ISSUES AND DEVELOPMENTS REGARDING GIFT ANNUITIES

Planned Giving Roundtable of Arizona

June 3, 2014

Presented by:

Frank Minton
Frank Minton Consulting LLC
16538 Beach Drive N.E.
Lake Forest Park, WA 98155
E-mail: FDMinton@gmail.com
Telephone: 206-365-5154

INTRODUCTION

The gift annuity has a long history. Will it also have a long future, and how might it change over time?

Predecessors of the gift annuity were established in medieval times in England and possibly even during the time of the Roman Empire. The arrangement in England was called a corrody. A person would pay to an abbey or a lord a certain price in exchange for lodging, food, and clothing for life. The price might be paid in lands or money. The amount probably depended on the anticipated duration and value of the benefits to be received.

The first “modern” gift annuity in the United States was believed to have been issued by the American Bible Society in 1843 in exchange for a contribution of $500 cash. However, both Yale and Princeton University have records of gift annuities issued in the 1830s.

In the decades that followed, those early gift annuity arrangements were not promoted by charities but seemed to arise from the donor’s offer to make a gift if fixed life payments based on the gift’s value could be received. Relatively few such agreements were written until after World War I, but during the 1920s the gift annuity became a popular method of fundraising among church boards and a few other charities that began actively promoting them.

During this period, each organization developed its own set of annuity rates, which normally meant incurring the expense of professional actuarial advice. Moreover, organizations that, in their zeal to issue gift annuities, offered excessively high rates sometimes discovered that a particular annuity left little or nothing for charitable purposes. This led to the formation of the Committee on Gift Annuities, later renamed the American Council on Gift Annuities (“ACGA”) for the purpose of recommending maximum gift annuity rates.

Following World War II, private colleges and universities starting offering gift annuities. Next to offer them were public university foundations, national health and environmental organizations, and eventually all types of charities. For many charities, the bequest and gift annuity constitute nearly all of their planned gifts. More dollars are contributed for charitable remainder trusts than for gifts annuities, but the number of gift annuities greatly exceeds the number of trusts.

This paper assumes that the reader already has a basic understanding of gift annuities. It begins with some recent developments pertaining to gift annuities. Then it focuses on how to raise more money through gift annuities by expanding the types of assets accepted and showing a greater variety of applications. It concludes with comments on how to measure and assure the profitability of a gift annuity program.

MARKETING GIFT ANNUITIES WHEN RATES ARE LOW

The American Council on Gift Annuities ("ACGA") reduced its suggested maximum rates rather significantly, effective January 1, 2012, and those rates were extended by the ACGA at it April, 2013 board meeting and again at its April, 2014 board meeting. The new rates are the lowest since the ACGA began recommending rates in 1927.

The following table shows rates for three ages (65, 75, and 85) for each year in which there was a new rate determination.

Year	Age 65	Age 75	Age 85
1927	6.8%	8.7%	9.0%
1931	6.2	7.3	8.0
1934	5.7	7.0	8.0
1939	5.1	6.2	7.0
1955	5.0	6.3	7.4
1965	5.2	6.5	8.0
1971	5.6	7.0	8.0
1974	6.0	7.4	10.0
1977	6.2	7.7	10.5
1980	6.6	7.9	11.2
1983	7.3	8.5	11.4
1986	7.3	8.5	11.4
1989	7.3	8.5	11.4
1992	7.3	8.5	10.9
1994	6.5	7.7	10.0
1997	7.2	8.4	10.5
1998	7.0	8.2	10.5
1999	7.0	8.2	10.5
2001	6.7	7.9	10.4
2002	6.7	7.9	10.4
2003 (1/1)	6.3	7.3	9.7
2003(7/1)	6.0	7.1	9.5
2004(7/1)	6.0	7.1	9.5

2005(7/1)	6.0	7.1	9.5	
2006(7/1)	6.0	7.1	9.5	
2007(7/1)	6.0	7.1	9.5	
2008(7/1)	5.7	6.7	8.9	
2009(2/1)	5.3	6.3	8.1	
2010(7/1)	5.5	6.4	8.1	
2011(7/1)	5.3	6.5	8.4	
2012(1/1)	4.7	5.8	7.8	(Still in effect)

Note that until the recent rate reduction the rate for a 65-year-old was never below 5.0 percent, and the rate for a 75-year-old was never below 6.0 percent. The rate for an 85-year-old had remained above 8.0 percent for nearly 50 years.

Prior to 1997, the rates were reviewed every three years, but now they are reviewed annually or even more often if deemed necessary by changing economic factors. This, of course, has led to more frequent rate changes.

The recent change was the largest ever percentage decrease in the rates. The age 65 rate dropped by 11.3 percent, the age 75 rate by 10.8 percent, and the age 85 rate by 7.1 percent. Commercial annuity rates also decreased during 2011 but by a smaller percentage.

The lower rates resulted from three factors:

- The first, and most significant, was the decline in interest rates. The assumed rate of return underlying the AGCA rates is based on a portfolio consisting of 40 percent equities, 55 percent 10-Year Treasury Notes, and 5.0 percent cash. The blended return is computed using the historical total return on equities less 2.0 percent, the average current yield on the 10-Year Treasuries over the past three months, and the average current yield on cash equivalents over the same period. The primary driver is the yield on the 10-Year Treasury Note, which in late 2011 was only in the 2.0 percent range. It has risen somewhat since then but remains low. The low interest on the fixed-income component resulted in a blended return of 4.25 percent, and a net return of 3.25 percent, since the cost of investing and administration is presumed to be 1.0 percent. The 2011 rates had been based on a net return of 4.0 percent. Although the current blended return is somewhat higher than 4.25 percent, the ACGA board decided that an increase in rates was not justified at this time.

- The second factor, primarily affecting annuitants in their 60s and younger, is the new requirement that the present value of the projected residuum be at least 20 percent of the contribution.

- The third factor is the extremely-low Sec. 7520 rate. The ACGA has always tried to suggest rates that would result in a gift value (normally the deductible amount) of more than 10 percent of the contribution as required in IRC Sec. 514(c)(5) for a qualified annuity. With a Sec. 7520 rate of only 1.4 percent or less, many of the ACGA rates were failing to generate the required gift value.

This was particularly true of deferred gift annuities, which previously were credited with a compound interest rate of 4.0 percent during the deferral period. The current ACGA deferred gift annuity rates assume a compounding rate of 3.25 percent.

The major question is whether the lower gift annuity rates are making gift annuities less appealing to donors. Probably, the lower rates will discourage some donors from establishing a gift annuity. For example, a 65-year-old donor might look at the 4.7 percent rate (4.2 percent in the case of a couple both age 65) and think, "Why should I surrender capital for such low payments when I can retain my capital and perhaps earn 5.0 percent if interest rates return to a more normal level within the next few years.?"

No doubt, the greatest negative impact will be on deferred gift annuities. The 3.25 percent compounding rate is barely the historical average inflation rate and well below historical average returns on equities and bonds. It does compare favorably with current yields on mid-term Treasuries, and it is certain, but people may decide to invest in something like a mutual fund and delay a gift arrangement. Notwithstanding the fact that the lower rates may result in fewer annuities than would have been the case if there had been no rate decrease, it is still possible to show that gift annuities make sense for charitably-minded individuals. One way to do this is to compare the after-tax cash flow from a gift annuity with that from fixed-income investments.

<u>Example</u>

Sarah, age 75, receives pension income, Social Security payments, dividends from a few stocks, and interest from CDs. Her cash flow has been declining as interest rates have fallen. In fact, her CDs are now earning only 2.0 percent. To increase her cash flow and provide a gift to the healthcare institution where her late husband was treated, she could contribute $50,000 from a maturing CD for a gift annuity. Here is how her situation would change:

<u>Prior to the Gift</u>

Invested in the CD	$50,000
Interest	1,000
Tax on interest (30% combined tax rate)	300
Net spendable	700

<u>After the gift</u>

Contribution for gift annuity	$50,000
Annual payment	2,900
Ordinary income	713
Tax-free	2,187
Income tax (30% combined tax rate)	214

Net spendable	2,686

The cash flow from the gift annuity is almost four times that from the CD. However, with the CD Sarah retains her capital, while it is irrevocably committed in the case of the gift annuity. It should be noted that if Sarah lives beyond her life expectancy, the gift annuity payments will be fully taxable as ordinary income.

In addition to significantly increasing her cash flow, Sarah receives an income tax charitable deduction of $22,886, which results in tax savings of $6,866. (The deduction and taxation of payments are based on a Sec. 7520 rate of 2.4 percent.)

Another way to make the case for a gift annuity is to show the net cash flow as a percentage of the net cost of the gift.

Example

The three donors below each contribute $10,000 cash for a gift annuity and elect a Sec. 7520 rate of 2.4 percent. Each is subject to a 33-percent combined marginal tax rate.

Age	Deduction	Net Cost of Gift	After-tax Cash Flow	After-tax Cash Flow as a % of net cost
65	$3,490	$8,848	$423	4.78%
75	4,577	8,490	533	6.28%
85	5,660	8,132	733	9.01%

To generate equivalent after-tax cash flow, the pre-tax returns on a fully-taxable investment would have to be:

65-year-old	6.31%
75-year-old	7.96%
85-year-old	10.94%

In the current environment a person cannot come anywhere close to these returns on fixed-income investments. Pointing this out could be persuasive to an individual who is just looking at the gift annuity rates without taking into consideration the charitable deduction and the tax-free component of payments.

The same approach can be used with a person, who is unexcited about a deferred gift annuity because of the low compounding rate. Because of the up-front tax savings, the net cost of the gift will be less than the amount contributed. Thus, the effective compounding rate will be higher than 3.25 percent. Indeed, it could approximate the yield on a 30-Year Treasury bond. Although the rate of growth of the annuity during the deferral period may not be exciting, it is comparable to a safe fixed-income investment, and the individual has the satisfaction of making a gift.

Two current factors are having opposite effects on the charitable deduction from gift annuities. The lower gift annuity rates will generate a larger charitable deduction, but the extremely low Sec. 7520 rate results in a smaller deduction. The end result is that the deduction from a gift of a certain size may be approximately the same as it was when both the gift annuity rates and the Sec. 7520 rate were higher. However, a higher proportion of the payments will be tax-free because of the very low Sec. 7520 rate.

When talking to prospects who complain about the low rates, gift planners may want to note that lower rates mean a larger deduction, but they should not imply that total financial benefits are the same, for they are not. In this economic environment, the main selling point of a gift annuity (other than the charitable element) will be the favorable taxation of payments. If the Sec. 7520 rate eventually rises to 5.0 percent of higher, then the focus may again be more on the charitable deduction.

ILLUSTRATING AND ADMINISTERING GIFT ANNUITIES WHEN DIFFERENT CAPITAL GAIN RATES MAY APPLY

The following federal capital gain tax rates would apply to various categories of taxpayers:

Taxpayer situation	Capital Gain Tax Rate
In tax bracket of 10% or 15%	0%
In tax bracket of 25%, 28%, 33%, or 35%	15%; 18.8% if AGI above threshold*
In tax bracket of 39.6%	20%; 23.8% if AGI above threshold*
Has gain resulting from depreciation in real estate	Max. 25%; 28.8% if AGI above threshold*
Has gain from tangible personal property	Max. 28%; 31.8% if AGI above threshold*

*The thresholds are $200,000 of AGI for single individuals, $250,000 for married couples filing jointly. A person in a 39.6 percent tax bracket will always have income above these thresholds.

In gift annuity illustrations you will continue to show the portion of payments taxed as capital gain when appreciated property is contributed, but you should probably note that the tax rate on capital gain depends on AGI.

You might point out to a donor in a low-income tax bracket that he/she could contribute appreciated property and avoid any tax on the capital gain.

More explicit instructions regarding Form 1099-R may be forthcoming. It would seem that a charity should at least differentiate between (1) ordinary gain, (2) capital gain from securities, (3) capital gain from the depreciation in real estate, and (4 capital gain from tangible personal property. Certain vendors that administer gift annuities already do this. It would be the responsibility of a donor and his/her tax preparer to apply the appropriate tax rate.

The 3.8-percent healthcare surtax does not apply to gain now being reported ratably from annuities that were completed before the enactment of ATRA. It does apply to gift annuities funded after the law's enactment.

The more complicated federal capital gain tax rates should not have a negative impact on gift annuities because people have to deal with those rates for their investments whether or not they establish a gift annuity. However, donors are likely to be confused by the different rates, and more detailed explanations will be required in meetings with donors.

POSITIONING GIFT ANNUITIES IN THE CURRENT ENVIRONMENT

All life income plans were negatively affected by the stock market correction between late 2001 and mid-2003, and then they declined significantly following the financial crisis of 2008. However, gift annuities fared better than charitable remainder trusts. That was partly due to the fact that in a time of volatile stock markets and personal security, people like the assurance of fixed payments unaffected by the market place. An annuity trust was not an option for many of them because it became hard to pass the 5.0-percent probability test as the discount rate fell. Gift annuities were also appealing when interest rates on CDs and money market funds were at very low levels.

Another reason that gift annuities fared better than charitable remainder trusts is that they are less sensitive to tax rate changes. Most charitable remainder trusts had been funded with appreciated securities and real estate, and they were more likely to be established by individuals in the higher tax brackets. With the reduction of the top income-tax rate to 35 percent and the capital gain rate on securities and un-depreciated real estate to 15 percent, individuals had less incentive to give rather than sell the asset. Gift annuities, by contrast, are more likely to be funded with cash by people of more modest wealth, so the reduction of these rates had minimal effect on them.

Going forward, there are reasons to expect a revival of charitable remainder trusts. Stocks have been performing well, and real estate values, at least in many markets, are rising again. The capital gain tax rate is the highest it has been since 1997, and the top income tax rate is again at 39.6 percent. Thus, with more appreciated assets and a larger tax bite if they are sold, more people are considering charitable remainder trusts, especially unitrusts. The question is whether a revival of charitable remainder trusts would be at the expense of gift annuities. The answer is probably No because they mostly appeal to different markets. Although a few wealthy individuals, who were establishing gift annuities with gifts of $500,000 or more because of concerns about the stock markets, may now choose a charitable remainder trust, the overwhelming majority of gift annuity donors will continue to be people of more modest wealth, who contribute smaller amounts, and like the simplicity and safety of a gift annuity. For them, a charitable remainder trust is not a serious alternative.

In the event that our fractured Congress comes together enough to pass tax reform which reduced tax incentives for charitable gifts in general, gift annuities will be negatively affected like all gifts, but not nearly to the degree as charitable remainder trusts. For gift annuity donors, fixed payments that are partially tax-free are more important than the charitable deduction. Even if the charitable deduction were eliminated entirely, gift annuities could survive because the most important benefits would remain.

The number of new CRTs during the first dozen years of the new millennium was much lower than it was during the 1990s. With the improvement of the stock market, recovery of real estate prices, and higher capital gain tax rates, we will probably see some revival of CRTs.

The question is whether this will be at the expense of gift annuities. It should have no effect on people of moderate wealth who contribute smaller amounts. For most of them, the gift annuity will be the only available life income plan. However, people who can make larger gifts, and who previously pulled back from the stock market, might now have the confidence to do a charitable remainder unitrust rather than a gift annuity. Also, a NIMCRUT (usually with a "flip" provision) may now be more appealing than a deferred gift annuity for those who want a supplemental retirement plan and for those who want to fund's a student's college education.

As the Sec, 7520 rate rises, it will be possible for more people to establish a charitable remainder annuity trust. It has been difficult to pass the 5.0-percent probability test unless the beneficiary was in the upper 70s or older. Some people seeking fixed income might now choose an annuity trust instead of a gift annuity.

ASSETS WITH WHICH A GIFT ANNUITY MIGHT BE FUNDED

Some charities will accept only cash and publicly-traded securities for a gift annuity. This is unfortunate, for such a restriction forecloses many gifts from individuals who are not able to give these traditional assets. With proper safeguards, all of the following types of property, discussed in this section, could fund a gift annuity.

- Real estate
- Closely-held C stock
- Closely-held S stock
- LLC shares
- Tangible personal property
- Precious metals
- Life insurance policy with cash value
- Commodities

Gift Annuity Funded with Real Estate

The preferred instrument when a person wants to contribute real estate and receive income is a net-income charitable remainder unitrust, with or without a make-up provision, that contains a "flip" provision allowing it to convert to a standard unitrust upon the sale of the property. However, some donors may insist on a gift annuity because they want fixed payments, preferably beginning soon. Also, a gift annuity may be the only practical alternative if the property is subject to a mortgage, or if the value of the property is below the minimum amount required for a charitable remainder trust.

A charity is understandably concerned about the risk of accepting real estate for a gift annuity, for it commits to fixed payments, not knowing when the property will sell or for how much. The risk can be minimized by adopting one of the following strategies:

- Offer a lower-than-normal gift annuity rate, based on a conservative estimate of net sales proceeds and the time period the charity would be making payments prior to the sale of the property. For example, if the normal gift annuity rate is 5%, the charity would offer a rate of 4%. If the charity operates in a regulated state to which it has submitted the schedule of rates it offers, it cannot vary from those rates except by the donor's knowledge and written consent.

- Ask the donor to defer payments for a year or two. This does not eliminate risk, but at least the charity is less likely to have to advance its own funds prior to the sale.

- Identify a buyer prior to the date the property is transferred. The charity would enter into a purchase-and-sale agreement with the interested buyer after receipt of the property. The risk is that for various reasons the sale to the interested buyer may not close.

- The charity secures a pledge from the donor and then seeks a purchaser. In the pledge agreement, the donor commits to transferring the property for a gift annuity per x terms at whatever time the charity consents to accept the property. Before notifying the donor that it is prepared to accept the property, the charity, acting on its own with no involvement of the donor, will have entered into a purchase-and-sale agreement with a buyer contingent on the charity's receiving the property by gift. If the charity is unable to find a buyer, it simply would never consent to accept the property.

- Exercise a "put" agreement with a prospective buyer in advance of accepting the property. This is conceptually similar to the approach immediately above. The difference is that upon receipt of the property, the charity can, in its own discretion compel the buyer to purchase the property for the agreed price.

Sometimes the rental income from the real property may approximate the annuity payments the charity agrees to pay. That eliminates advancing any of the charity's own money and significantly diminishes the risk.

In other cases, the charity may want to use the property for its exempt purposes. A gift annuity is an excellent way to acquire the property, for effectively the charity is purchasing it at a discounted price. It would be like an installment bargain sale, which in some instances might be preferable to a gift annuity.

In summary, charities should consider accepting real estate for a gift annuity and adopt one or more of the above strategies to keep risk at an acceptable level.

Charitable Reverse Mortgage. Many older individuals, who own their home free and clear, would like to continue living in it and also receive income to supplement what they are receiving from Social Security and their retirement plan. One possibility is a reverse mortgage arranged through a bank, though the fees can be high, and the payments to them will not necessarily continue for life. If they are charitably inclined, and the charity is willing to assume some risk and has some available funds, they might arrange a charitable reverse mortgage with the charity. They would transfer title to the charity, receiving in return a life estate (right to live in the home for life) and life payments in exchange for the remainder interest in the residence. The charity must determine an annuity amount so that the value of the property at the end of the life estate is expected to be well above the future value of all payments advanced.

Gift Annuity Funded with Closely-Held C Stock

A person who owns stock in a closely-held C corporation could contribute some of that stock to a net-income or net-income-with-make-up provision unitrust that converts to a regular unitrust upon the sale of the stock. Provided certain procedures are followed, the corporation could purchase the shares from the trust using some of its accumulated cash.   The shares could also be sold to other shareholders, provided they are not disqualified persons. A non-shareholder, unrelated party, who wants to acquire the company, could also purchase the shares held by the trust, though that person is more likely to be interested in purchasing corporate assets. The donor may opt for a gift annuity rather than a unitrust if (1) the expected purchasers are disqualified persons, such as children of the donor, (2) the donor prefers the certainty of fixed income, (3) or the gift is too small to be practical for a charitable remainder trust.

Example: Lewis, age 69, the principal shareholder of ABC Company, a C corporation, contributes shares appraised for $1,000,000 to a charity in exchange for a gift annuity that will pay him $50,000 per year. The cost basis of the shares is only $60,000. His two sons are minority owners, and Lewis would like for their percentage of ownership to increase as he prepares to hand over management to them and to retire. Each of them has recently inherited a substantial sum from their maternal grandmother, and they would like to purchase the stock from the charity. Under an existing agreement, if any shareholder wants to sell his or her stock, other shareholders first, and then, if no shareholder is interested, the corporation, must be given a right to purchase the stock for the appraised value. Subsequent to receipt of the stock, the charity notifies the other shareholders that it wants to sell its shares for the recently-appraised value. The sons accept the offer. The charity then invests the $1,000,000 cash in its gift annuity reserve fund. Lewis received an immediate income-tax charitable deduction for $398,760, and his annual payments of $50,000 will be taxed $14,000, as ordinary income, $33,840 as capital gain, and $2,160 as tax-free return of capital for the duration of his life expectancy. The sons wind up with a higher percentage of ownership of the company.

A charitable remainder trust would not have been possible in this case because the sons are disqualified persons and could not purchase the stock. Although existing shareholders have a right of first refusal, the charity is under no obligation to sell the shares, so the donor should not be taxed on the gain in the stock. An appraisal of closely-held stock can be costly. If an appraisal is being done for other purposes, the appraiser could be asked also to appraise the shares that are being contributed.

Gift Annuity Funded with Closely-Held S Stock

The 1996 tax legislation added IRC Sec. 501(c)(3) organizations to the list of eligible shareholders of S stock, but did not add charitable remainder trusts, which are described in Sec. 664. Thus, a contribution of S stock to a charitable remainder trust would disqualify the S election.

It is possible to fund a gift annuity with S stock because the donee (and resulting shareholder) would be the charity, a Sec. 501(c)(3) organization. A charity might be willing to accept S stock for a gift annuity if it is reasonably certain that (1) it can sell the stock to other shareholders in the near term or (2) the corporation will make regular distributions of income to shareholders.

If the charity retains the stock, any income earned by the corporation will be taxed as unrelated business taxable income. Even income deriving from interest, dividends, and rents – the type of passive income normally not taxable to a charity – will be taxed. If the charity sells the stock, it will be taxed on the gain (which will be the difference between the sales price and the present value of the annuity as of the date of the gift and, hence, its cost basis). Note that when a charity receives and sells S stock, it will pay less tax if the stock is contributed for a gift annuity than if it is contributed outright, in which case the charity's cost basis is whatever the donor's was.

Example: On May 15, 2014 Marguerite, age 72, contributed S stock to a charity in exchange for a gift annuity. The stock was appraised at $400,000, and Marguerite's adjusted cost basis was only $10,000. Shortly after the contribution, the charity sold the stock to another shareholder for $400,000. While the charity would ordinarily pay the 5.4-percent ACGA rate, it reduced the rate to 5.0 percent in this instance to compensate for the tax it will pay.

Benefits to Marguerite

Value of S stock	$400,000
Adjusted cost basis	10,000
Present value of annuity	
(charity's acquisition cost)	213,352
Charitable deduction	186,648

Annual payment
taxed as follows during each full
year of life expectancy:

Ordinary income	$5,280	
Capital gain	14,352	
Tax-free	368	
		$20,000

Implications for Charity

Capital gain taxed to charity ($400,000 – 213,352)	$186,648
Tax on gain (assuming the charity is a corporation and a 34% rate applies)	$63,460
After-tax proceeds	$336,540
Annual annuity as a percentage of after-tax proceeds	5.9%*

*The charity could offer an annuity rate lower than 5.0 percent so that the annuity rate as a percentage of after-tax proceeds would be closer to the ACGA rate.

Gift Annuity Funded with LLC Shares

A limited liability company (LLC) is a hybrid between a corporation and a partnership. For tax purposes it is normally treated as a partnership, but like a corporation, it insulates owners (called "members") from personal liability for obligations of the entity. Income, capital gain, deductions, credits, etc. all pass through to the members. A charity can own an LLC interest if permitted by the operating agreement. If the operating agreement has a provision that does not allow the transfer of any LLC interest to a charitable entity, it may be possible to amend the operating agreement to permit such an interest to be owned by a charity.

If the LLC has only passive income, the charity would not be taxed on that income. If the LLC operates an active business, the income from that business allocated to the charity would be taxed as unrelated business taxable income. In the case of an S corporation, the income allocated to the charity would be taxed to the charity whether it is passive or derives from an active business. Thus, from a charity's standpoint an LLC interest is generally better than S stock. When the charity sells its LLC interest, it is not taxed on the capital gain, whereas the gain would be taxed on the sale of S stock. This is another advantage of charitable gifts of LLC interests over S stock.

A charity could accept an LLC interest for a gift annuity. However, the charity probably would not want to accept such an asset for a gift annuity unless it was either reasonably certain that it could sell the interest in the near term of that its share of income would equal the annuity payments.

Example: Suppose that Marguerite in the above example contributed an LLC interest appraised at $400,000 for a gift annuity, and suppose further that all of the income of the LLC is rental income from an apartment building. The charity would not be taxed on its share of rental income so long as it holds the interest, and if it sells its interest to another member, it would not incur tax on the capital gain. Because the entire net sales proceeds, rather than the proceeds reduced by tax on the gain, could be invested in the gift annuity reserve fund, it might not be necessary for the charity to discount the gift annuity rate very much, if at all.

Gift Annuity Funded with Tangible Personal Property (Artworks, Collectibles, etc.)

Tangible personal property refers to a physical item, other than real estate, that can be touched and that is generally movable. Examples include a painting, stamp collection, an automobile, a boat, and fine china.

The person making the gift executes a deed of gift conveying ownership and delivers the object to the charity. The gift is complete when both of these events have occurred.

According to IRC Sec. 170(e)(1)(B)(i), a donor of tangible personal property can deduct the full present market value if the object is related to the exempt purpose of the charity. Examples would be a painting given to an art gallery and a wooden boat for display at a nautical museum. If the object is unrelated to the charity's exempt purpose, a donor's deduction will be the lesser of present fair market value and the cost basis. If the object is given for a related use, it is recommended that the donor secure from the charity a letter stating that fact. Should changed circumstances necessitate the charity's selling the object sometime in the future, the donor's related-use deduction will not be disallowed, if the donor at the time of the contribution could reasonably expect the donated object to be used for a related purpose. See Reg. 1-170A-4(b)(3)(ii).

If the charity is reasonably sure that the object can be sold soon after the contribution, it might be willing to issue a gift annuity. Since the charity will sell the object, the object will be for an unrelated use, so the deduction will be based on the cost basis.

Example: George age 75 funds a gift annuity with a painting by an artist whose reputation has been rising. He purchased the painting for $20,000 several years ago, and it was recently appraised for $100,000. The charity sells the painting to a gallery as soon as practical for the full appraised value. George's income tax charitable deduction is $9,154. The charitable gift value is 45.772% of the appraised value, but since the gift is for an unrelated use, the deduction is 45.772% of the cost basis rather than 45.772% of the appraised value. His annual payment is $5,800 of which, for the duration of his life expectancy, $1,426.80 is ordinary income, $3,498.56 is capital gain, and $874.64 is tax-free.

Suppose that George had contributed the painting to the gallery, which is a Sec. 501(c)(3) institution, and the gallery added the painting to its collection and made annuity payments from its general assets. In that case, George's deduction would have been $45,772. An art museum might be eager to acquire a painting by a well-known artist for its collection, but the owner is unwilling to part with it unless she receives payments in return. The museum could offer a gift annuity in exchange for the painting. Since the gift would be for a related use, the donor's deduction would be based on the appraised fair market value.

However, even if the object is for an unrelated use (the charity sells it) and the deduction is small, the gift could be appealing to the donor, for the donor is able to convert the object to a stream of income, avoid tax on some of the gain, and report the taxable gain ratably over life expectancy. Even though the deduction may not be large, it is immediate. If tangible personal property were transferred to a charitable remainder trust, no deduction would be allowed until the object is sold.

Gift Annuity Funded with Precious Metals

People invest in gold and silver by purchasing coins (American Eagle, Canadian Maple Leaf, Krugerrand, etc.), purchasing bullion, or purchasing Exchange Traded Funds (ETFs). The latter is more common. Each share of the ETF represents a certain amount of gold or silver, which is typically stored at a bank.

An individual might also purchase shares in mining companies. The individual does not own the metal but has ownership in a company that is in the business of extracting the metal. These shares are treated like the shares in any company.

If precious metals are tangible personal property, the charitable deduction resulting from a gift of them would be the lesser of market value and cost basis because the gift would be for an unrelated use, except in the unlikely case the coins would be retained and used for the charity's exempt purposes – for example, display of coins in a museum.

Clearly, coins that are old and rare and that have value beyond the value of the metal itself are tangible personal property. The answer is less clear regarding coins where the value is simply that of the metal.

Inasmuch as the gain in all of these items is taxed at the rate applicable to tangible personal property, it would be consistent for the IRS to regard them as tangible personal property when they are contributed. However, in PLR 9225036, dealing with a proposed gift of Krugerrand gold coins to a charitable remainder unitrust, the IRS took a different position. Here is the pertinent paragraph:

South African Krugerrand coins are more akin to money than to coins that have value as collector's items. South African Krugerrand gold coins are one of the best known types of gold bullion coins. They have no numismatic value. Moreover, in the case at hand, the trustee is authorized to dispose of the coins. Therefore, pursuant to the rationale of Rev, Rul. 69-63, we conclude that South African gold coins are not tangible personal property within the meaning of section 170(a)(3) of the Code.

The IRS apparently was taking a different position in a later PLR that was withdrawn when the applicant died before issuance.

Thus, we must conclude that there is uncertainty as to whether coins, bullion, and ETFs would be treated as tangible personal property when contributed. In support of the position that they would not be tangible personal property, we have Rev. Rule 69-63 and PLR 9225036. However, doubt is raised by the fact that the IRS was apparently ready to reverse its position in the withdrawn PLR, and particularly by the fact that when these items are sold the gain in them is taxed as if they are tangible personal property. If they are, indeed, tangible personal property (as we believe) the income tax charitable deduction for an unrelated-purpose gift, would be the lesser of current fair market role and cost basis.

Gold and silver prices are very volatile. For example, gold reached $1,800 per ounce two years ago but has now fallen back considerably. Still, it remains well above its price in the late 1990s. Donors with gold and silver investments, concerned about a decline in values, might be interested in locking in their gains, but they are hesitant to incur the significant tax (federal rate as high as 31.8%) on the gain. They might be willing to make an outright gift of some portion of their investment, and they could, of course, leave their gold and silver to charity by bequest. If they want to reduce their holdings without current taxation of gain and convert the current value to predictable life payments, they could contribute their gold or silver for a gift annuity.

Example: John, now age 72, purchased 300 ounces of gold in 1999, when it was selling for $279 per ounce. In early May of 2014 it was selling for about $1,300 per ounce. Knowing that gold prices are subject to significant fluctuations and wanting to lock in his gain, John had been thinking of selling the gold and simply paying the tax on the gain, which could be as much as $97,403 ($306,300 gain x 31.8%). The maximum tax rate of gain in tangible property is 28%, and assuming the 3.8% surtax applies, the total rate would be 31.8%.

Instead of doing that, John contributed the gold for a gift annuity, realizing these results:

Income tax charitable deduction	$ 36,485 (1)
Annual annuity	$ 21,060

Payments taxed as follows during each full year of life expectancy:	
Ordinary income	$5,559.84
Capital gain	12,173.59 [(2)]
Tax-free return of capital	3,326.57
	$21,060.00

(1) The deduction assumes the gold is tangible personal property. If it is not so regarded, the deduction would be $166,340.

(2) The top tax rate on gain in tangible personal property is 28%, or 31.8% if the surtax applies. On the Form 1099-R a charity should differentiate the type of gain.

Even if, as we believe, the gold is tangible personal property, the gift annuity is appealing. Some of the gain will not be taxed and the taxable portion can be reported over life expectancy. Most important, John will have predictable payments for life and doesn't have to worry about changed economic conditions that could cause gold prices to tumble.

Gift Annuity Funded with a Life Insurance Policy

Some individuals have life insurance policies that are either paid up or, at least, have been owned long enough to have accumulated considerable cash value. In some cases, the policy is no longer needed for family protection or liquidity to cover estate expenses, and it is just sitting in the safe deposit box. To derive some current benefit from the policy, the owner might be willing to transfer ownership to a charity for a gift annuity.

In many cases, the current value of the policy will exceed the policy holder's adjusted cost basis. The gain, if the policy were surrendered, would be taxed as ordinary income, not as capital gain. If the policy is contributed for a gift annuity, the income tax charitable deduction must be reduced by the amount of gain allocated to the gift value. The reduction is computed the same way as when "unrelated use" tangible personal property is contributed for a gift annuity.

It is not clear whether taxable gain in a life insurance policy, or other ordinary income property, that is contributed for a gift annuity can be reported ratably over the donor's life expectancy. Reg. §1.1011-2(a)(4)(11) simply refers to "gain" in providing for ratable reporting. However, the example to which reference is made – 1.1011-2(c)(8) – concerns a gift of long-term capital gain property. Arguably, the example merely cites the most common type of gifted property and is not meant to be limiting.

Example: Mildred, age 76, owns a paid-up life insurance policy which she would like to contribute for a gift annuity. The face value is $100,000, the replacement value is $40,000, and the adjusted cost basis is $22,000.

She could either transfer ownership of the policy or surrender the policy and then contribute the cash proceeds. In both cases, her annual payments for the rest of her life will be $2,400.

However, the tax consequences will be different, depending on whether she transfers the policy or gives the proceeds.

If she transfers the policy:

Income tax deduction	$10,218
Taxation of payments during life expectancy:	
Taxable	1,402
Tax-free	998

If she surrenders the policy and contributes the proceeds:

Income tax deduction	$18,578
Taxation of payments during life expectancy:	
Taxable	585
Tax-free	1,814
Taxable ordinary gain in year of gift	$18,000

The advantage of transferring ownership of the policy is that none of the gain in the policy will be taxed in the year of transfer. However, a smaller portion of each payment will be tax-free. Surrendering the policy and then contributing the proceeds causes the gain to be taxed in the year the policy is surrendered. However, the charitable deduction will offset most of the taxable gain, resulting in little tax.

The advantage of this second alternative is that more of the payments will be tax-free. In deciding which alternative is preferable, the donor must weigh the larger up-front savings from transferring the policy against the more favorable taxation of payments from giving the proceeds following the policy surrender.

Gift Annuity Funded with Commodities

Crops might be wheat, corn, soybeans, cotton, oranges, or any other commodity. Un-harvested crops could be sold with the land, but reference here is to harvested crops.

The farmer would prepare a conveyance document describing the commodity and the quantity being contributed, and in an accompanying letter the farmer should ask the charity where it wants the grain delivered. The charity would typically designate a grain elevator or other receiving station and would provide a receipt upon delivery. In the case of equipment there would be a deed of gift describing the items.

Harvested crops are tangible personal property, and the donor will be entitled to a deduction only for any costs of production that have not already been deducted as an expense. This means that in many cases there will be no deduction. However, the farmer-donor will not be subject to income or self-employment tax on the value of the donated crops. Equipment is also tangible personal property, so the charitable deduction will be limited to cost, which will likely be zero because the farmer probably had already deducted the cost on his income tax return.

Individuals who are retiring from farming might be interested in contributing farm equipment since the entire proceeds probably would be taxed as ordinary income, especially if they might receive income in return. Those still engaged in farming and who are facing a large taxes because of the increases in grain prices, might be willing to make a gift or a portion of their crops. Again, this would be more appealing if they could receive life income in return.

These items could, of course, be given outright, but crops, such as grain, could be contributed for a gift annuity. The annuity would be low risk in the case of grain because the charity would know at the time of the contribution the approximate amount for which the grain could be sold.

Example: Roger and Thelma contribute corn valued at $400,000 to a gift annuity. At the time, they had already deducted most of the production costs, so the charitable deduction was very small. They would have incurred income tax plus self-employment tax of 13.3% on the profit. With the gift annuity they avoid these taxes and, he and his wife receive payments for life. The real benefit, other than the satisfaction of making a gift, is receiving income from the entire proceeds from sale of the corn and spreading the taxable income over time, which will likely result in a lower tax bracket.

Acceptable Assets for Gift Annuity Reserves

If a charity is registered to offer gift annuities in Florida or California, it may not be able to use the above assets to meet reserve requirements. California specifically prohibits real estate, and Florida allows it only up to 5% of the reserve fund. Both states disallow any assets not approved for reserve investments.

States (NY, NJ, WA, MD, AR, HI, TN) that follow the prudent investor standard might take issue with certain types in investment, though it is likely that they would object only if the “non-traditional” assets constitute a significant portion of the reserve fund. Another issue is whether the asset is actually in the reserve fund. For example, if a painting were given in exchange for a gift annuity, and the reserve fund is not a separate trust to which the painting is transferred, the painting would be owned by the charity and not in the reserve fund.

In many instances, the reserve fund may have a surplus of reserves, in which case no additional assets are needed to meet the increased reserve requirement due to the addition of an annuity funded with a non-traditional asset. However, in California, no matter how large the existing reserve fund, the charity must place the required reserve amount for each gift in the California trust account. Thus, in California, the charity must be prepared to use some of its cash to meet reserve requirements when it accepts an asset that is not allowable for the reserve fund. Of course, once the charity sells the object, it can replace the general funds it temporarily transferred.

In any state, even in California, any of the above assets can be accepted for a gift annuity. The issue is not the acceptability of the asset for funding a gift annuity, but rather whether the asset can be used to satisfy reserve requirements.

Marketing Suggestions

If a charity believes it can increase the number of gift annuities by accepting a greater variety of assets for them, it may be necessary, as a first step, for the charity to revise its Gift Acceptance Policies. While expanding the list of acceptable assets, the Policies would provide a process for screening gifts that would potentially entail greater risk.

In its marketing material, the charity will also want to include examples of gift annuities funded with different kinds of assets. If all of the examples are of gift annuities funded with cash and appreciated, publicly-traded securities, prospective donors will conclude that these are the only possible funding assets.

Next, the charity will want to segment its prospect base so that in its mailings it can direct information about a particular funding asset to the right audience.

Then it will want to prompt people to think of the particular assets they are holding, and which might be put to more productive use. It might, for instance, talk about putting an idle asset to work, or it might picture a variety of assets, and then pose the question, “Did you know that you could convert any of these assets to a steam of payments for life?”

APPLICATIONS OF GIFT ANNUITIES TO VARIOUS DONOR SITUATIONS

According to the national surveys of gift annuities conducted by the ACGA over the past two decades, the average age of annuitants at the time an immediate gift annuity was established has fluctuated between 77 and 79. However, according to the 2013 survey it was 75. In most cases the donor was also the annuitant. Based on the surveys as well as conversations with charities, charities are marketing immediate gift annuities to older donors, who want the security of fixed payments during their remaining retirement years. Charities also issue deferred gift annuities, though they constitute less than 10% of total annuities, and these are primarily funded by people 50 and older who want to supplement retirement income from other sources.

Just as a charity may close more gift annuities if it accepts a greater variety of assets, it may also close more if it describes the versatility of gift annuities in meeting various donor objectives. This section discusses the following applications of gift annuities:

- Immediate gift annuity with payments to a person other than the donor
- Commuted payment gift annuity
- Flexible deferred gift annuity
- Super-flexible deferred gift annuity
- Inflation-adjusted gift annuity
- Testamentary gift annuity
- Gift annuity funded with remaining retirement funds
- Gift annuity as a virtual endowment

Immediate Gift Annuity with Payments to a Person Other than the Donor

Sometimes it makes sense for a donor to establish a gift annuity for someone else. This means that younger individuals – for example, those who must help support an aged parent and those who want to assist a friend or provide for a retiring domestic worker – could be prospects. Often, such assistance is paid with after-tax dollars, which can be quite costly for the donor. For example, a couple subject to a 35-percent tax rate must earn $769 in order to provide a $500 monthly check to one of their parents. It could be advantageous to transfer capital for a gift annuity and name as the annuitant the person whom the donor desires to help. The donor receives an income tax deduction, and the tax paid by the annuitant will probably be minimal because a portion of the annuity payments will likely be tax-free for a number of years, and the taxable portion of the payments will be taxed at a low rate.

Example: Forrest contributes stock having a fair market value of $100,000 and a cost basis of $40,000 for a gift annuity and names his mother as annuitant, reserving no power to revoke her interest. His mother, age 82, will receive $7,200 per year ($1,800 per quarter) based on the ACGA rate of 7.2 percent.

Forrest in the example will recognize the capital gain allocated to the present value of the annuity, which is $28,443. However, his charitable deduction of $52,595 will offset the taxable gain and reduce taxes on other income somewhat, assuming he is able to use the deduction.

Since Forrest will already have recognized the taxable gain, no part of his mother's payments will consist of capital gain. For the balance of her life expectancy, $5,710 will be tax-free, and only $1,490 will be ordinary income. The payments to her will be taxed the same as they would have been if Forrest had contributed $100,000 cash.

Forrest made a gift to his mother of $47,405 (the present value of her annuity payments). As a present-interest gift, it qualified for the gift tax annual exclusion of $14,000. Thus, assuming he made no other gifts to her in the year he established the gift annuity, the taxable gift to his mother was $33,405 ($47,405 – 14,000). He could have avoided making any taxable gift by retaining in the gift annuity agreement the right, during his life or upon his death, to revoke his mother's annuity interest. Then he will make no completed gifts to his mother until she actually receives the annuity payments, and since each year's payments are under $14,000, they will be covered by the gift tax annual exclusion.

Note: In some instances, a company or a nonprofit organization might choose to establish an annuity for an employee, perhaps one for which no adequate retirement plan had been provided. This can be done, though the employee would be taxed on the present value of the payments unless the organization has retained a right to revoke payments.

Commuted-Payment Gift Annuity

According to IRC Sec. 514(c)(5), a gift annuity cannot be for a term of years or guarantee a minimum or maximum number of payments. However, the IRS in certain private letter rulings (e.g. 9042043, 9108021, 9527033, and 200233023) has approved gift annuity agreements that permit an exchange of life payments for a lump sum or for installments to be received during a limited period of time. The actuarial value of the installments must be the same as the actuarial value of the life payments.

In most instances, the commuted payment gift annuity has been used to provide educational expenses for a student attending a college or university, which is why it is often called "the college annuity." A grandparent might establish a gift annuity when a grandchild is young, stipulating that life payments begin when the grandchild reaches 18. Then an authorized person exchanges ("commutes") the life payments for eight semi-annual installments that can be paid at the beginning of each semester the grandchild is in college. The payments could be over a longer period to allow the grandchild more time to complete his or her degree(s). The installments will, of course, be much larger than life payments would have been, and the charity would not have consented to an annuity for a person of such a young age unless the payment period was limited.

The college annuity has the advantage of predictable payments for educational expenses, an income tax charitable deduction for the donor, and, of course, a charitable gift. However, it has these disadvantages:

- Payments will be subject to a 10% penalty tax per IRC Sec., 72(q) because term payments start before age 59½.
- If the annuity is funded with appreciated property, the donor is taxed on part of the capital gain.

A charitable alternative that would avoid these two disadvantages is a term-of-years net-income unitrust that converts to a regular unitrust when the student reaches age 18. Because this alternative is often preferable and because certain non-charitable plans may be a better way to fund a college education, it is probably not a good idea to promote the college annuity.

However, the commuted annuity could be very useful in other circumstances when a person wants income for a certain period of time and it is not practical to establish a term-certain CRT. The contributed amount might be below the minimum required for a CRT, or perhaps the beneficiary likes the simplicity and assurance of a gift annuity.

Example: Maria, age 60, plans to start withdrawals from a well-funded retirement plan when she reaches 70, and she expects her income from that plan and other sources to be quite adequate. However, she would like to increase her income somewhat between age 62, when she plans to reduce her working hours, and age 70. She would like to divest herself of some highly-appreciated stock that she thinks may not perform so well in the future. She purchased the stock for $40,000, and it is now worth $200,000. Maria contributes the stock for a deferred gift annuity with life payments starting at age 62 and then commutes those payments to quarterly installments for an eight-year period starting at age 62.

Starting at age 62, she will receive $24,974 ($6,243.50 per quarter) for eight years. She will receive an immediate income tax charitable deduction of $90,890, and the taxable gain can be reported ratably over the payment period. From the charity's standpoint, it is much better to be able to use the residuum after only 10 years rather than waiting until the end of a 60-year-old's life.

Flexible Deferred Gift Annuity

Most gift planners by now are probably familiar with the flexible deferred gift annuity. Three Private Letter Ruling pertaining to it have been issued (9743054, 200449033, and 200742010). It appeals to donors because they can decide later when to start payments, knowing that the longer they wait the larger the payments will be.

The price is this flexibility is a somewhat smaller charitable deduction because the deduction will be the lowest that would result from any possible start state. This disadvantage is offset by the fact that a smaller deduction results in more of the payments being tax-free

Example: David, whose date of birth is February 28, 1960 wanted to supplement his income when he retired, but he did not know when he would be ready to retire. On April 1, 2014, he contributed stock having a fair market value of $100,000 and a cost basis of $60,000 for a gift annuity, and he reserved the option to start quarterly payments on June 30 of any year during the period 2024-2034.

The income tax charitable deduction (the lowest deduction resulting from any of the possible payment start dates) was $27,414. The following table shows taxation of payments for full years during life expectancy.

Elective Start Date	Age at Start Date	Capital Gain	Tax-free Portion	Ordinary Income	Total Annuity
6/30/2024	60	$1,205.36	$1,808,04	3,086.60	$6,100.00
6/30/2025	61	$1,252.44	$1,878.66	$3,168.90	$6,300.00
6/30/2026	62	$1,296,24	$1,944.36	$3,359.4	$6,600.00
6/30/2027	63	$1,349.12	$2,023.68	$3,427.20	$6,800.00
6/30/2028	64	$1,402.56	$2,103.84	$3,693.60	$7,200.00
6/30/2029	65	$1,459.20	$2,188.80	$3,952.00	$7,600.00
6/30/2030	66	$1,520.00	$2,280.00	$4,200.00	$8,000.00
6/30/2031	67	$1,586.96	$2,380.44	$4,332.60	$8,300.00
6/30/2032	68	$1,659.96	$2,489.94	$4,550.10	$8,700.00
6/30/2033	69	$1,736.96	$2,605.44	$4,857.60	$9,200.00
6/30/2034	70	$1,827.48	$2,741.22	$5,131.30	$9,700.00

Super-Flexible Deferred Gift Annuity

The disadvantage for David is that once he makes the election, he must start receiving the entire amount. To maximize flexibility, he could simultaneously establish 10 flexible deferred gift annuities, each funded with $10,000. Then he could elect payments as needed. In the event he becomes disabled or ill, he could elect payments from all 10 annuities at the same time.

Example: Suppose that David in the previous example created 10 flexible deferred gift annuities, each funded with $10,000, rather than a single flexible deferred gift annuity funded with $100,000. At age 62, David decides to reduce his work hours to allow more time for travel. Then, at age 65 he retires but continues to do some consulting. He elects to activate two of the annuities at age 62, three more at age 65, and one each year beginning at age 66. His payments would be:

Beginning at Age	Annual Payment
62	$1,320
65	$3,600

66	$4,400
67	$5,230
68	$6,100
69	$7,020
70	$7,990

The 10 flexible deferred gift annuity agreements would be identical, so it would not be much work to produce them, and the donor, to maximize flexibility, would sign his name 10 times. The payments from all of the annuities could be combined into a single check or direct deposit, and the charity could send a single Form 1099-R.

Inflation-Adjusted Gift Annuity

The advantage of a gift annuity is that payments never go down. The disadvantage is that they never go up and thus offer no inflation protection. It is possible to combine the advantages of a gift annuity and a unitrust by designing the annuity so that it has set payments that increase each year by the historical average of the Consumer Price Index. This inflation-adjusted gift annuity is also known as the "step annuity" because payment automatically step-up in amount each year. It is actually an immediate gift annuity combined with a bundle of deferred gift annuities.

Example: Sylvia, age 70, wants her gift annuity payments to increase at the rate of 3.5% per year, which is close to the historical inflation rate, though higher than the Consumer Price Index rate of increase in recent years. The following chart shows how much she would contribute if she wanted these adjustments annually for 10 years:

Type of Annuity	Contribution Amount	Payment Beginning Date	Payment Increment	Total Payment
Immediate	$100,000	4/30/2014	-0-	$5,100
Deferred	$3,236	4/30/2015	$185	$5,485
Deferred	$3,131	4/30/2016	$192	$5,677
Deferred	$3,046	4/30/2017	$199	$5,876
Deferred	$3,015	4/30/2018	$206	$6,082
Deferred	$2,890	4/30/2019	$213	$6,295

Deferred	$2,808	4/30/2020	$220	$6,515
Deferred	$2,735	4/30/2021	$228	$6,743
Deferred	$2,776	4/30/2022	$236	$6,979

Sylvia's total contribution is $123,637, and her payments will retain their purchasing power for the next eight years (or for whatever period she chose). Assuming the future rate of inflation approximates the historical average.

A charity might hesitate to agree to this plan because the amount contributed for each deferred gift annuity is less than the stated minimum in the Gift Acceptance Policies. However, the charity may be willing to make an exception because the total amount contributed is well above the minimum, the bundled annuities are identical except for the payment beginning date and the annuity amount, and they can be consolidated for the purpose of making payments and tax filing. A single agreement that incorporates the payment adjustments might be possible, but it would be prudent to secure a ruling.

Testamentary Gift Annuity

A gift annuity, like a charitable remainder trust, can be established at the end of one's life to provide payments to survivors. In the case of a gift annuity, the number of beneficiaries (annuitants) would be limited to two. In a will or living trust, a person would designate a specific sum or all or a portion of the residual estate to fund the gift annuity. The size of the payments will depend on the amount transferred to the charity and the annuity rate then in effect for persons the nearest age(s) of the annuitant(s) as of the time of the donor's death.

Here is possible language that could be used in the case of one annuitant:

I give, devise, and bequeath ($[*amount*]or "the residue of my estate") to [*Charity*] provided that if [*annuitant*] survives me, [*Charity*] shall pay [*him/her*], in quarterly installments at the end of each calendar quarter, a life annuity, the annual payments of which shall be equal to the value of the property transferred to [*Charity*] multiplied by the charitable gift annuity rate suggested as of the date of my death by the American Council on Gift Annuities for a person then [*his/her*] nearest age.

If a donor wants his or her survivor to receive a specific amount, the following language could be used:

I give, devise, and bequeath to [Charity] the amount [Charity] requires as a contribution to provide a life annuity of $[Amount] to [annuitant] based on the charitable gift annuity rate suggested as of the date of my death by the American Council on Gift Annuities for a person then [his/her] nearest age, and I direct that the annuity be paid in quarterly installments at the end of each calendar quarter.

The language could be modified if the testator wants payments to the annuitant to be deferred for a certain number of years following his or her death.

Gift Annuity for a Survivor Funded with Remaining Retirement Funds

It is possible to fund a testamentary gift annuity with assets in an IRA or defined-contribution retirement plan such as a 401(k) or 403(b). (See Private Letter Ruling 200230018.) The donor would take two actions. The first is completion of a beneficiary designation form designating to the charity all or some portion of assets remaining in the retirement plan. Second, is execution of a gift annuity agreement according to which the charity agrees to pay a life annuity to one or two named annuitants, which shall be equal to the value of the retirement plan assets transferred to the charity multiplied by the gift annuity rate then paid by the charity for a person (or persons) of the annuitant's(ts') age(s) at the time of the donor's death.

It is possible that Congress might enact legislation forcing retirement funds of a decedent to be distributed within five years to beneficiaries other than a surviving spouse. If that should happen a gift annuity might be the only way of stretching out the payments to non-spousal beneficiaries. Even if such legislation is not enacted, a gift annuity is an attractive option for those who want to use retirement funds to provide for survivors for these reasons:

- The donor can assure fixed payments to a survivor for life and make a charitable gift. If the survivor is beneficiary of a retirement plan with payments over life expectancy, the mandatory payments will increase with age, and the fund conceivably could be exhausted. By contrast, the gift annuity payments would continue for life.

- Market risk and management responsibility are eliminated.

Gift Annuity as a Virtual Endowment

Some individuals would like to create an endowment now and have the satisfaction of seeing the endowment income put to use, but they hesitate for fear that they might need all of the income from their capital in the future. A charity might suggest to those persons that they establish a virtual endowment with a gift annuity. The following example demonstrates how it would work.

Example: Lois, age 75, has good cash flow and rather significant investments. At present, her after-tax income exceeds her expenditures, so she is growing her investments. While she expects this to continue, she cannot be absolutely certain. She would very much like to fund scholarships now while she is living. She could, of course, simply retain her assets and make an outright contribution of $20,000 each year for scholarships so long as she is able

Alternatively, she could contribute $450,000 for a gift annuity, but authorize the university to retain the annuity payments for scholarships until whatever time that she directs the payments to made to her. The payments will be reported on a Form 1099-R as if she were receiving them, and she will receive a charitable deduction for the amount of the payments, for she is, in fact, contributing them. The withholding arrangement merely avoids having to make a decision and write a check each time she receives a payment.

Suppose she contributed stock valued at $450,000 with a cost basis of $300,000.

Amount available for annual scholarships		$26,100
Initial deduction		205,974
Taxation of payments		
Tax-free	$13,119	
Capital gain	6,560	
Ordinary income	6,421	
	$26,100	

Since the annual deduction exceeds taxable income, she will save some taxes each year. At the end of her life, the residuum from the annuity will be used for an endowed scholarship fund in her name.

This alternative, which could be called a “Virtual Endowment” provides more for scholarships in the near term. In the event that her circumstances ever change, she can suspend the scholarships and receive the $26,100 annuity payment.

Marketing Suggestions

The most important thing a charity can do to increase the volume of gift annuities is to expand the demographic. Although the key demographic for gift annuity marketing remains those age 70 and older, it can actually include people from mid-forties and older. People in these younger ages may be interested in establishing gift annuities for older individuals, such as parents, and for using them as supplemental retirement plans.

Charities are not realizing the potential of testamentary gift annuities because they rarely mention an annuity established by a donor at the end of life. Yet, many individuals prefer to leave a survivor fixed payments rather than a lump sum or a trust that could decline in value. Provision in a will or living trust for a testamentary gift annuity could be incorporated as part of general bequest marketing.

Another omission is a gift annuity funded with remaining retirement funds. Charities will certainly promote the Charitable IRA Rollover if it is renewed, and they regularly propose naming the charity as a beneficiary of some percentage of whatever may remain in an IRA or other retirement fund, but they do not very often suggest a testamentary gift annuity as an alternative to a stretch IRA. This option would appeal to people who want to assure payments for the lifetime of a survivor and make a charitable gift, and it would become particularly attractive if Congress limits the distribution period for non-spousal beneficiaries.

In marketing, a charity could also think of the reasons why people hesitate to estate a gift annuity and then show how to overcome them. Perhaps something like this: "You may have considered a gift annuity but hesitated because …" The flexible deferred gift annuity, the inflation-adjusted gift annuity, the commuted gift annuity are all ways overcome reasons a person might be reluctant to create a gift annuity.

In its marketing to same-sex couples, the charity should be mindful that gift annuities are now more appealing to them. When they establish an annuity funded with jointly-owned or community property, taxable gain can now be reported over joint life expectancy, and an annuity established by one for the other now qualifies for the federal gift tax marital deduction.

Finally, consider the research on proven methods for marketing gift annuities, and then develop modifications for the donor situations mentioned in this section.

ASSURING THE PROFITABILITY OF A GIFT ANNUITY PROGRAM

Even in a sound, profitable gift annuity program, a particular annuity may be a money loser. The cause could be that the annuitant lived well beyond life expectancy and/or that the contribution was added to the reserve fund shortly before a major market correction. It is conceivable, though less common, for the entire gift annuity program to lose money. Some charities do not track the balances of individual annuities. There is no need to do so because all of their annuities are for the general, unrestricted purposes of the institution. They are concerned only about the profitability of the program as a whole. Other charities accept gift annuities for restricted purposes – a named endowment, for example – so they are concerned about the balances of each annuity as well as overall profitability. If a particular annuity runs dry, they cannot draw upon the reserves of annuities designated for other purposes in order to make the payments from the exhausted annuity. Obviously, these charities must track the reserves for each annuity, in other words do fund accounting.

The following formula can be used to calculate the profitability of an entire gift annuity program:

$P = (D_p + D_f) – E$, where

P is profit,

D_p is the total of all past distributions,

D_f is the total of projected future distributions, and

E is the total of direct administrative expenses, past and projected, paid from general institutional funds and not deducted from gift annuity reserves.

The value of D_f (future distributions) cannot be known, but it can be approximated to the degree necessary to determine the likely profitability of the gift annuity program, not taking into consideration new annuities that may be established. There are two methodologies for projecting future distributions. One is the “constant-net-return model,” and the other the “Monte Carlo model.”

The former assumes that the charity earns a fixed constant net return on gift annuity reserves until the annuity terminates. It further assumes that every annuitant lives to the end of life expectancy, determined as of the date the analysis is done. The latter determines the probability that the residuum will be “x” or higher based on hundreds of simulations overlaying various returns and mortality possibilities.

Should a Charity Expect to Realize a Profit Equal to 50 Percent of the Contributions?

This question is based on the fact that one of the assumptions underlying the ACGA rates is that the residua will average 50 percent of contributions. Actually, for certain younger and older ages, rates are suppressed, resulting in projected residua in excess of 50 percent. This does not mean that the residuum of every single annuity is expected to be half of the contribution. When annuitants die early, it will obviously be more, and when they live a long time it may be less. The 50 percent is an average.

Thus, it might be concluded that a gift annuity program producing a profit equal to 50 percent of contributions would be average, while one with a profit below 50 percent would sub-par, and one with a profit above 50 percent could be regarded as superior.

The fact that most ACGA rates assume a residuum of 50 percent does not reflect the average residuum charities are actually achieving. According to all of the national gift annuity surveys, the residuum averaged over 75 percent. The survey is being repeated this year, so next spring there will be updated data on how gift annuity programs are performing.

Assuming a 50-percent-of-contribution profit is normative, a hypothetical gift annuity program could be evaluated per this benchmark:

Contributions for matured annuities	$410,000
Contributions for existing annuities	1,270,081
Total contributions	$1,680,081

Distributions from matured annuities	$305,000
Projected distributions from existing annuities (assuming four-percent constant net return)	781,528
Total received and projected distributions	$1,086,528
Administrative expenses paid from general funds	(40,000)

Net distributions	1,046,528
Profit (Percentage of retained contributions)	62.29%

Per a benchmark of a profit equal to 50 percent of contributions, this program is performing quite well.

Does It Make Sense to Continue or Establish a Gift Annuity Program?

1. Concerns about Financial Viability.

   Business officers and governing boards are paying attention to gift annuity programs as they have never done before. Alarmed by the risk of losses on gift annuities, and surprised by having to transfer precious unrestricted funds to meet the requirements of state-mandated reserve funds, a few have suspended gift annuity programs.

   Some charities that intended to establish a new gift annuity program have put their plans on hold. Increasingly, people are asking whether a gift annuity program makes sense. Here are some of the concerns that are being expressed.

   a.) In the current economic environment we cannot earn as much as the gift annuity rates we are paying.

   b.) Life expectancies are continuing to increase, and we are committing payments for a period that could be much longer than we anticipate.

   c.) Even if we don't incur an actual loss, the present value of the residuum we eventually receive is often too small to justify the effort. For example, the present value of the residuum of a $10,000 contribution by a female, age 65, is only $2,181, assuming we earn a constant net return of 4.5 percent and use the same percentage for computing present value. Thus, it would seem that time is better spent securing outright gifts and bequests. While the latter may be revocable, at least they don't subject us to risk.

   d.) Even if gift annuities can be beneficial to our charity, now is perhaps not the right time to offer them. Let's suspend the program and reconsider it when economic conditions improve.

2. **Responses to These Concerns.**

   While we take all of these concerns seriously, we believe that it is possible to alleviate all of them and demonstrate that gift annuity programs still make sense.

   a) Annuities, whether issued by insurance companies or charities, return part of the capital investment to the annuitants. It is expected that annuity rates, especially by older annuitants, will be higher than the return on investments. A charity that follows the ACGA rates needs a net return of only 3.25 percent for the average amount remaining for the charity to be 50 percent of the contribution.

b) The rates suggested by the ACGA are based on projected increases in life expectancy since the Annuity 2000 mortality tables were published. These rates, in fact, assume longer life expectancies than commercial rates do. A recent ACGA mortality study found that gift annuitants were not, in fact, living as long as had previously been supposed. A certain charity reviewed terminated gift annuities and found that 60 percent of the annuitants had died prior to the end of life expectancy determined when the annuities were established. Another charity might find that more than half of its annuitants lived longer than life expectancy, but there is sufficient evidence to suggest that the ACGA rates are based on realistic mortality assumptions.

c) According to the 2009 ACGA national survey, the average amount contributed for a gift annuity was $43,371, and the average annuitant age at the time of the contribution was 78. Such an annuity would have a present value in the range of $20,000. A charity would certainly welcome outright gifts of that size. It should also keep in mind that many gift annuity donors are unable to make outright gifts of this size. Often, they establish multiple annuities, so even if a single annuity is of modest size, cumulatively the present value is substantial.

d) A gift annuity brings the donor into a closer relationship with the charity and may stimulate other gifts. According to the most recent ACGA survey, some 30 percent of donors increased annual giving after establishing a gift annuity. Although hard data are not available, there is anecdotal evidence that those who establish annuities are also more likely to include the charity in their wills.

e) As a result of gift annuity rate reductions during recent years, new gift annuities are very likely to result in significant residua for the charity, even if returns are low. Moreover, the issuance of new annuities based on the current ACGA rates will result in the infusion of surplus reserves, and this will help a charity meet the reserve requirements of a state where it may be registered.

The immediately-following chart shows projected residua, assuming (1) constant returns, (2) ACGA rates, (3) quarterly payments, and (4) female life expectancies per the Annuity 2000 tables with a one-year setback in ages. It demonstrates that with current ACGA rates, a charity will make money on a gift annuity even if its constant net return is only 3.0 percent. If its net return is 4.0 percent or more, the residuum will be well above 50 percent.

Projected Residua Based on ACGA Rates and Life Expectancies per Annuity 2000 Mortality Table with These Adjustments:

All annuitants are assumed to be female, and ages are set back one year.

Age	Gender	Single/Joint	Gift Amount	ACGA Rate	Annuity	Constant Net Return			
						3%	4%	5%	6%
60	F	Single	$10,000.00	4.4%	$440.00	$3,974.00	$7,916.00	$13,697.00	$21,719.00
60/60	F/F	Joint	$10,000.00	3.9	390.00	4,737.00	$10,714.00	19,657.00	32,855.00
65	F	Single	$10,000.00	4.7	470.00	4,090.00	7,219.00	11,367.00	16,827.00
65/65	F /F	Joint	$10,000.00	4.2	510.00	4,455.00	8,908.00	15,194.00	23,973.00
70	F	Single	$10,000.00	5.1	510.00	4,425.00	6,250.00	9,670.00	13,220.00
70/70	F /F	Joint	$10,000.00	4.6	460.00	4,241.00	7,523.00	11,903.00	17,705.00
75	F	Single	$10,000.00	5.8	580.00	4,456.00	6,127.00	8,126.00	10,511.00
75/75	F /F	Joint	$10,000.00	5.0	500.00	4,546.00	6,958.00	10,000.00	13,818.00
80	F	Single	$10,000.00	6.8	680.00	4,536.00	5,714.00	7,065.00	8,609.00
80/80	F /F	Joint	$10,000.00	5.7	570.00	4,568.00	6,279.00	8,330.00	10,781.00
85	F	Single	$10,000.00	7.8	780.00	5,124.00	5,962.00	6,885.00	7,903.00
85/85	F /F	Joint	$10,000.00	6.7	670.00	4,626.00	5,824.00	7,197.00	8,768.00
90	F	Single	$10,000.00	9.0	900.00	5,711.00	6,309.00	6,950.00	7,636.00
90/90	F /F	Joint	$10,000.00	8.2	820.00	4,582.00	5,417.00	6,341.00	7,362.00
Total			$140,000.00			63,891.00	101,268.00	135,389.00.	201,687.00

CONCLUDING WORD

Gift annuities still make sense for charities. In addition to generating a profit for an institution, gift annuities have ancillary benefits, such as stimulating more annual gifts and prompting donors to include the organization in a will. Also, if a charity does not offer gift annuities, its donors may migrate to a charity that does offer them. The currently-low gift annuity rates cause the charity's risk to be extremely small.

The gift annuity will continue to be the most common gift after the bequest. That has been true for a long time, and there is no reason to believe it will change. It can become an even greater source of philanthropic funds if marketing initiatives show its amazing versatility.