GIFT ANNUITY ESSENTIALS

PG CALC WEBINAR

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I. OVERVIEW OF GIFT ANNUITIES

A. Description of 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. A person who receives payments is called an "annuitant" or "beneficiary." The contributed property becomes part of the charity's assets, and the payments are a general obligation of the charity. The annuity is backed by all of the charity's assets, not just by the property contributed.

The charity may spend a portion of the contribution immediately, provided it retains sufficient reserves to satisfy the requirements of applicable states in which gift annuities are regulated. Most charities, however, keep the entire contribution (increased by earnings and decreased by annuity payments and expenses) in reserve until the sole or surviving annuitant dies. The remaining portion of the contribution is called the "residuum."

B. Types of Gift Annuities

1. Immediate Gift Annuity

With an immediate gift annuity the annuitant starts receiving payments at the end (or beginning) of the payment period immediately following the contribution. Payments can be made monthly, quarterly, semi-annually, or annually. The most common arrangement is quarterly payments at the end of the quarter. The first payment is customarily prorated from the date of the contribution to the end of the first period, and thus is smaller than subsequent payments, but it is possible to stipulate that the first payment be for the full amount. All of these factors have some effect on the charitable deduction.

The annual annuity is determined by multiplying the amount contributed by the annuity rate. For example, if a person, age 65, contributes $10,000 and the charity follows the current American Council on Gift Annuities (ACGA) suggested rate of 4.7 percent (more later on the ACGA rates), the annual annuity would be $10,000 × 4.7% = $470. If quarterly payments have been selected, the annuitant would receive $117.50 for each full quarter.

2. Deferred Gift Annuity

With a deferred gift annuity, the annuitant starts receiving payments at a future time, which must be more than one year after the date of the contribution. As with immediate gift annuities, payments can be made monthly, quarterly, semi-annually, or annually. Because payments are deferred, they are larger than for an immediate gift annuity that starts making payments to an annuitant of the same age. For example, if a person age 55, contributes $10,000, with payments to start

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when the donor is 65, the current ACGA suggested rate would be 6.4% and the annual annuity would be $10,000 × 6.4% = $640.

3. Flexible Gift Annuity

A flexible gift annuity is a variation on the deferred gift annuity. Instead of specifying the date the payments will start, the annuity agreement includes a schedule of possible start dates from which the annuitant can choose a start date after the gift is made. The later the start date the donor ends up choosing, the greater the annuity amount the charity will pay. The flexible gift annuity is appealing to donors who aren't sure when they want their annuity payments to begin. The cost of this flexibility is that the deduction available for a flexible gift annuity is generally lower than for a comparable deferred gift annuity.

C. Arrangements Similar to Gift Annuities

The contractual nature of a gift annuity distinguishes it from other types of life income gifts. Charitable remainder trusts, which have roots going back many centuries but which have been reshaped in recent decades, are indeed trust arrangements. Contributions are made not to a charity directly but instead to a separate legal entity, which then makes payments to one or more income beneficiaries throughout the duration of the trust. Despite the fact that a charity may serve as trustee of such a trust, the charity typically receives nothing in its own right until the trust has ended. Likewise, until that time, ensuring that payments are made to income beneficiaries is the responsibility of the trustee, not of a charitable remainder beneficiary.

Another type of trust arrangement is a pooled income fund, in which, once again, life payments are made by the trust. Even though, as with a gift annuity, only one charity can benefit from a pooled income fund, money is not received by the charity in its own right until a given payment obligation ends.

See *Appendix A* for a comparison of gift annuities and charitable remainder trusts.

D. Relationship Between Gift Annuities and Commercial Annuities

Although different from annuities available through insurance companies, charitable gift annuities do not exist totally apart from these commercial marketplace arrangements. Charities set their annuity rates comfortably below those offered by insurance companies, in order to leave a significant residuum for charitable purposes. In contrast to commercial annuities, which can be fixed or variable, gift annuities always pay a fixed amount. Also, in contrast to commercial annuities, a gift annuity does not have a term certain or refund option. Payments from a gift annuity are made for the duration of the life of one or two annuitants, whereupon the charity's obligation terminates.

E. Some Facts About Gift Annuities

1. The average size of a gift annuity is $43,371.*

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2. At the time immediate gift annuities are funded, the average age of annuitants is 79.**

3 Approximately 57 percent of annuitants are female. **

4. Approximately 87 percent of annuities start payments immediately, 12 percent are deferred, and approximately 1 percent are flexible deferred. **

* Data from 2009 ACGA survey. ** Data from 2013 ACGA Survey.

F. Profiles of Donors

- Oldest group of donors – 65 and up, especially over age 70.
- Those who want a stable cash flow of fixed payments.
- Those who would like part of the payment to be tax-free.
- Those interested in assisting an elderly parent.
- Deferred annuity: Mid-life professionals and executives who are interested in a supplemental retirement plan. The flexible gift annuity variation is increasingly popular with this group.

II. Tax Aspects of Gift Annuities

A. Allowance of Charitable Deduction

A gift annuity is a form of bargain sale, for the present value of the lifetime annuity is less than the value of the property transferred to the charity. The donor is entitled to an income tax, gift tax, and/or estate tax charitable deduction for the difference between the amount transferred and the present value of the annuity as determined following IRS rules. [See Reg. Secs. 1.170A-1(d)(1) and 20.2055-2(f).]

B. Determination of the Charitable Deduction

The amount of the deduction depends on the following factors:

1. The amount contributed.

2. The age of the annuitants.

3. The annuity rate paid by the charity.

4. The frequency of the installments – i.e., whether they are paid annually, semi-annually, quarterly or monthly. The more frequent the installments, the smaller the deduction.

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5. The Charitable Midterm Federal Rate ("CMFR"). The CMFR (also called the "IRS discount rate") is an interest rate that is redetermined and published monthly by the Treasury Department. The donor has the option of using the CMFR for the month of the gift or for either of the two preceding months. The higher the applicable rate, the larger the charitable deduction. The current CMFR (January 2016) is an historically very low 2.2%. The CMFR is 120 percent of the annually compounded Applicable Federal Rate for mid-term federal obligations, rounded to the nearest .2 percent. Internal Revenue Code ("IRC") Section 7520 deals with this discount rate.

   The Treasury Regulations dealing with determination of the present value of the annuity are Reg. Secs. 1.170A-1(d)(2), 1.101-2(e)(1)(iii)(b)(2), and 25.2512-5.

   Gift planners use computer software, such as PG Calc's *Planned Giving Manager*, to determine the deduction, though the deduction can be calculated manually using the tables in IRS Publication 1457.

C. Taxation of Annuity Payments

1. Contribution of Cash

   When cash is contributed, the portion of the annuity payments that represents a return of the donor's investment in the contract (present value of the payments to be received) will be tax-free. To understand why this is true, imagine that you deposit $100,000 in a money market fund and withdraw $10,000 per year. Part of each withdrawal consists of interest earned, and part consists of the cash that you deposited in the first place. You are taxed on the interest, but not on the cash that is returned to you. Similarly, the portion of each annuity payment that is construed to be a return of the assets you gave in the first place is not taxed, while the balance, which is the earnings on these assets, is taxed.

   Computer software will calculate for you the taxable and tax-free portions of the annuity payments, though you could also do this manually using tables in the Treasury Regulations.

Example: *Ms. Palmer, age 74, contributes $100,000 cash for a gift annuity. The charity to which she makes the gift uses the ACGA rate of 5.7%, and the CMFR is 2.2%.*

PRESENT VALUE OF ANNUITY	*GIFT VALUE*
A	***B***
$56,552	*$43,448*

Annual payment $5,700

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A *is the present value of the annuity based on the IRS mortality tables and discount rate. It is equivalent to the purchase price of the annuity. This purchase price is returned tax-free to the annuitant over the annuitant's life expectancy.*

B *is the amount by which the contribution ($100,000) exceeds the present value of the annuity. This "excess" is the charitable deduction.*

According to tables in the Regulations, Ms. Palmer's life expectancy is 13.1 years, and during that period the amount of her capital returned each full year is $56,552 ÷ 13.1 = $4,315. This portion of her annual payment is tax-free. The balance of her annuity payment, $1,385, is taxed as ordinary income. At the end of her life expectancy, the entire capital will have been returned and, thereafter, the annuity payments will be fully taxable as ordinary income.

If the sole annuitant of a one-life annuity or the survivor annuitant of a two-life annuity dies before the end of the annuitant's life expectancy, the annuitant gets an income tax deduction on his or her final income tax return for the amount of their purchase price for the annuity that was not returned to them during life (i.e., for the total unpaid tax-free amounts). [See IRC Sec. 72(b)(3)(A).] The annuitant is entitled to this deduction for use on the final income tax return regardless of whether the annuitant or another person funded the annuity. The deduction is a miscellaneous deduction reported on Line 28 of Schedule A and is not subject to the 2% of adjusted gross income (AGI) limitation applicable to many other miscellaneous deductions.

2. Contribution of Long-Term Capital Gain Property.

When property, such as stock, that has appreciated in value is contributed for a gift annuity, the portion of the capital gain that is attributable to the gift value is not taxed. This is just like an outright contribution of appreciated stock to a charity. However, the portion of the gain attributable to the present value of the payments is taxable. The only question is when.

If the following conditions are met, that gain can be reported in equal installments ("ratably") over the life expectancy of the annuitant. [See Reg. Sec. 1.1011-2(a)(4)(ii).]

a. The annuity is non-assignable except to the charity.

b. The donor is the sole annuitant or is one of the annuitants in a two-life annuity. If a husband and wife fund the annuity with jointly-owned or community property, and the annuity payments are made to them jointly and then to the survivor, the gain can be reported over their joint-life expectancy.

If the annuity payments are paid to someone other than the donor, then the gain attributable to the present value of the payments must be reported in the year property is transferred for the annuity.

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If the annuity is funded with the donor's separate property, but is payable to the donor and then to another, the gain is reported over the donor's life expectancy only. However, any gain not reported by the time the donor dies must be reported by the surviving annuitant. The amount reported each year by the surviving annuitant will be the same as the donor was reporting, and will continue to be reported for the duration of the donor's life expectancy as determined at the time of the gift. Sometimes, it will be impossible to report all of the gain over the donor's life expectancy. When that is the case, computer programs show the remaining gain continuing to be ratably reported by the successor annuitant for however many years it takes to completely report it.

Any gain unreported at the death of the sole or surviving annuitant is not taxed because it is part of the residuum that belongs to the charity.

Example: *Instead of contributing $100,000 cash for the gift annuity, Ms. Palmer contributes stock with a fair market value of $100,000 and a cost basis of $40,000.*

PRESENT VALUE OF ANNUITY $56,552		***GIFT VALUE $43,448***	
A	***B***	***C***	***D***
$ 22,621	*$33,931*	*$17,379*	*$26,069*

A *is the cost basis of the present value of the annuity. This is the capital that is returned to Ms. Palmer tax-free.*

B *is the capital gain allocated to the present value of the annuity. Since Ms. Palmer is the annuitant, it is reported ratably over her life expectancy.*

C + D *is the amount by which the contribution ($100,000) exceeds the value of the annuity. This "excess" is the charitable deduction.*

C *is the cost basis allocated to the charitable gift (the deductible portion of the contribution)*

D *is the capital gain allocated to the charitable gift. Since this portion of Ms. Palmer's capital gain is being given to the charity, it is not taxed.*

For the duration of her life expectancy, Ms. Palmer's payments will be taxed as follows:

Tax-free	$22,621 ÷ 13.1	=	$1,726
Capital gain	$33,931 ÷ 13.1	=	2,589
Ordinary income (the balance of the payment)			1,385
			$5,700

At the end of her life expectancy the entire capital will have been returned, and the entire taxable gain will have been reported. Thereafter, the annuity payments are fully taxable as ordinary income.

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If Ms. Palmer dies prior to the end of her actuarial life expectancy – i.e., before 13.1 years – the unreturned capital can be taken as an income tax deduction on her final income tax return. Any unreported capital gain will not be taxed.

If she were the donor and another person – her brother, for example – were the successor annuitant, the capital gain would be reported ratably over her life only. However, if she were to die before the end of her actuarial life expectancy, her brother would continue the ratable reporting of gain until it has all been reported.

When gain is ratably reported, annuity payments usually consist of three elements: ordinary income, capital gain, and tax-free return of capital. The amount of ordinary income will be the same as it would have been had an equivalent amount of cash been contributed. The tax-free portion of the payments will be reduced by the amount of gain reportable. When property with a very low basis is contributed, there may be no tax-free portion.

The foregoing specifically applies to an immediate gift annuity, but the same method of reporting gain also applies to deferred payment gift annuities. The capital gain would not be reported until the payments begin, and then would be reported ratably over the donor's remaining life expectancy.

D. Gift and Estate Tax Implications

A donor who funds a gift annuity and names an annuitant in addition to, or instead of, himself or herself makes two gifts: one to the charity and one to the annuitant. Depending on the circumstances, the gifts may or may not be reportable and taxable. Inclusion of revocation language in the gift annuity agreement may eliminate or postpone a taxable gift.

III. GIFT ANNUITY RATES

How Rates are Determined

The gift annuity rates most charities follow are those suggested by the American Council on Gift Annuities (“ACGA”). The rates are reviewed at least annually, and ordinarily changes become effective on July 1. As circumstances warrant, the ACGA conducts an additional review of rates during the year and announces a rate change as of a different date. This was the case in the fall of 2011, and resulted in a new schedule of rates with an effective date of January 1, 2012.

Following are the assumptions underlying the January 1, 2012 rates, which are still in effect as of January 2016:

1. The residuum (percentage of contribution remaining for the charity at the termination of an annuity) will be 50%. Additionally, the present value of the residuum will be at least 20% of the original contribution for the annuity.

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2. Life expectancies are based on the Annuity 2000 mortality table for female lives with a one-year setback. Projections for increasing life expectancies are factored into rate calculations.

3. Annual expenses for investment of gift annuity reserves and administration of gift annuities are assumed to be 1% of reserves.

4. The total annual return on gift annuity reserves is 4.25 %.

5. The rates for the oldest ages are somewhat lower than the rates that would follow from the above assumptions. Rates are capped at age 90 and above, and rates for annuitants between ages 81and 89 are graduated downward from the rate cap.

6. The compound interest factor for deferred gift annuities is 3.25 %. (Reductions in the factor are made, as needed, for annuities with lengthy deferral periods.)

A table of gift annuity rates for all ages is available on the ACGA web site at www.acga-web.org. They are also included in most planned giving software. Below are rates for selected ages and age combinations in effect as of January 2016.

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Age	One Annuitant	Ages	Two Annuitants (Either successive lives or joint and survivor)
60	4.4%	60/60	3.9%
61	4.4%	61/61	3.9%
62	4.5%	62/62	4.0%
63	4.5%	63/63	4.1%
64	4.6%	64/64	4.2%
65	4.7%	65/65	4.2%
66	4.8%	66/66	4.3%
67	4.8%	67/67	4.4%
68	4.9%	68/68	4.4%
69	5.0%	69/69	4.5%
70	5.1%	70/70	4.6%
71	5.3%	71/71	4.7%
72	5.4%	72/72	4.7%
73	5.5%	73/73	4.8%
74	5.7%	74/74	4.9%
75	5.8%	75/75	5.0%
76	6.0%	76/76	5.2%
77	6.2%	77/77	5.3%
78	6.4%	78/78	5.4%
79	6.6%	79/79	5.6%
80	6.8%	80/80	5.7%
81	7.0%	81/81	5.9%
82	7.2%	82/82	6.1%
83	7.4%	83/83	6.3%
84	7.6%	84/84	6.5%
85	7.8%	85/85	6.7%
86	8.0%	86/86	7.0%
87	8.2%	87/87	7.3%
88	8.4%	88/88	7.6%
89	8.7%	89/89	7.9%
90+	9.0%	90/90	8.2%
		92+/92+	8.8%

IV. Compliance with Federal and State Regulations

A. Federal Regulations

1. Disclosure Statement

In compliance with the Philanthropy Protection Act of 1995, a charity is required to give donors, prior to the execution of a gift annuity agreement, a disclosure statement regarding the governance of the charity and the investment of its gift annuity reserves.

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2. Reporting Requirements

    - The charity (or administrator retained by the charity) completes a Form 1099-R for each annuity and sends a copy to the annuitants by January 31 of each year.

    - By the end of February, the charity (or Administrator) sends to the IRS copies of all Forms 1099-R attached to a completed Form 1096.

B. State Regulations

At the present time:

- 11 states require a segregated reserve fund, annual reporting, and/or a detailed application. (Four additional states that exempt charities from most regulations require a reserve fund.)

- 15 states exempt gift annuities from regulation but require a notification to the state of an intent to issue gift annuities. All of these states require certain disclosure language in the gift annuity agreement.

- 20 states exempt gift annuities from regulation and do not require notification to the state. Six of these states require disclosure language in the gift annuity agreement.

- 4 states and the District of Columbia either do not address gift annuities or have determined that they are not subject to insurance regulation.

(See *Appendix B* for a summary of current state regulations. For detailed information about the regulatory requirements of each state, see the ACGA web site.)

A charity is subject to the regulations of the state where the donor resides at the time the agreement is executed. It is not enough to comply with the regulation of the state where the charity is domiciled. If state regulators become aware of a charity's failure to comply, they could issue a "cease and desist order," levy a fine, order the charity to refund contributed money, or impose other penalties. The charity could also be vulnerable to a lawsuit filed by a disgruntled heir or donor.

V. COMMON APPLICATIONS OF GIFT ANNUITIES

Most commonly, gift annuities are funded with either cash or publicly-traded securities. Typically, there will be a single donor who is also the annuitant, or a husband and wife who contribute jointly-owned or community property for a joint and survivor annuity for the two of them. Donors who establish immediate gift annuities are usually retired, and most of them will be over age 70. Donors who establish deferred gift annuities are usually in the 45-60 age range, and they are interested in a supplemental retirement plan. Here are examples of three typical gift annuities, two of which are immediate and one deferred.

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A. Immediate Gift Annuity Funded with Cash

Example: *Ms. Sylvester, age 75, receives pension income plus interest from bonds and CDs and dividends from various stocks. As interest rates have fallen her cash flow has declined, and the return on her CDs is now 2%. In making a charitable gift she would also like to increase her cash flow.*

To accomplish her objectives, she contributes $50,000 from a maturing CD for a gift annuity. Here is how her situation changes. (The figures that follow assume a discount rate of 2.2% and quarterly payments.)

Prior to the Gift

Invested in CD	$50,000
Interest (2%)	1,000
Income tax on interest (28% federal rate) [1]	- 280
Net spendable	$720

After the Gift

Contributed for gift annuity	$50,000
Annual payment	2,900
Taxed as follows:	
Ordinary income	684
Tax-free[2]	+ 2,216
Income tax (28% x $684)[1]	- 192
Net spendable	$2,708

In addition to more than tripling her cash flow from the $50,000 that had been invested in CD's, Ms. Sylvester receives a charitable deduction of $22,514, which results in income tax savings of $6,304 (assuming Ms. Sylvester itemizes her deductions).

[1] The calculations do not take into consideration state income tax, which would vary from state to state. If the donor lives in a state with a state income tax, or is in a higher federal tax bracket, tax savings would be larger and the net spendable amount lower. In 2016, the 28% federal income tax bracket starts at taxable income of $91,150 for a single person and at $151,900 for married couples filing jointly and surviving spouses.

[2] At the end of her life expectancy, the annuity payments will become fully taxable as ordinary income.

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B. Immediate Gift Annuity Funded with Long-Term Appreciated Stock

Example: *Mr. and Mrs. Gregory are ages 79 and 76, respectively. Many years ago they paid $20,000 for stock that is now worth $50,000. The stock's annual dividend is 3%. They would like to increase their cash flow from this asset. Nevertheless, they are reluctant simply to sell the stock and reinvest the proceeds, due to the capital gains tax that would be due at the time of the sale. They are, however, open to the possibility of using the stock to make a charitable gift if they can accomplish their other objectives. Accordingly, they decide to contribute the stock for a charitable gift annuity. Here is how their situation changes. (The figures that follow assume a discount rate of 2.2% and quarterly payments.)*

Prior to the Gift

Fair Market Value of Stock	$50,000
Dividends	1,500
Income tax on dividends (15% rate)[2]	- 225
Net spendable	$1,275

After the Gift

Contributed for gift annuity	$50,000
Annual payment	2,650
Taxed as follows:	
Ordinary Income	615
Long-term capital gain[1]	+ 1,221
Tax-free[1]	+ 814
Income tax (33% x $615, 15% x $1,221)[2]	- 386
Net spendable	$2,264

In addition to significantly increasing their cash flow from the stock, Mr. and Mrs. Gregory receive a charitable deduction of $20,279, which results in tax savings of $6,692.

[1] At the end of their joint-and-survivor actuarial life expectancy, the annuity payments are fully taxable as ordinary income.

[2] Again, the calculations of tax savings and net spendable income do not take into consideration possible state income tax. In 2016, the 33% federal income tax bracket starts at taxable income of $231,450 for married couples filing jointly and surviving spouses.

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C. Deferred Gift Annuity Funded with Cash

Example: *Dr. Hecht, a staff physician, age 50, would like to supplement the retirement income expected from his hospital plan. To this end, he contributes $50,000 cash for a deferred gift annuity, with payments to begin when he reaches age 65. (The figures assume a discount rate of 2.2%, and quarterly payments.)*

Contributed for gift annuity	$50,000
Annual payment	3,800
Taxed as follows:	
Ordinary income	2,090
Tax-free	1,710
Income tax charitable deduction	15,986
Tax savings (33% tax rate, state income tax not included)	5,275

D. Flexible Gift Annuity Funded with Cash

Example: *Suppose Dr. Hecht is not yet sure when he will retire. It could be as early as age 60 or as late as age 75. If possible, he'd like to commit to a start date for his annuity payments only after he knows when he will retire. In this case, a flexible gift annuity is a good solution for him. He could contribute $50,000 cash for a flexible gift annuity, with payments that can begin on March 31 of any year from when he turns 60 to when he turns 75. (The figures assume a discount rate of 2.2%, and quarterly payments.)*

Contributed for gift annuity	$50,000

Annual payment will depend on chosen start date (see Appendix B for complete schedule)

Year he turns 60	3,050
Year he turns 75	6,450

Taxation will depend on chosen start date

If he chooses the year he turns 60:	
Ordinary income	1,479
Tax-free	1,571
If he chooses year he turns 75:	
Ordinary income	3,399
Tax-free	3,051
Income tax charitable deduction	12,156

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Tax savings (33% tax rate, state income tax not included)	4,011

As you can see, the longer Dr. Hecht chooses to defer the start of his annuity payments, the greater the amount of his payments will be. For example, if he waits until he turns age 75, his annual payment will be more than double what it would be if he elects to start payments at age 60. On the other hand, the later he elects to start payments, the greater the proportion of his payments that will be taxed as ordinary income rather than tax-free. His deduction is established at the time of his gift and does not depend on when he elects to start payments.

Notice that Dr. Hecht's deduction is somewhat lower than the deduction he would get if he were to fund a deferred gift annuity that commences payments when he turns 65 (see case C above). This is because he has the option to start receiving payments as early as age 60.

VI. Establishing and Operating a Gift Annuity Program

A. Determining Whether a Charity Should Issue Gift Annuities

A charity should not issue gift annuities unless it meets the following criteria:

1. It has sufficient financial strength to assure payments to donors. (Some states require that a charity, in order to issue gift annuities, must have been in existence for a certain number of years and maintain a minimum amount of unrestricted assets.)

2. It is prepared to arrange for investments of gift annuity reserves and administration of the annuities, either by assigning this responsibility to internal staff and arranging for them to receive training, or by outsourcing the responsibility to a financial institution.

3. It is prepared to make a long-term commitment to a gift annuity program and budget some money for start-up costs.

4. It has a significant number of donors age 65 and older.

If it does not meet ALL of these criteria, it should consider having gift annuities issued by an affiliated organization. Many national organizations with local affiliates have established gift annuity programs. The local affiliates can direct their donors to establish a gift annuity through the national office. Small charities not affiliated with a national organization may be able to have annuities for their donors issued by the local community foundation.

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B. Steps Necessary to Establish a Gift Annuity Program

1. The governing board of the charity adopts a resolution authorizing the issuance of gift annuities and approving policies regarding the gift annuity program.

   The policies will concern:

   - Gift annuity rates to be offered (ACGA rates recommended).
   - Types of assets that can be accepted for a gift annuity.
   - Minimum amounts that can be contributed for immediate and deferred gift annuities.
   - Minimum ages of annuitants at the time an immediate or deferred gift annuity is funded.
   - When there will be an expenditure of all or part of the contribution for charitable purposes.

2. The planned giving office (or general development office) obtains a set of gift annuity agreements and has them approved by legal counsel. (A complete set of gift annuity agreements that covers all donor-annuitant combinations, and that meet the requirements of the various states, is embedded in the PG Calc's *Planned Giving Manager* software.)

3. The planned giving office (or general development office), in collaboration with the business office, takes steps to comply with the laws of the states where the charity will issue gift annuities.

4. The planned giving office (or general development office), again in collaboration with the business office, drafts a disclosure statement to be given to donors as required by the Philanthropy Protection Act of 1995 (*Planned Giving Manager* can produce this statement).

5. The governing board and/or the business office arranges for the investment of gift annuity reserves and the administration of gift annuities.

6. The planned giving office (or general development office) develops a plan to market gift annuities.

C. Marketing Gift Annuities

Charities employ various techniques to identify prospects for gift annuities. Following are some of the more common ones:

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1. Targeted Mailings

The targeted group will depend on the objective. If the objective is to identify prospects for immediate gift annuities in general, the mailing could be sent to a selected group of individuals age 70 and older.

If the objective is to identify those possibly interested in using a deferred annuity to supplement their future retirement income, the mailing could be to individuals in the 45 to 60 age range. This same age group might be targeted with a piece that highlights setting up an immediate gift annuity for the benefit of an aging parent. In fact, focusing on establishing an annuity for someone else can be directed to individuals at any age, as many people set up an annuity for the benefit of a sibling, a child, or even an employee.

A targeted mailing can be done either through a letter package or a postcard.

Letter
The letter should be written in a personal, conversational tone, with two main purposes in mind: strengthening the connection between the recipient and the organization, and helping the individual see themselves in a situation where a gift annuity is beneficial. If possible, have the letter signed by a donor who has made a gift to the organization – the letter might be written by the individual, or he or she could be interviewed by someone in the development or planned giving office who would then draft the letter for the donor's review.

Just as a testimonial letter can generate more interest on the part of the recipient, so too can a letter that contains personalized information. If ages (actual or approximate) of the recipients are known, illustrate the benefits of a gift annuity for an individual or couple of those ages, rather than including a generic illustration that is the same for everyone receiving the letter (PG Calc's BatchCalcs Service can produce these personalized illustrations for you).

In addition to the letter, the mailing should also include a form to be completed and returned if the recipient would like a personalized illustration for a possible gift, and a pre-addressed, postage-paid return envelope.

Postcard
An alternate way to reach a target audience is with a postcard mailing. It consists simply of a postcard, usually the size of a ½ piece of paper or smaller, printed on heavy card stock. A postcard format addresses concerns that a donor may not take the time to open a gift annuity letter and read it through. And because a postcard mailing is simpler and less expensive to produce, it may help a charity to get its message out more frequently.

To maintain the visual openness of a postcard but allow for inclusion of more information, some charities have gone to using a "self-mailer." The paper is likewise of heavier weight but is larger, and is then folded to postcard size. This

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allows for a “teaser” on the outside, details on the inside, and use of a response device.

2. Printed Advertisements

The most common placement of print ads is in an organization’s own publication. The more consistent the advertising – in message and/or in occurrence in the publication throughout the year – the more successful such marketing is likely to be. Cost is a consideration, as some organizations charge the planned giving department for space, whereas others provide it at a reduced rate or do not charge at all.

Some charities do place ads in external publications, perhaps a local paper for a regionally based charity, or a national publication that appeals to a demographic similar to an organization’s existing supporters. Such ads can be quite expensive, and inevitably prompt some responses from people who have little charitable motivation and who are exploring investment alternatives. The quality of leads will be better if the advertisement mentions the mission of the charity as well as the financial benefits to the donor.

3. Receipt Inserts

Anyone who pays a credit card bill likely has to shuffle through a number of inserts selling everything from watches to tool sets. Obviously these inserts work. They can also work for the charity by calling attention to a particular gift plan. The purpose of the insert is to pique interest and prompt a request for more information. It could simply pose a question such as, “Did you know you can make a gift and receive guaranteed payments for life?” and then say how to obtain information. As with any marketing plan, it’s best to segment the audience. If demographic information is available, include the inserts only with gift receipts to people over a certain age. Or they might be included with receipts for gifts at a certain level.

4. Check-off Boxes

To help prospects self-identify, a check-off box can be added to annual giving response cards. This effort can generate leads at essentially no cost. The line can be very specific – “I would like more information on a charitable gift annuity” — if donors and prospects are seeing the charity’s gift annuity message in other venues and are familiar with the concept. A more general line – “I would like more information on gifts that make payments to me for life” – works better in other instances.

5. Newsletters

For some charities, the planned giving newsletter continues to be, year after year, one of the most important sources of planned giving prospects. Its purpose is to give visibility to the charity’s planned giving program, to educate readers on gift

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instruments, and to prompt them to identify themselves as prospects by returning a response card. From time to time, an issue of the newsletter can feature gift annuities and offer a follow-up booklet on the subject. Since readers are drawn to stories about a real person, a testimonial article is far more effective than an article describing gift annuities in the abstract.

6. Internet

The largest Internet marketing presence for most charities is their website. There should be easy links from the home page to a page about types of gifts, and from the page about types of gifts to a page about gift annuities, with content such as:

- A description of how a gift annuity works and a listing of the benefits, plus a button to click for an example.
- A visual example for an annuitant (or annuitants) in the typical age range of annuity donors.
- A response device whereby people who visit the site can complete a form and e-mail it to receive a personalized financial illustration.
- A hyperlink arranged with a software vendor so that site visitors can obtain an immediate calculation of the annuity and deduction amounts when they key in pertinent information.
- A contact page making it easy to obtain more information.

Some organizations are expanding their online presence through use of social media, by establishing a Facebook page or making use of Twitter. The posts and “tweets” are relatively short and primarily used to link visitors back to more detailed information on the website. It is also possible to place ads on Facebook, which can be very cost effective (it is possible to place a daily spending cap), targeted by age, and allow for the testing of messaging and the measuring of results. Again, the ads generally provide a link that takes the reader back to the organization’s website for additional information. Social media provides another avenue for building relationships, reaching people for whom this may be the preferred way to be connected and receive information.

7. Telemarketing

Just as telephone solicitors call prospects and ask for an outright gift, they can call selected individuals regarding a charitable gift annuity. After selecting those to be called, a pre-call introduction letter is sent. The objective of the call is not to secure a commitment for a gift but rather to obtain the prospect’s consent to receive a financial illustration. The calling can be done with a charity’s own staff, with some training, or by hiring an outside vendor that provides such telemarketing services.

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VII. CONTROLLING RISK TO THE CHARITY

A well-managed gift annuity program can generate significantly more dollars for your charity, and much of this money may come from those who are not in a position to make outright gifts of such amounts. By virtue of establishing gift annuities, individuals are also brought into a closer relationship with your charity and, as a consequence, may be more likely to leave a charitable bequest to it. Sometimes they even increase annual giving because the gift annuity improves their cash flow.

Such benefits account for the popularity of gift annuity programs. However, a charity must be mindful that it assumes some risk with gift annuities and take steps to control that risk. Here are some risk-control strategies.

A. Do not exceed the rates suggested by the ACGA.

Exceeding the ACGA rates puts a charity at greater risk of losing money and definitely reduces the residuum. When the discount rate is low, higher rates may also cause the present value of the annuity to exceed 90 percent of the contribution, in which case the obligation to make annuity payments will be treated as acquisition indebtedness, possibly creating unrelated business taxable income for the charity. (A charitable gift annuity will not be considered commercial insurance and will be tax exempt to the charity, provided it meets the conditions of IRC Sec. 514(c)(5), one of which is that the present value of the annuity is less than 90 percent of the value of the property transferred.)

B. Invest gift annuity reserves prudently.

An investment strategy for gift annuity reserves, in addition to taking applicable state regulations into consideration, may include the following risk-control techniques:

- An asset allocation that strikes the proper balance between risk and potential return.
- Diversification within each asset class.
- Selection of investments based on expected cash flow needs.

C. Consider reinsuring some or all gift annuities.

One way to transfer most of the financial risk of gift annuities is to reinsure them. The charity would use a portion of the contributed assets to purchase an annuity from an insurance company that will pay the amount promised to the annuitants. It may be prudent, for example, for a charity to reinsure an annuity that represents a disproportionately large fraction of its total gift annuity pool. All this being said, most charities self-insure most or all of their annuities.

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D. Adopt sensible policies regarding gift annuities.

The present value of the residuum is generally larger when annuitants are older, though the mortality risk (the risk that an annuitant will outlive his or her life expectancy by a substantial margin) is higher in the case of the oldest annuitants. On balance, a charity likely can increase the cost effectiveness of its gift annuity program by raising its minimum age of annuitants, so charities have a good reason to take this action.

For an annuity to be cost effective, it should also be of at least a certain size. Most charities require a minimum funding amount of $10,000 or more.

E. Adopt a prudent policy regarding expenditure of gift annuity funds for charitable purposes.

The most common practice by charities is to place the entire contribution for a gift annuity in a reserve fund and, upon termination of the annuity, use the residuum for charitable purposes. This practice is an assumption in the methodology underlying the ACGA rates.

There are some charities that elect to spend some portion of the contribution before termination of the obligation. This is permissible so long as the charity maintains sufficient reserves to back outstanding annuities and meet state reserve requirements. However, it increases the risk that, during an economic downturn, a charity may have to move some of its general funds into the reserve fund. A charity that finds itself financially-strapped may be tempted to spend a portion of each contribution when it is received, or to make an "early withdrawal" from the reserve fund. However, if the reserve fund later drops below the required amount, the charity may find it difficult to replace these "borrowed" funds. To avoid finding itself in such a situation, a charity should either use none of the contribution until the obligation terminates (the recommended procedure) or it should at least maintain surplus reserves, ideally of 125 percent or more of required reserves.

F. Promote gift annuities in good times and bad.

Although the annuity rates suggested by the ACGA are designed to preserve approximately 50% of a gift annuity's funding amount as residuum for the charity, the success of any individual gift annuity depends on the investment performance of its underlying assets, and that performance can be heavily dependent on timing. If a gift annuity is funded at the beginning of a significant market downturn (such as 2008), these assets may loose substantial value in the first year or two of the gift. This decline is compounded because the charity must pay the same annuity amount each year, further eroding the value of the underlying assets. The result can be an asset value that spirals downward and, if the annuitants live long enough, even goes negative.

Fortunately, the opposite can happen, too. If a gift annuity is funded at the beginning of a strong bull market (2009 or 2013), its funding assets may gain substantial value in the first few years of the gift. Since annuity payments are fixed, all of this increase stays in

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the gift annuity pool and can be invested to generate future increases. The result can be an asset value that spirals upward rather than downward.

The best way to limit the risk of bad timing is to diversify, to raise gift annuity dollars at all times in all markets. Some charities suspended or even terminated their gift annuity programs during the Great Recession of 2007-2008. This was exactly the wrong thing to do. These charities locked in the losses of their most recently acquired gift annuities while missing out on the gains that gift annuities issued in 2010-2013 would have enjoyed.

VIII. Conclusion

Gift annuities have appeal for a wide range of donors. While they should be of at least a certain size to be worthwhile for the charity, gift annuities can make sense for donors of even rather modest means. Immediate payment annuities generally are attractive to donors who are well into retirement, while deferred gift annuities and flexible gift annuities provide an opportunity to attract life income gifts from younger donors. Compared to charitable remainder trusts and pooled income funds, gift annuities are also relatively easy to set up and, with the exception of a few states, to administer. For all these reasons, charitable gift annuities are are by far the most popular form of life income gift.

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APPENDIX A

COMPARISON OF GIFT ANNUITIES AND CHARITABLE REMAINDER TRUSTS

	Gift Annuities	**Charitable Remainder Trusts**
Type of property accepted	Cash, publicly-traded securities, and possibly other assets	Cash, publicly-traded securities, closely held stock, real estate.
Number of individual beneficiaries	Maximum of 2	No maximum, provided present value of remainder interest is at least 10% of value of property contributed.
Amount of payments	Fixed amount based on ages of beneficiaries at time of contribution.	CRAT - Fixed amount, at least 5% of initial value of contributed assets. CRUT - set percentage (at least 5%) of trust assets as revalued annually.
Duration of payments	Life of beneficiaries	Life of beneficiaries or term of years, not exceeding 20.
Taxation of payments	Determined in advance. If cash contributed, partly tax-free, partly ordinary income for duration of life expectancy. If appreciated property contributed partly ordinary income, partly capital gain and possibly partly tax-free.	Per four-tier system: ordinary income, capital gain, tax-exempt income, and tax-free return of capital, depending on source of payments.
Income tax charitable deduction	Yes, for excess of contribution over present value of payments.	Yes, for present value of charitable remainder interest.
Tax on capital gain	Charity not taxed on gain. The gain attributable to present value of payments ratably reported by donor, if donor is a beneficiary. If donor not a beneficiary, this gain taxed up front to donor.	Trust not taxed on gain. Distributed gain taxed to beneficiaries.

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	Gift Annuities	**Charitable Remainder Trusts**
Charity at risk?	Yes, backs payments by total assets.	No, unless charity is fiduciary.
Beneficiary at risk?	If charity becomes insolvent.	If trust assets are exhausted.
Possible to designate purpose of gift	Yes, subject to charity's policies.	Yes, subject to charity's policies.
Ability to change charitable recipient	No, assets transferred to charity in exchange for contractual obligation.	Yes, can retain right in agreement.

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APPENDIX B

SCHEDULE OF ELECTIVE ANNUITY START DATES FOR CASE D ON PAGE 14.

Flexible Gift Annuity

ASSUMPTIONS:

Annuitant	50
First Payment Start Date in Range	3/31/2026
Last Payment Start Date in Range	3/31/2041
Cash Donated	$50,000.00
Payment Schedule	quarterly

BENEFITS:

Charitable Deduction$12,156.00

Schedule for Elective Payment Start Dates

Elective Start Date	Age at Start Date	Annuity Rate	Tax-free Portion	Ordinary Income	Total Annuity
3/31/2026	60	6.1%	$1,570.75	$1,479.25	$3,050.00
3/31/2027	61	6.3%	$1,631.70	$1,518.30	$3,150.00
3/31/2028	62	6.6%	$1,689.60	$1,610.40	$3,300.00
3/31/2029	63	6.8%	$1,761.20	$1,638.80	$3,400.00
3/31/2030	64	7.2%	$1,828.80	$1,771.20	$3,600.00
3/31/2031	65	7.6%	$1,900.00	$1,900.00	$3,800.00
3/31/2032	66	8.0%	$1,980.00	$2,020.00	$4,000.00
3/31/2033	67	8.3%	$2,066.70	$2,083.30	$4,150.00
3/31/2034	68	8.7%	$2,161.95	$2,188.05	$4,350.00
3/31/2035	69	9.2%	$2,267.80	$2,332.20	$4,600.00
3/31/2036	70	9.7%	$2,381.35	$2,468.65	$4,850.00
3/31/2037	71	10.4%	$2,490.80	$2,709.20	$5,200.00
3/31/2038	72	10.9%	$2,610.55	$2,839.45	$5,450.00
3/31/2039	73	11.5%	$2,742.75	$3,007.25	$5,750.00
3/31/2040	74	12.3%	$2,890.50	$3,259.50	$6,150.00
3/31/2041	75	12.9%	$3,050.85	$3,399.15	$6,450.00

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State Filing Required (Department of Insurance)

APPENDIX C

I. STATE LAW REQUIRES SEGREGATED RESERVE, ANNUAL REPORTING, AND/OR DETAILED APPLICATION (11):

STATE	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Investment limitations	Other registrations	Notes:
AL	- - -	- - -	yes	yes	- - -	- - -	Regulated by Securities Dept. rather than Insurance
AR	5	yes	- - -	yes[1]	yes[2]	- - -	[1] May elect to segregate AR annuitants; [2] Prudent investor standard allowed
CA	10	yes	yes	yes[3]	yes[3]	- - -	[3]CA annuitants only
FL	5	- - -	yes	yes[4]	yes[4]	- - -	[4] May elect to segregate FL annuitants;
HI	10 in HI	- - -	yes	yes	- - - [5]	- - -	[5] Prudent investor standard; law requires $200,000 of assets in Hawaii
MD	10 in MD	- - -	yes	yes	- - - [6]	- - -	[6] Prudent investor standard
NJ	10	yes	- - -	yes	- - -[7]	yes[8]	[7] Prudent investor standard; [8]registration w/ Div. of Revenue and Dept. of Law and Public Safety
NY	10	yes	- - -	yes	- - -[9]	- - -	[9] Prudent investor standard
ND	- - -	- - -	- - -	yes	- - -	- - -	
TN	- - -	- - -	yes	yes[10]	- - -[11]	- - -	[10] TN-only fund allowed but no longer mandated; [11]Prudent investor standard
WA	3	- - -	- - -	yes	- - -[12]	yes[13]	[12] Prudent investor standard; [13] registration w/ Secretary of State; organization must have $500,000, unrestricted net assets

II. STATE LAW PROVIDES FOR EXEMPTION - NOTIFICATION REQUIRED (15):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Available assets	Other registrations	Notes:
AK	3	- - -	yes	- - -	$300k	- - -	
CT	3	- - -	yes	- - -	$300k	- - -	
GA	3	- - -	yes	- - -	$300k	- - -	Annual submission of audited financial statement
ID	3	- - -	yes	- - -	$100k	- - -	
IA	3	- - -	yes	- - -	$300k	- - -	
MS	3	- - -	yes	- - -	$300k	yes[14]	[14] Registration w/ Secretary of State (as charitable organization)
MO	3	- - -	yes	- - -	$100k	- - -	
MT	3[15]	- - -	yes	yes[15]	$100k[15, 18]	- - -	[15] Waived if reinsured; [16] $100,000 in unrestricted assets or $300,000 net worth; annual renotification
NV	3	- - -	yes	- - -	$300k	- - -	
NH	3	- - -	yes	yes	$300k	yes[17]	[17] General registration with the Dept. of Justice; annual renotification; annuity rates must not exceed ACGA suggested rates
NM	3	- - -	yes	- - -	$300k[18]	- - -	[18] Either in unrestricted assets or reserve fund
NC	3	- - -	yes	- - -	$100k	- - -	
OK	3	- - -	yes	- - -	$100k	- - -	Annual submission of audited financial statement
TX	3	- - -	yes	- - -	$100k	- - -	
WV	3	- - -	yes	- - -	$300k	- - -	

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No State Filing Required (Department of Insurance)

III. State law provides for exemption - no notification required (20):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Available assets	Other registrations	Notes:
AZ	3	- - -	- - -[19]	- - -	$300k	- - -	[19] Detailed disclosure statement to donor prior to gift
CO	3	- - -	yes	- - -	- - -	- - -	
IL	20[22]	- - -	- - -	- - -	$2 mil.[20]	- - -	[20] Waived if annuities reinsured
IN	- - -	- - -	- - -	- - -	- - -	- - -	
KS	- - -	- - -	- - -	- - -	- - -	- - -	
KY	- - -	- - -	- - -	- - -	- - -	yes[21]	[21] Certain charities must file copy of Form 990 with Attorney General
LA	- - -	- - -	- - -	- - -	- - -	- - -	
ME	5	- - -	- - -	- - -	- - -	yes[22]	[22] Registration w/ Secretary of State (qualified as foreign corporation)
MA	- - -	- - -	- - -	- - -	- - -	- - -	
MI	- - -	- - -	- - -	- - -	- - -	- - -	
MN	- - -	- - -	- - -	- - -	- - -	- - -	
NE	3	- - -	- - -	- - -	- - -	- - -	
OR	5	- - -	yes	yes	$300k	- - -	
PA	3	- - -	yes	yes	$100k	yes[23]	[23] Certain charities must register w/ Dept. of State (general solicitation law)
SC	5	- - -	- - -	- - -	- - -	- - -	
SD	10	- - -	yes	- - -	$500k	yes[24]	[24]Registration w/ Secretary of State (qualified as foreign corporation)
UT	- - -	- - -	- - -	- - -	- - -	- - -	
VA	3	- - -	yes	- - -	$100k	- - -	
VT	3	- - -	yes	- - -	$300k	- - -	
WI	3	- - -	yes[25]	- - -	- - -	- - -	[25]Registration w/ Secretary of State (qualified as foreign corporation)

IV. State law does not specifically address gift annuities (5):

DE[26] DC OH[27] RI WY

[26] Insurance Code definition of annuity excludes those issued by tax-exempt organizations.
[27] Ohio previously provided for an exemption from securities law under now rescinded administrative rule. Court of Appeals case decided in 2002 held gift annuities not subject to insurance regulation (Ohio Supreme Court declined to hear appeal).