percent of annuities are immediate and 10 percent are deferred.*
- ◆ Nearly 31 percent of gift annuity donors increase their annual giving.*

* Data from 2009 ACGA survey

Persons Who Might Benefit From a Gift Annuity

Ms. K is a rather typical gift annuity donor, though the amount she contributed was considerably larger than the average gift. Most gift annuity donors are retired, want to increase their cash flow, seek the security of fixed payments, and would like to save taxes. A charitable gift annuity could be right for people in any of the following circumstances:

- ◆ The interest rates on their CDs and other fixed-income investments have declined, and they would like to increase their cash flow.
- ◆ They own appreciated stock or mutual fund shares and have considered selling some of the shares and reinvesting the proceeds to generate more income, but they have hesitated because they don't want to pay tax on all of the capital gain.
- ◆ They would like to count on fixed payments, which are unaffected by interest rates and stock prices and which they cannot outlive.
- ◆ They want to assure continuation of payments to a surviving spouse without the delay of probate proceedings.
- ◆ They would like to provide financial assistance to an elderly parent, a sibling, or other person in a tax-advanced manner.

Although gift annuities are most commonly established by retired individuals and couples in the above circumstances, they are sometimes used as a supplemental retirement plan by people who are still

working. Those who are contributing the maximum allowable to their IRA, 401(k), 403(b), or other qualified retirement plan, may wish to accumulate more for retirement on a tax-sheltered basis. To do this, they contribute some excess income or other assets during their working years and arrange for payments to begin at retirement age.

What Is a Gift Annuity?

A gift annuity is a contract under which a charity, in return for a transfer of cash or other property, agrees to pay a fixed sum of money for a period measured by one or two lives. The person who contributes an asset for the annuity is called the "donor," and the person who receives payments is called the "annuitant" or "beneficiary." Usually, the annuitant is also the donor, but this is not always true. Like Ms. K, a donor can make the contribution and direct the payments to herself. However, the donor could have the payments made to someone else — a sibling or parent, for instance.

The maximum number of annuitants is two, and payments can be made to them jointly or successively. Here are some possible donor/annuitant arrangements:

- ◆ X is both donor and annuitant.
- ◆ X is the donor but Y is the annuitant.
- ◆ Mr. and Mrs. X are donors, and payments are made to them jointly and then to the survivor. This is the most common arrangement for couples. When the first spouse dies, there is no decrease in the payments. The surviving spouse receives the same amount the couple had been receiving.
- ◆ X is the donor. Payments are made to X for life and then to Y (if Y survives X) for the duration of his or her life. Y in this case is the successor annuitant.
- ◆ X is the donor (or perhaps Mr. and Mrs. X are donors). Payments are made to Y for life, then to Z for the duration of his or her life (if Z survives Y). Payments also could have been divided between Y and Z while both were living and thereafter made to the survivor.

Immediate-Payment Gift Annuity

With an immediate-payment gift annuity, the annuitant(s) start(s) receiving payments at the end (or beginning) of the payment period during which the contribution is made. Payments can be made monthly, quarterly, semi-annually, or annually. The most common arrangement is quarterly payments at the end of the calendar quarter.



I bet the college didn't plan on this party when they set up my gift annuity.

The first payment is customarily prorated from the date of the contribution to the end of the first period.

Suppose, for example, that a contribution is made on August 16, and the annuitant is entitled to an annual annuity of \$8,000 paid in quarterly installments at the end of the calendar quarter. The first payment would occur on September 30 and, if prorated, would be for \$1,000 (one-half of the normal quarterly amount). Subsequent payments would be for the full quarterly amount of \$2,000. Some charities make a practice of prorating the first payment while others do not.

Deferred-Payment Gift Annuities

With a deferred-payment gift annuity, the annuitant(s) start(s) receiving payments on a future date. As with immediate gift annuities, payments can be made monthly, quarterly, semi-annually, or annually, but the first payment will always be for the full amount due for the payment period. For example, a donor age 50 funds a gift annuity now but stipulates that the first quarterly payment is to be made on March 31, 15 years from now. Suppose the annual annuity, taking into consideration an assumed compounded rate of growth in the value of the contributed asset during the deferral period, is \$16,000 per year. The first quarterly payment, 15 years in the future, will be for \$4,000.

It is possible to design a deferred-pay-

ment gift annuity with a flexible starting date. The donor does not have to choose in advance when payments begin. That decision can be made later depending on circumstances. The longer the annuitant waits to start payments, the larger they will be.

Fixed Payments

Whether a gift annuity is immediate or deferred, payments are fixed from the outset. They will neither increase nor decrease, whatever happens to interest rates or the stock market. (Even with the flexible deferred-payment gift annuity, the size of payments is predetermined for each possible beginning year.)

Case Study One

Mr. and Mrs. G are ages 79 and 76, respectively. Some years ago they paid \$20,000 for stock that is now worth \$50,000. The annual dividend from the stock is only two percent. They would like to increase their cash flow from this asset, but they are reluctant to sell the stock and reinvest the proceeds because of the tax they would incur on the capital gain.

To accomplish their objective and make a gift, they transfer the stock for a charitable gift annuity. As a consequence, none of the gain is taxed at the time of the transfer, and their cash flow increases from \$1,000 to \$2,950. For the duration of life expectancy, their payments will be partly capital gain, partly ordinary income, and partly tax-free. By contrast, their dividends were fully taxable at the applicable dividend rate. As an added bonus, they receive an income tax charitable deduction of \$19,566.

**Payments are fixed
from the outset.**

A charity is contractually obligated to make the payments.

A charity is contractually obligated to make the payments, even if it has to dip into its general funds to do so. Fixed payments are a source of comfort to people who don't want their future security dependent on the performance of financial markets. The disadvantage of fixed payments is that they offer no inflation protection. Twenty years from now an annuity of \$10,000 per year may have considerably less purchasing power than it does today.

Factors Affecting the Size of Payments

The size of the payments from a gift annuity depends on the following five factors:

1. *The gift annuity rate offered by the charity.* (This will be discussed in the next section.)

2. *The value of the contribution.*

3. *The number of annuitants.* For example, the annuity rate for a two-life annuity where both annuitants are age 70 will be lower than the annuity rate for a one-life annuity where the sole annuitant is age 70. That is because the combined life expectancy of the two annuitants is longer than the life expectancy of the single annuitant.

4. *The age(s) of the annuitant(s).* At least with gift annuities, older is better. Annuity rates increase with age because a charity can afford to pay more when the duration of the payments is shorter.

5. *In the case of deferred gift annuities, the length of the period between the date of the contribution and the annuity starting date.* The amount contributed is presumed to grow at a certain rate during the deferral period. Thus, the longer that period, the larger the accumulation by the time payments begin.

Schedule of Gift Annuity Rates

Since 1927, the American Council on Gift Annuities (ACGA), which was previously known as the Committee on Gift Annuities, has been periodically publishing a schedule of suggested gift annuity rates. This is a nonprofit organization, supported by sponsoring charities, and its purpose is to provide educational services to the charitable community, especially regarding gift annuities.

Although a charity is free to offer any schedule of rates it wishes — so long as its rates don't exceed the limits imposed by federal and state laws — most charities, in fact, follow the rates suggested by the ACGA. Thus, donors generally find that the rates offered by the various charities they may wish to support are identical, or at least very close to each other.

The ACGA rates are based on certain assumptions about the percentage of the contribution that should remain for the charity when the annuity terminates, the longevity of annuitants, the projected return on reserves, and the costs of investing reserves and administering gift annuities. The rates are lower than those offered by insurance companies to purchasers of commercial annuities so that a significant portion of a contribution will be available for charitable purposes.

Though lower than commercial rates, they are still very attractive to individuals who want simultaneously to support a favorite charity and provide payments to themselves or others. The rates are periodically adjusted from time to time to reflect changes in financial markets, mortality experience, and other pertinent factors.

A change in the rates affects only gift annuities completed after the date of the change. A person who completes a gift annuity today can count on the current gift annuity rate for life, whatever happens to gift annuity rates in the future.

TABLE A on page 5 presents the ACGA rates for selected ages and age combinations. A current and complete schedule of rates is available from any charity that offers gift annuities. The rates offered by any particular charity may or may not be the same as those shown here, and these ACGA rates are subject to change in the future. Nevertheless, these sample rates should provide a fairly close approximation of the rate available to one or two annuitants of a given age.

Payments for Immediate Gift Annuities

To determine the amount a person would receive from an immediate annuity, simply multiply the applicable annuity rate by the value of the property contributed. Consider these examples:

- ◆ A single male, age 80, contributes \$20,000 cash for a gift annuity and names himself as annuitant. He will receive during each full year for the balance of his life $\$20,000 \times 7.2$ percent = \$1,440. If payments are quarterly, each installment will be \$360.
- ◆ A single female, age 74, contributes stock having a fair market value of \$30,000 for a gift annuity and names herself as annuitant. Her annual annuity will be \$1,890 ($\$30,000 \times 6.3$ percent). If payments are semi-annual, each installment will be \$945.
- ◆ A couple, both age 70, contributes \$50,000 cash for a gift annuity. The

payments will be made to them jointly and then to the survivor. Their annual annuity will be \$2,700 (\$50,000 x 5.4 percent), and if payments are quarterly, each installment will be in the amount of \$675.

tween the date of the contribution and the annuity starting date, which, in this case, is the beginning of the quarter ending on September 30, 2025.

\$100,000 compounded at 4.5 percent will have grown to \$193,528 by the end of 15 years. This is 1.935 times the original contribution.

The current immediate gift annuity rate for a person age 65 is 5.5 percent. The deferred gift annuity rate is 5.5 percent x 1.935 which equals 10.6 percent (rounded to the nearest .1 percent). Thus, the annual annuity beginning at age 65 will be \$100,000 x 10.6 percent, which equals \$10,600.

Note: The compounding rate (currently 4.5%), like the schedule of gift annuity rates, is subject to change by the ACGA. However, it can only change for future annuities. When a deferred gift annuity is completed, the contribution will compound at the rate in effect at the time.



ACGA recommended rates are subject to change.

Table A

Gift Annuity Rates

Recommended by the American Council on Gift Annuities

(These rates became effective on July 1, 2010 and may change periodically. Visit www.acga-web.org for current rates.)

Age	One Annuitant	Ages	Two Annuitants*
60	5.2%	60/60	4.9%
61	5.2%	61/61	5.0%
62	5.3%	62/62	5.0%
63	5.3%	63/63	5.0%
64	5.4%	64/64	5.1%
65	5.5%	65/65	5.1%
66	5.5%	66/66	5.1%
67	5.6%	67/67	5.2%
68	5.7%	68/68	5.2%
69	5.8%	69/69	5.3%
70	5.8%	70/70	5.4%
71	5.9%	71/71	5.4%
72	6.0%	72/72	5.5%
73	6.1%	73/73	5.6%
74	6.3%	74/74	5.6%
75	6.4%	75/75	5.7%
76	6.5%	76/76	5.8%
77	6.7%	77/77	5.9%
78	6.8%	78/78	6.0%
79	7.0%	79/79	6.1%
80	7.2%	80/80	6.3%
81	7.4%	81/81	6.4%
82	7.5%	82/82	6.5%
83	7.7%	83/83	6.7%
84	7.9%	84/84	6.9%
85	8.1%	85/85	7.1%
86	8.3%	86/86	7.3%
87	8.6%	87/87	7.5%
88	8.9%	88/88	7.8%
89	9.2%	89/89	8.0%
90+	9.5%	90/90	8.3%
		95+/95+	9.3%

*Either successive lives or joint and survivor.

Case Study Two

Mr. L has been paying \$800 per month toward the costs of his 83-year-old mother's residency in a retirement home. Since his combined federal and state tax rate is 39 percent, it costs him \$1,311 per month in pre-tax dollars to provide this subsidy.

He contributes \$130,000 cash for a gift annuity and names his mother as annuitant. His mother receives fixed annual payments of \$10,010 (\$834 per month). The tax on these payments is minimal because less than a fourth of the payments is taxable for the duration of his mother's life expectancy and she is in the lowest tax bracket.

Mr. L realizes an income tax deduction of \$70,509, which saves him \$27,498 in income tax. He avoids making a taxable gift by reserving the power to revoke the annuity payments. Wanting to make the arrangement emotionally satisfying to his mother, he involves her in deciding the charitable purpose.

Taxation of Annuity Payments

When a gift annuity is funded with cash, a portion of the payments will be taxed as ordinary income and a portion will be tax-free. When a gift annuity is funded with appreciated securities or real estate owned more than one year, and the donor is an annuitant, a portion of the payments will be taxed as ordinary income, a portion will be taxed as capital gain, and a portion may be tax-free.

By January 31 of each year, the charity that issued the annuity will send to the annuitant(s) a Form 1099-R, showing how payments are to be reported for income tax purposes. The charity will also send a copy of this form to the IRS (and to the revenue department of the state where the annuitant resides, if required).

Payments for Deferred Gift Annuities

Determination of the annual payment from a deferred gift annuity entails an additional step, namely calculating the amount by which the contribution compounds before the annuity starting date. Consider this example:

- ◆ A single person, whose date of birth was May 13, 1960, contributed \$100,000 on July 1, 2010, and stipulated that she was to begin receiving quarterly annuity payments on September 30, 2025 at the age of 65. (See below for calculations.)

The \$100,000 contribution is assumed to compound at the rate of 4.5 percent be-

**A significant portion
of her payments is
tax-free.**



"It's better to have an annuity than to be regarded as scintillating." – Oscar Wilde

Gift Annuity Funded With Cash

To understand how the taxation of payments is determined, consider the case of Ms. J, age 74, who contributes \$100,000 cash for a gift annuity and names herself as annuitant. The applicable annuity rate at the time of her contribution is 6.3 percent, so she receives \$6,300 each full year the annuity is in existence.

Based on the IRS mortality tables and applicable discount rate in effect at the time, the present value of her annuity payments is determined to be \$57,521. This is the amount she has actually invested for the annuity. The rest of her contribution (\$100,000 – \$57,521 = \$42,479) qualifies as a charitable deduction.

Note: The "discount rate" refers to the Charitable Midterm Federal Rate (CMFR) that the IRS publishes each month, and which is to be used to calculate the charitable deduction for gift annuities and other planned gifts. It is the IRS's presumed annual return on contributed assets for the duration of the contract. A donor can select the CMFR for the month of the gift or for either of the immediately-preceding two months. The May 2010 CMFR of 3.4 percent was selected for this calculation as well as for other calculations in this article. Hereafter, the term "CMFR" will be used to refer to the IRS discount rate described in Internal Revenue Code Section 7520.

According to IRS tables, Ms. J's life expectancy is 13.1 years. Her investment in the an-

nuity contract is presumed to be returned to her over her life expectancy, and the portion of it received each year is tax-free.

The amount of her investment that is returned each full year is thus $\$57,521 \div 13.1$, which equals \$4,391. The balance of her payment is construed to be interest, and it is taxable. Therefore, for the next 13.1 years her payments will be taxed as follows:

Taxed as ordinary income	\$1,909
Tax-free	<u>\$4,391</u>
Total annual payment	\$6,300

If Ms. J lives beyond 13.1 years, her payments become fully taxable as ordinary income, for her entire investment will have already been returned. On the other hand, if she dies earlier than 13.1 years, the portion of her investment that has not been returned can be taken as a deduction on the final income tax return filed by her personal representative.

The fact that a significant portion of her payments is tax-free for the duration of her life expectancy makes the gift annuity very attractive indeed. Suppose that the \$100,000 she contributed had previously been invested in a CD paying 2.5 percent:

Interest on CD	\$2,500
Amount taxable	\$2,500
Tax (28% rate)	<u>\$700</u>
After-tax income (\$2,500 - 700)	\$1,800

Annuity payment	\$6,300
Amount taxable	\$1,909
Tax (28% rate)	<u>\$535</u>
After-tax payments (\$6,300 - 535)	\$5,765

Because the annuity rate is higher than her CD rate, and because a significant portion of her annuity payment is tax-free, her after-tax cash flow more than triples. However, she will have irrevocably committed her principal whereas she would have retained that principal with a CD.

Case Study Three

Ms. F, who is 52 years old, would like to supplement the income expected from her company's retirement plan and provide for a favorite charity. She contributes \$50,000 for a deferred-payment gift annuity and stipulates that quarterly payments be made to her beginning 14 years later. Starting then, she will receive quarterly payments of \$1,275 (\$5,100 per year) for life.

In the year she makes the gift she will receive an income tax charitable deduction of \$15,903 which, given her 33-percent tax bracket, reduces her taxes by \$5,248.

Gift Annuity Funded With Appreciated Securities

Now suppose that instead of contributing cash, Ms. J had contributed stock having a fair market value of \$100,000 and a cost basis of \$40,000. Her charitable deduction will be unaffected, but her payments will be taxed differently. That is because the portion of the total capital gain allocated to her investment in the annuity must be reported over her life expectancy.

The total gain in the stock is \$60,000, and the portion of gain allocated to her investment in the annuity is \$34,513 [$(\$57,521 \div \$100,000) \times \$60,000$].

The amount of gain that must be reported each year of her life expectancy is \$2,635 ($\$34,513 \div 13.1$).

The balance of her investment in the annuity represents her cost basis, and it will be returned tax-free over her life expectancy.

Thus, her payments during life expectancy would be taxed as follows:

Taxed as ordinary income	\$1,909
Taxed as capital gain	\$2,635
Tax-free	<u>\$1,756</u>
Payments	\$6,300

Note that the portion taxed as ordinary income is the same whether she contributes cash or long-term appreciated stock. However, part of what was tax-free in the case of a cash contribution is now taxed as capital

gain. Even so, the taxation of the payment remains very favorable considering that capital gain is taxed at a lower rate than ordinary income. Particularly appealing is the fact that Ms. J is taxed on none of the capital gain at the time she transfers the stock. She is able to transform an appreciated asset into much larger cash flow with no up-front tax cost.

If she funded the annuity with appreciated property and named someone else as annuitant — her sister, for example — she would have to report the \$34,513 of gain in the year of the gift. It cannot be reported ratably over life expectancy when someone other than the donor is the initial annuitant. The silver lining is that, from the annuitant's standpoint, the payments are taxed as if the annuity were funded with cash, meaning that — at least in this case — well over half of the payments will be tax-free.

Precisely how gift annuity payments are taxed depends on the CMFR in effect at the time, but generally, in the case of cash contributions, 40 to 60 percent of the payments will be tax-free for the duration of life expectancy. Fortunately, all of these numbers can be generated very quickly on the charity's planned giving software. This section has explained why annuity payments are taxed as they are, but in practice no one needs to perform these calculations manually.

Allowance of an Income Tax Charitable Deduction

A gift annuity donor receives an income tax charitable deduction, which may result in significant tax savings. To understand how the deduction is determined, consider the previously-cited example of Ms. J.

She contributes \$100,000 for a gift annuity and receives life payments having a present value of \$57,521. This is the amount required to provide payments of \$6,300 per year for life, based on IRS mortality tables and assuming that the charity will invest the money and earn a return equal to the CMFR. Ms. J does not get a deduction for the \$57,521, for it is the value of what she gets back. Her deduction is rather for the excess of her contribution over the present value of what will be returned to her, which is \$42,479.

\$100,000 Contribution	}	\$42,479 Charitable Deduction
		\$57,521 Present Value of Payments Received

She transforms an appreciated asset into much larger cash flow.

The deduction is only beneficial to those who itemize deductions.

The size of the charitable deduction depends on the amount contributed, the age(s) of the annuitant(s), the gift annuity rate paid by the charity, the CMFR, and when payments will be made. Because the CMFR fluctuates monthly, the deduction for a gift annuity completed in September could be different from the deduction for an annuity completed in August, even if all other factors remain the same. However, as noted, a donor may elect to use the discount rate (CMFR) for the month the gift is made or for either of the two immediately-preceding months. The deduction for any set of circumstances can be calculated by the charity using its planned giving software.

In most cases, the charitable deduction will be 20 to 50 percent of the total contribution. TABLE B provides some examples of the deduction, assuming the ACGA rates that became effective July 1, 2010 and assuming a 3.4 percent discount rate.

Table B

Tax Deductions for \$10,000 Gift Annuity Contribution

Age(s) of Annuitants	Charitable Deductions	Percentage Deductible
65	\$3,060	30.6%
65/65	\$2,108	21.1%
70	\$3,802	38.0%
70/70	\$2,738	27.4%
75	\$4,400	44.0%
75/75	\$3,543	35.4%
80	\$5,006	50.1%
80/80	\$4,184	41.8%
85	\$5,684	56.8%
85/85	\$4,836	48.4%
90	\$6,219	62.2%
90/90	\$5,394	53.9%

As with all charitable gifts to public charities, the maximum amount of the deduction that can be used in any one year is 50 percent of adjusted gross income when cash is contributed, or 30 percent of adjusted gross income when appreciated property owned over one year is contributed. Any deduction that is unusable due to these ceilings can be carried forward for up to five more years. Obviously, the charitable deduction is only beneficial to those who itemize deductions on their tax returns.

The amount of tax savings realized by itemizers depends on their tax bracket. For example, a person subject to a combined federal and state income tax rate of 33 percent realizes tax savings of \$1,650 from a \$5,000 deduction.

Suppose the person had contributed \$10,000. Viewed one way, the \$10,000

contribution results in a \$1,650 tax refund. Viewed another way, the net cost of the annuity is only \$8,350.

Gift Tax Implications

Donor Is an Annuitant — A person who contributes for a gift annuity and names himself or herself as the sole annuitant makes a gift to the charity. It is fully deductible for gift tax purposes.

Someone Other Than Donor Is an Annuitant — A person who contributes for a gift annuity and names someone other than himself or herself as annuitant makes two gifts — one to the charity and one to the annuitant. The first qualifies for a gift tax charitable deduction. The second may be subject to the federal gift tax.

Spouses are Donors and Annuitants — When a married couple funds an immediate gift annuity with jointly owned or community property, and payments are made to the couple jointly and then to the survivor, each spouse makes two gifts — one to the charity and one to the other spouse. The husband gives the wife a survivorship interest in his one-half of the property, and the wife gives the husband a survivorship interest in her one-half of the property. If they are both U.S. citizens, their gifts to each other qualify for the unlimited gift tax marital deduction, and their gifts to the charity qualify for the gift tax charitable deduction.

In summary, donors typically need not worry about the gift tax in the two most common scenarios:

- ◆ The donor is the annuitant;
- ◆ Spouses are joint and survivor annuitants of an immediate annuity.

In the case of an immediate gift annuity, it is only when the annuitant is someone other than the donor or donor's spouse that there is a potential gift tax. (In the case of a deferred gift annuity, a taxable gift could result even when the donor's spouse is the annuitant.)

A donor who names someone else as sole or surviving annuitant can avoid making a taxable gift by reserving the right to revoke that person's annuity payments. Even if the donor has no intention of ever canceling that person's payments, merely having the right to do so prevents a completed gift from having been made for gift tax purposes.

As each payment is actually made it will constitute a gift, but if it is within the annual gift tax exclusion amount (currently \$13,000) no taxable gift will result. While donors need to be mindful of the gift tax



Don't worry, I established a gift annuity for us.

when they want to benefit someone else with a gift annuity, the gift annuity agreement can usually be drafted in a way that either eliminates the gift tax entirely or minimizes its effect.

What Can Be Contributed for a Gift Annuity?

Cash and publicly traded securities are the most common assets. Most gift annuities are funded either with cash or publicly traded securities. These assets are, of course, always acceptable to a charity. When an annuity is funded with securities, the payments are based on their fair market value on the date they are transferred to the charity.

Other assets readily convertible to cash are usually acceptable assets. Assets, in addition to publicly traded securities, that are readily convertible to cash are also usually acceptable to a charity. These include U.S. savings bonds, life insurance policies, and deferred variable annuities that have been purchased from insurance companies.

Savings bonds. Some individuals own Series E bonds purchased before the government started issuing Series EE bonds. None of these Series E bonds will earn interest after 2010, so if they are retained beyond the interest-bearing period they will be non-productive assets. Although

Series EE bonds are still earning interest, they provide no current benefit to the owners. Upon an owner's death, the gain in these bonds will be taxed as ordinary income unless they are given to charity.

It could be advantageous to surrender the bonds and contribute the cash proceeds for a gift annuity, thereby converting an idle asset to a stream of payments. The accrued interest will be taxable upon surrender, but the charitable deduction can partially or totally offset the gain.

Life insurance policies. Some individuals have life insurance policies that are paid up or have been owned long enough to have accumulated considerable cash value. If a policy is no longer needed to provide for heirs or for estate liquidity, it could be transferred to a charity in exchange for a gift annuity. Alternatively, it could be surrendered and the proceeds contributed for a gift annuity.

Commercial variable deferred annuity. Large amounts have been invested in variable deferred annuities. Although an owner can elect to receive life payments from the insurance company, chances are the owner has simply held the contract to get the benefit of tax-deferred growth. As with savings bonds, the accrued gain will be taxed at the owner's death if individuals are beneficiaries.

Owners of these contracts can transfer them for a gift annuity, or cash surrender

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**Charities in the U.S.
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them and contribute the proceeds for the gift annuity. In either case, the deduction may eliminate or significantly reduce the tax on the gain, and the owner will receive life payments while having the satisfaction of making a charitable gift.

IRA assets. At the present time, an individual who wants to fund a gift annuity with IRA funds must withdraw money from the IRA and then contribute the proceeds. The distribution from the IRA will be fully taxable unless the donor had made non-deductible contributions to it. Unfortunately, the charitable deduction from the contribution will be smaller than the taxable distribution, resulting in a net tax cost. However, a donor could withhold the amount necessary for tax, taking into consideration the charitable deduction, and contribute the balance. Then there would be no out-of-pocket cost, and a substantial portion of the payments would be tax-free for the duration of life expectancy.

Over the years, bills have been introduced in Congress that would permit a tax-free rollover of IRA funds for gift annuities and certain other gift plans. If such a bill is enacted, gift annuities funded with IRA assets would likely become very popular. Even under existing law, a gift annuity for a survivor, funded with IRA funds remaining at the donor's death, may be a viable plan.

Illiquid property is possibly an acceptable asset. Charities are generally very cautious about accepting real estate, closely held stock, and collectibles for a gift annuity. They are reluctant to promise payments of a certain amount when they don't know when they may be able to sell the donated property or for how much. The policies of many charities prohibit the funding of a gift annuity with such illiquid assets.

Other charities will consider such assets on a case-by-case basis. If the real estate appears to be readily marketable, the closely held stock is likely to be

purchased by the company or by other shareholders, or the collection (such as coins or stamps) can be sold at auction, the charity may be willing to accept it for a gift annuity. Possibly, however, it will pay a lower-than-normal gift annuity rate to compensate for sales costs. A charity might also accept real estate or artwork for a gift annuity if it wants to retain and use the property.

How Safe Are Gift Annuities?

Charities have been issuing gift annuities for over 160 years in the United States. Thousands of charities now offer them, and hundreds of thousands of annuities totaling billions of dollars are now in force. Even so, default on gift annuity payments is exceedingly rare. This fact attests to their relative safety.

Many states regulate, to some degree, the issuance of gift annuities. To assure that only established charities with sufficient financial strength offer gift annuities, some states require that a charity have been in existence for a certain number of years and have total unrestricted assets of a minimum value. Other states go further and require the charity to establish a segregated reserve fund containing at least the amount required to meet outstanding annuity obligations.

A gift annuity is backed by a charity's full faith and credit. Contributions for gift annuities are included as assets of the charity on the balance sheet, and the present value of future annuity payments is shown as a liability. A charity that maintains a segregated gift annuity reserve fund would still be obligated to make payments from its general fund if, for any reason, the segregated fund were exhausted.

Obviously, the safety of a gift annuity from the donor's standpoint depends on the financial strength of the charity. In the unlikely event that a charity becomes insolvent, there is no external guaranty association that would step in and make payments. Some states require charities to disclose this fact in the gift annuity agreement. The Philanthropy Protection Act of 1995 requires a charity to disclose information about its management and financial condition before accepting property for a gift annuity.

Donors who make contributions only to reputable, well-established charities that demonstrate financial strength on their disclosure statement can have a high degree of assurance that their annuities are safe.

Case Study Four

Mr. P, age 75, purchased a deferred variable annuity a number of years ago for \$50,000, and it has a current cash value of \$80,000. Wanting additional cash flow and desiring to make a charitable gift, he assigns ownership of the variable annuity to a charity in exchange for payments of \$5,120 per year for life. The \$30,000 of ordinary gain is more than offset by the \$35,203 income tax charitable deduction. Thus, he is able to convert this asset to a stream of payments without tax cost. Moreover, approximately 70 percent of the payments will be tax-free for the duration of his life expectancy.

From the standpoint of the charity's governing board, a gift annuity is safe if there is a low probability of exhausting the contribution prior to the termination of the contract. This can happen if the annuitant lives well beyond life expectancy and the charity's investment return on the assets contributed is low. However, charities that follow sound policies and invest gift annuity reserves prudently seldom lose money on a particular annuity.

According to a 2009 survey conducted by the ACGA, on average, 81.6 percent of the original contribution remains for the charity when the annuity terminates as a result of the death of the sole or surviving annuitant. Organizations that do not exceed the ACGA's suggested rates and invest their gift annuity reserves prudently almost always find gift annuities to be a profitable way to fund their charitable work.

Case Study Five

Ms. W has a close friend who is not as financially well situated as herself and whom she has been assisting with periodic cash gifts. She wants to make sure that the friend is financially secure if she predeceases her. However, she is not interested in giving her friend a lump-sum bequest, a portion of which could wind up in the hands of her friend's heirs.

She decides to include a provision in her will for the funding of a gift annuity that will make payments to her friend, if her friend survives her. This example is particularly noteworthy because it demonstrates that a gift annuity can be established under a will to provide for one or two survivors.

Steps to Complete a Gift Annuity

The procedure for completing a gift annuity is relatively simple. The first step, of course, is to determine whether an annuity is appropriate for the donor's situation. To assist the donor in that determination, the charity ordinarily provides a financial illustration showing, for an assumed contribution of certain property, the amount of the payments, how they would be taxed, and the charitable deduction generated by the gift. The donor will be encouraged to discuss the illustration with his or her tax and financial advisors in order to make an informed decision, taking into consideration all relevant factors.

Having decided to proceed with a gift annuity, the donor must then decide how much cash or other property to contribute. Most charities have a minimum contribution requirement. That can be as low as \$1,000 or as high as \$50,000, but the most common minimums are \$5,000 and \$10,000. Many donors start with a modest

amount and then fund additional annuities when they accumulate surplus assets. One person established over 250 annuities with a single charity!

An annuity agreement is executed upon the transfer of property to the charity. The most common practice is for both the donor(s) and an officer of the charity to sign the gift annuity agreement, which will be dated as of the day the funding asset is transferred.


However, some charities follow a different procedure: They have the donor(s) sign an application form, but only an officer of the charity signs the agreement itself. In either case, the gift annuity agreement is a contract under which the charity, in exchange for the transfer of certain property, obligates itself to pay a stated sum to one or two annuitants for life.

The contract may also contain other elements, such as the right (described above) to revoke an annuitant's payments, or instructions about the use of the gift. Charities usually permit donors to designate annuity contributions for a particular purpose, though many donors wisely allow the gift to be used where it is most needed at the discretion of the charity. Provided the annuity is of sufficient size, a named endowment might be created upon termination of the obligation.

According to the 2009 ACGA survey, 17 percent of charities spend a portion of the contribution for gift annuities while donors are alive, setting aside enough to cover the annuity obligation. The overwhelming majority (83 percent) retain the entire contribution in reserve until the contract terminates at the death of the sole or surviving annuitant. Only then do they use the remaining assets for the designated purpose.

Prior to the execution of the gift annuity agreement, the charity will have given the donor a disclosure statement as required by the Philanthropy Protection Act of 1995. It will also provide such notice as may be required regarding the privacy of annuitants.

Following the execution of the agreement, the charity typically sends a letter informing annuitants about the amount and timing of payments and the amount of the charitable deduction. When a gift annuity is funded with publicly traded securities, the amount of the payments and deduction will not be determinable until after the financial markets have closed and the "highs" and "lows" for the day are known. In that case, the gift



**One person established
over 250 annuities
with a single charity!**

NEXT MONTH

- ◆ How Waivers Protect Charitable Bequests
- ◆ The CRT That Helped Mr. Marston Survive
- ◆ Dead Men Do Tell Tales
- ◆ And More . . .

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annuity agreement will probably be finalized after the gift but made effective as of the transfer date. Likewise, the deduction calculation can only be finalized when the actual value of the securities on the date of transfer is known.

Case Study Six Just-in-Case Gift Annuity

Ms. L has more than enough income for now, and she has considered making a \$100,000 outright gift. However, she worries that her circumstances could change in the future. To make sure that she has enough money "just in case," she arranges a deferred gift annuity with a flexible payment beginning date, and plans to elect payments only if she needs them. If, at any time, she decides she will never need them, she can assign her future right to payments to the charity and get another charitable deduction.

Administration of Gift Annuities

The administration of gift annuities entails four responsibilities, none of which is complicated.

1. *Investment of the assets that are contributed and held in reserve.* Although a number of charities assign this responsibility to their business office, a growing number outsource it to a financial institution. If a charity issues gift annuities in a state, such as California, that imposes investment restrictions, the assets may have to be invested more conservatively than the charity prefers. Financial institutions understand these restrictions and are accustomed to designing the optimum possible portfolio.

2. *Timely payments to annuitants.* Some annuitants like their payments mailed. Others prefer that, as with Social Security payments, they be directly deposited into their bank account.

3. *Federal and state reporting.* There are only two federal requirements, neither of which takes much time. One is to complete a Form 1099-R for each annuity and send it to the annuitant by January 31 of each year. The other is to send copies of all Forms 1099-R, attached to a Form 1096, to the Internal Revenue Service by the last day of February. Certain states require an annual report showing actuarially-determined required reserves along with a financial statement and list of investments. These reports can be quite time-consuming, but fortunately only a few states require them.

4. *Action upon termination of an annuity.* When an annuity terminates, the charity should provide whatever information the annuitant's personal representative may

need for estate settlement. Most charities at this point remove from the reserve fund the assets attributable to the annuity and use them for the intended purpose.

While a charity could outsource either the investment or administrative functions and keep the other in-house, it may well outsource both. Financial institutions typically handle payments to annuitants and federal reporting as well as investment of assets. However, they often do not complete state reports as part of the package.

ACGA's suggested gift annuity rates presuppose that investment and administrative expenses will be one percent of gift annuity reserves each year. That is approximately what outsourcing will actually cost. Charities that do everything in-house using existing staff will probably spend less.

Longevity of Gift Annuitants

Annuitants of commercial annuities sold by insurance companies live longer than the general population.

Based on an ACGA mortality study, annuitants of gift annuities appear to live even longer than annuitants of commercial annuities.

The ACGA takes this longer life expectancy into consideration when recommending gift annuity rates.

Is philanthropy conducive to health and longevity?

* Based on a mortality study conducted by ACGA in 2001.

A Final Word

The gift annuity has been called "longevity insurance." With ever-increasing lifespans, people want to be sure they don't run out of money. A gift annuity offers that assurance. No matter how long a person lives, the payments keep coming. And in addition to enhancing their own financial security, donors have the personal satisfaction of providing for the future of a favorite charity. ◆

About The Author

Frank Minton, PhD, is senior advisor for PG Calc, a planned giving software and consulting firm headquartered in Cambridge, Massachusetts. Located in Seattle, Frank consults with charities throughout the United States and Canada and speaks frequently at regional and national conferences. He has received numerous awards for his leadership and contributions in the planned giving profession.

Frank is a recognized expert in every area of planned giving and especially with matters dealing with charitable gift annuities. He served as chair of the American Council on Gift Annuities (ACGA) as well as the National Committee on Planned Giving, now known as the Partnership for Philanthropic Planning. He is the principal author of *Charitable Gift Annuities: The Complete Resource Manual* and is co-author of *Planned Giving for Canadians*.

In addition to his writing projects, Frank consults with charities regarding the establishment and operation of planned giving and gift annuity programs, conducts risk audits of gift annuity programs and general audits of planned giving programs, and assists charities both nationally and locally, with particular gifts and policy matters.

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