GIFT ANNUITY CHALLENGES AND HOW TO ADDRESS THEM

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Presented by:

Bill Zook, Vice President and
Director, Seattle Office
PG Calc
115 NE 100th Street NE, Suite 300
Seattle, Washington 98125-8008
Phone: (206) 329-8144
Email: bzook@pgcalc.com
Website: www.pgcalc.com

I. Introduction

Despite their relative simplicity, charitable gift annuities sometimes entail complications. Certain challenges are present – if perhaps lurking in the background – in every gift annuity. Others reveal themselves early on when specific fact patterns occur. Still others can create surprises as events unfold over the years in connection with what had previously seemed to be just "plain vanilla" arrangements.

While this paper is not a systematic, comprehensive treatment of all potential challenges associated with gift annuities, it does highlight a dozen relatively common or at least potentially significant situations gift planners will find it helpful to be aware of. In each instance the paper offers ideas either for overcoming obstacles entirely or for minimizing concern and negative consequences.

II. Inherent Challenges

A. In issuing gift annuities, a charity takes on some risk.

<u>Discussion of the Challenge</u>

The ultimate risk a charity faces with each annuity it issues is that the amount contributed could be exhausted before the payment obligation ends. In that event, because the obligation is absolute, the charity would need to draw upon other assets to make the remaining payments, and when the obligation finally ended, nothing would be left for charitable use. This is a particularly troubling result when a gift annuity has been established to further a particular charitable purpose, rather than simply for the charity's general, unrestricted use. Still, even the most successful gift annuity programs occasionally lose money on a gift annuity.

A related risk is that the financial benefits a charity derives from its gift annuity program will be subpar. An organization can take little comfort in minimizing the number of gift annuities that lose money if it otherwise typically nets only modest amounts. What constitutes a modest residuum? A good working benchmark is anything substantially less than half of the amount contributed. For many decades, the American Council on Gift Annuities (ACGA) has used a target residuum of 50 percent in formulating its suggested gift annuity rates. Because the overwhelming majority of U.S. charities offering gift annuities adhere to those rates, achieving a lower residuum is at least implicitly an unwelcome result. This is especially so, given that surveys conducted by the ACGA over the last 20 years reveal that charities generally wind up with something more than half of what was contributed for each annuity.

Here again, even in the case of a successful gift annuity program, certainly not every gift annuity the charity issues can be expected to produce a residuum of at least 50 percent. The goal, though, should always be not only to minimize the downside but also to maximize the upside. In other words, whenever solid results are achievable, mediocre results should not suffice.

In setting its suggested annuity rates, the ACGA acts on behalf of charities (as well as annuitants) to address three fundamental risks that underlie the more global risks just discussed: mortality risk, investment risk, and the risk that whatever victories a charity wins in confronting

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the first two will be squandered by excessive fees and other direct costs of operating a gift annuity program. Although detailed consideration of these three risks is beyond the scope of this paper, each deserves a brief bit of attention.

Mortality risk is the possibility that a particular annuitant will live significantly longer than one would expect based on his or her age. The ACGA rates compensate for this risk by increasing the life expectancy associated with each applicable age in two ways. First, even though ACGA surveys conducted over the years have found that slightly more than half of annuitants are women, the ACGA rates are based on the assumption that all annuitants are women. Since women have longer life expectancies than men, this adds an element of conservatism with respect to male annuitants. Second, with respect to all annuitants, an additional element of conservatism is found in the fact that every annuitant is assumed to be a full year younger than he or she actually is.

Investment risk reflects the possibility that the charity may earn an insufficient return on what donors have contributed for gift annuities. On the one hand, it is not realistic to expect a charity to earn each year the amount that needs to be paid in connection with all of its annuities for that year. Still, a charity should take prudent steps, through diversification, careful investment selection, etc., to maximize its return on the investment of gift annuity contributions, recognizing that the higher the desired return, the greater the risk. With this in mind, each time the ACGA develops or reviews a set of suggested annuity rates, it attempts to factor in a reasonable rate of return a charity can expect to earn on a realistic mix of cash, bond, and stock investments. At present, that rate is a relatively low 4.25 percent. It is based on current interest rates associated with fixed income instruments, as well as on historical returns associated with stock investments, as reduced to account for potential poor results during some years.

Expense risk is how one might conceive of the final category of concerns a charity should anticipate. While the charity will certainly incur costs for things such as staff time and marketing materials in the course of conducting its gift annuity program, these sorts of expenses are properly paid with funds other than the assets contributed for annuities. By contrast, fees for investment management and payment processing, along with tax and regulatory compliance, relate directly to maintaining a gift annuity effort. Drawing upon input from various sources, the ACGA's suggested rates assume that each year a charity will devote 1.0 percent of its gift annuity assets to paying such expenses. This effectively results in a current net rate of return on gift annuity investments of 3.25 percent.

Moreover, the ACGA assumes a charity will not spend any portion of any contribution until the applicable payment obligation has ended. This means that if a charity appropriates some of what a donor has contributed for a gift annuity before the annuity terminates – whether in a lump sum or periodically by means of recurring internal fees that exceed true expenses – this will increase both its investment risk and its expense risk.

To some extent, a charity will be better able to spread risk the more annuities it has, provided it exercises appropriate care in conducting its program. Yet even the very largest programs in the country generally do not benefit from the ability to neutralize mortality risk, obtain superior investment diversity, or control expenses through disciplined efficiency the way that even small insurance companies do. Nevertheless, a charity with 20 well-managed annuities probably has less risk than one with 10 such annuities, one with 50 has less risk than one with 20, etc.

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Note: Even though the discussion above makes frequent reference to the ACGA and to how it addresses the different forms of risk when it goes about establishing a set of suggested annuity rates, those risks exist regardless of the annuity rates a charity offers.

How to Address the Challenge

While no charity can eliminate completely the risks associated with gift annuities, those risks can be made tolerable by establishing sensible policies related to gift annuities, adhering to those policies once they have been adopted, and continually monitoring both the gift annuity program as a whole and the health of any individual annuities that may be faring poorly.

With regard to policies specifically, a charity should exercise care in setting forth:

- the maximum annuity rates to be offered;
- the minimum contribution amount;
- the maximum contribution amount (above which the charity, while not automatically declining to issue a gift annuity, will at least review in detail the acceptability of the arrangement);
- the types of assets that can be contributed;
- the minimum age of annuitants at the time payments begin;
- how much of a contribution may be spent before the annuity payment obligation ends (preferably zero, aside from what is needed to make payments and cover reasonable direct expenses); and
- prudent criteria for the investment of gift annuity contributions, along with assignment of responsibility for making investment decisions and evaluating investment results.

With regard to some of the bullet points above, surveys conducted by the ACGA during the last two decades provide valuable information about the policies of charities that responded to the surveys. Even though the survey completed most recently dates from 2009, the ACGA is currently conducting a new comprehensive survey, and information about it can be found on the organization's website (www.acga-web.org). With regard to all of the bullet points, however, what other charities do is merely one factor to be weighed, meaning each charity should determine for itself what is prudent.

Finally, consistent with what state law either permits or requires, a charity may want to consider purchasing a commercial annuity in order to secure the cash flow required to make the payments associated with any of its gift annuities. This so-called "reinsurance" approach may or may not make sense, depending on a gift annuity's charitable objectives and on the amount of time that has passed since the gift annuity was established. In any event, the security of the cash flow will ultimately be a function of the financial solidity of the insurance company selected.

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B. Annuitants also face some risk.

Discussion of the Challenge

One type of risk – although it is almost always going to be quite remote – is that the charity will become insolvent and therefore cease being able to make the annuity payments. Of course, an annuitant can generally feel relatively secure in knowing that the payment obligation undertaken by the charity is backed by all of the organization's assets, not just those contributed for gift annuities. In addition, under the law of several states, a charity must maintain a segregated reserve account to cover its gift annuity obligations, plus some charities maintain such accounts of their own accord. Nevertheless, an account could be exhausted or, in the case of insolvency, the assets within the account might not be insulated from the charity's other creditors. Unlike a bank deposit or a commercial annuity, a gift annuity is not backed by a guaranty association. Indeed, if a charity's financial situation worsens to the point that no source of funds remains available to draw upon in making annuity payments, the annuitant will probably have nowhere else to turn.

A separate concern is that the purchasing power of the annuity payments will decline over time, perhaps to an undesirable level. Inflation has been a reality in our economy for the better part of a century now, and while it is conceivable the purchasing power of a fixed sum of money received annually might actually increase at some point in the future (as a result of deflationary economic conditions), an annuitant should focus on the greater likelihood of at least some inflation occurring each year for the rest of her life. Moreover, an annuity's purchasing power will always be further eroded to some extent if an annuitant lives long enough that all of each annuity payment received from that point on is taxed strictly as ordinary income.

How to Address the Challenge

To the extent such is indeed true, the charity should assure potential donors that it is (and will likely remain) financially solid. This can be accomplished by sharing audited financial data, as well as perhaps by letting donors know that all annuity obligations have been met fully during the years/decades the charity has been issuing annuities.

Once a gift annuity has been established, the annuitant's role is a fairly passive one. Accordingly, the charity has a duty to confront conscientiously all the various risks it faces, not simply for its sake but also for the sake of its annuitants. The only conflict of interest is that the longer an annuitant lives, the less financial benefit the charity will derive from the arrangement (unless the annuity has been reinsured).

For her part, however, an annuitant who is also the donor should consider the charity's financial soundness before establishing a gift annuity with it. In addition, as payments are made each year, an annuitant may well be in a position to reduce her expenses in proportion to any decline in the purchasing power of the payments attributable to inflation.

A donor concerned about the impact of inflation could also supplement a gift annuity with one or more additional gift annuities as part of a so-called "step annuity" arrangement. Each subsequent annuity would be a deferred annuity, with the amount paid and the commencement of the

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payments designed to provide extra cash flow in later years based on how inflation is likely to reduce the purchasing power of the payments associated with the first annuity in the series.

C. Most states regulate gift annuities to one extent or another.

Discussion of the Challenge

A charity's legal right to issue gift annuities is governed not only by the law (usually statutory but occasionally administrative or judicial) of the state in which it is based, but also by the law of the state in which the donor resides. States vary widely in the extent to which they regulate gift annuities, both with respect to the basic ability to issue gift annuities at all and with respect to the procedures a charity must follow once it has begun to issue gift annuities. Below is a quick overview of what different states require.

1. State has no source of law specifically addressing gift annuities – DE, DC, OH, RI, and WY

On the one hand, such states have no particular requirements. On the other hand, their silence as to the status of gift annuities leaves open the possibility that charities issuing gift annuities could be regulated in the same manner that insurance companies selling commercial annuities are regulated.

2. State has no requirement that it be notified a charity is issuing gift annuities– AZ, CO, IL, IN, KS, KY, LA, ME, MA, MI, MN, NE, OR, PA, SC, SD, UT, VT, and VA

Nevertheless, before a charity can issue, in about two-thirds of these states it must meet one or more of the following requirements:

- have been either simply in existence or actively operating for a certain period of time;
- include certain disclosure language in gift annuity agreements;
- maintain a reserve account;
- have a certain level of unrestricted assets; and
- comply with separate legal requirements applicable to charities generally.

3. State must simply be notified before a charity issues gift annuities – AK, CT, GA, ID, IA, MS, MO, MT, NV, NH, NM, NC, OK, TX, WV

As with the states that have no notification requirement, certain additional requirements apply. Specifically, all of these states mandate a minimum period of time in existence/operation, certain disclosure language in gift annuity agreements, and a certain level of unrestricted assets.

4. State must affirmatively grant a charity permission to issue gift annuities – AL, AR, CA, FL, HI, MD, NJ, NY, ND, TN, WA, and WI

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The application process can sometimes take many months, and during this period the charity should not issue any gift annuities in the state. All such states require the charity to maintain a reserve account, as well as to submit some sort of filing each year. Many of them also have additional requirements similar to those that exist in connection with the two immediately preceding categories of states. In several cases, the charity must pay a fee when applying and annually thereafter, whereas fees are not charged by states in any of the other categories.

How to Address the Challenge

At a minimum, a charity must comply with the requirements of its own state. Thereafter, the charity can decide whether it will issue gift annuities in any other states. In each state where it does decide to issue, however, it will need to comply with the state's requirements by the time it issues its first gift annuity in that state. Fortunately, a number of vendors are available to assist charities with the various requirements different states have.

Note: As a practical matter, gift annuities are also subject to federal regulation, specifically by the IRS (in connection with the tax rules applicable to gift annuities and with various reporting requirements) and by the Securities and Exchange Commission, although regulation by the latter agency can be avoided entirely so long as a charity complies with the relatively simple disclosure requirements of the Philanthropy Protection Act of 1995.

III. Challenges at the Gift Planning Stage

A. Another charity is offering higher gift annuity rates.

Discussion of the Challenge

This challenge occurs relatively infrequently because almost all U.S. charities adhere to the rates suggested by the ACGA. Nevertheless, occasionally a particular donor will have been in contact with a charity that offers higher rates. The donor will then inquire of other charities whether one or more of them would be willing to match – or perhaps even exceed – the rate available from the first charity. In deciding whether to exceed the rates it normally offers (regardless of whether such rates are the ones suggested by the ACGA), a charity will likely have two primary concerns: increasing its risk and possibly violating state regulatory requirements.

Issuing an annuity at a higher rate can be a main or contributing factor in the annuity underperforming, i.e., the reserves held for the annuity becoming exhausted before the payment obligation terminates. As noted in the discussion under Challenge 1 above, in setting its rate schedule, the ACGA uses assumptions regarding certain matters, including residuum, mortality, investment return, and expenses. Presumably any charity that has created its own rate schedule would similarly have specific assumptions that form the basis for the rates. However a charity's rates have been settled upon, it should understand the assumptions and then assess the risk it would be taking on if it exceeded those rates in one or more instances. Of course, even if the charity does not lose money by offering a higher rate, the residuum it nets will necessarily be less than if it had not exceeded its standard rate, all other factors being the same.

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Apart from increasing the risk of exhaustion and decreasing the residuum, a charity needs to consider as well whether offering a higher rate would violate the requirements of any states in which it is issuing gift annuities. New Hampshire specifically prohibits offering annuity rates higher than those suggested by the ACGA at the time the annuity is issued. Certain other states – Alabama, Arkansas, California, Maryland, New Jersey, New York, Washington, and Wisconsin – require that a charity put on file a schedule of its *maximum* rates, and once filed the charity is not authorized to offer rates higher than those in the schedule (until/unless it files a revised schedule of rates with the state). California, in particular, has emphasized the inability to exceed the filed schedule, and views offering a higher rate as a discriminatory rating practice. Even if offering a higher rate would be acceptable to all applicable states, if any of those states has a reserve requirement, then the charity will likely need to hold in its reserve account a larger amount of money.

How to Address the Challenge

This is sort of a moment of truth for a charity. First, the charity might do well to confirm independently that the other charity is in fact willing to offer the rate the donor has claimed it is offering. Assuming confirmation is obtained, the charity can – after taking into account the considerations noted in the discussion above – either choose to match the rate or decline to do so.

In opting for the latter course, the charity can point out that the donor will receive a lower income tax charitable deduction. If the charity adheres to the rates suggested by the ACGA, it can also bring to the donor's attention the rationales that support such adherence. First, when charities offer the same rates, each donor can base his or her decision on which charity is most worthy of support, rather than on which one offers the highest rate. It also assures more dollars will be left for the charity than if it offered a higher rate. In addition, when charities compete with each other on rates, they could cause a gift annuity to be perceived as an investment, rather than as a means of making a charitable gift. That, in turn, could stimulate additional government regulation.

B. The donor is not the same person as the annuitant.

Discussion of the Challenge

Even though for the most part donors establish gift annuities to benefit solely themselves (and, of course, charity), annuity payments can be made to any one or two persons regardless of their relationship to the donor. For starters, however, a charity should be clear on the identity of the donor.

By way of example, gift annuities are frequently established by married couples using jointly-owned or community property. Nevertheless, sometimes an asset that two spouses regard as being owned by both of them turns out to be owned by only one of them, meaning that he or she alone will be the donor (unless measures are taken to transform his or her separate property into property owned by both spouses). Likewise, one spouse may not be aware that an asset he or she thinks is separate property is really owned jointly with the other spouse (although, once again, the two spouses can change the ownership if they wish). Furthermore, a donor claiming to want to donate "his" real estate in exchange for a gift annuity may need to confront the reality that the property is owned by a limited liability company or some other entity in which the donor has an

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ownership interest. In short, would-be donors sometimes claim to own assets that either are not theirs at all or that they own along with others.

In the context of a gift annuity, one issue will be the potential gift and/or estate tax implications of the particular donor-annuitant combination in question. In great measure, the historically large gift and estate tax exemptions in effect since 2011 remove these transfer taxes (as well as the generation-skipping transfer tax) from play in the case of almost all donors. Still, a gift planner must keep the threshold, $5.25 million currently and adjusted for inflation in the years to come, in mind in order to spot situations in which they must be confronted. Moreover, because a gift planner is seldom privy to all aspects of a donor's tax and financial situation, issuing a sort of default warning along the lines of "there may be gift and estate tax consequences for you, so please consult with your own advisors" might be a good idea.

Even when transfer taxes definitely appear to be an issue, the way in which an annuitant is related to a donor will be significant. One important distinction is whether an annuitant is a donor's spouse (with a further distinction needing to be made between U.S. citizen spouses and foreign spouses). Similarly, different degrees of kinship become relevant in connection with the generation-skipping transfer tax.

In addition, if a gift annuity is to be funded with capital gain property, a gift planner must keep in mind that the taxable portion of the gain can be spread only over the life expectancy of any donor or donors receiving the annuity payments initially. This means that if a husband and wife establish a gift annuity with capital gain property they own jointly but annuity payments are made to only one of them initially, half of the taxable gain will be realized in the year of the gift. Conversely, if a spouse uses her separate capital gain property to establish a gift annuity for the benefit of both herself and the other spouse, the gain can be spread only over the donor spouse's life expectancy (assuming all of the gain can be paid out over that period). Thus, in such a situation, the annuity is best structured so that payments are made initially strictly to the donor spouse and then to the other spouse if she survives the donor.

How to Address the Challenge

At least in the case of gift annuities established during the lifetime of the donor, the making of a large taxable gift to a non-donor annuitant can be postponed until the donor's death. This effectively transforms what would have been a single transfer for gift tax purposes into a series of smaller annual gifts followed by a possible subsequent transfer (typically of a reduced amount) for estate tax purposes. This is accomplished through the inclusion of a revocation provision in the gift annuity agreement. Even though the donor likely will never exercise his or her right to revoke an annuitant's interest in the annuity payments, merely reserving that power makes what for gift tax purposes would have been (1) a completed transfer equal to the present value of the annuitant's right to the annuity payments into (2) a series of annual gifts, each of which equals only the amount paid in that particular year. The power can generally be designed for exercise either during the life of the donor or upon his or her death, although applicable state law can affect the finer points of revocation rights.

Despite the existence of a fairly simple, definitely effective way around possible gift tax liability, some donors choose to have their gift annuities produce completed transfers anyway. Again, because the threshold for the federal gift tax is now so very high, a donor may well not owe any

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gift tax after making a taxable transfer. By contrast, transfers that are effective upon death (whether as a result of the gift annuity being testamentary to begin with or the taxable transfer becoming an estate tax matter, rather than a gift tax matter, as a result of the retention in the gift annuity agreement of a power of revocation) require the donor to confront the reality that some estate tax may be owed, depending on a variety of factors.

As to the capital gain tax issue, the handful of "fixes" that are available apply mostly either when the donor-annuitant scenarios involve strictly spouses (who will usually be able to transform jointly-owned assets into one spouse's separate property or vice-versa) or, in the case of a two-life annuity, when there is only one donor and he or she is the sole recipient of payments initially (a situation which, as noted above, can occur even between spouses). Otherwise, the consequence will be that some or all of the taxable capital gain will be recognized by the donor(s) in the year of the gift. This makes it worthwhile for a gift planner to work with the donor(s) and any advisors to determine the extent to which the charitable deduction will be able to offset the capital gain.

C. A donor or an annuitant lives outside the United States.

Discussion of the Challenge

The issue is not so much whether a donor or an annuitant lives outside the U.S. as it is whether the person is a U.S. citizen or is, for one reason or another, already a U.S. taxpayer. If either status applies, the tax aspects of a gift annuity will be largely the same as if the person lived in the U.S. Therefore, the balance of this discussion focuses on a situation in which the person is not a U.S. taxpayer.

From the donor's point of view, the tax consequences with the country where the donor resides will be a function of the laws of that country, along with whatever tax treaty that country may have with the U.S. To review the rules pertaining to different countries is well beyond the scope of this paper. Nevertheless, it is at least safe to point out that a U.S. charity cannot send a foreign national a typical gift annuity illustration, such as one generated using PG Calc software, and represent that the illustration reflects the tax implications for that person.

When gift annuity payments are made to a resident and citizen of another country, the taxable portion of each payment – as calculated according to U.S. law – may be subject to withholding by the charity. The withholding rate will vary depending on the provisions of the tax treaty, if any, between the U.S. and the country where the annuitant resides. For example, the withholding rate for Canadians is 15%, whereas for residents of the United Kingdom it is zero. For information on a specific country, see IRS Publication 515. In the absence of a treaty, the withholding rate is 30%. Even if a relevant treaty exists, a withholding rate of 30% applies unless the annuitant submits a completed IRS Form W-8BEN to the charity and complies with any requirements set forth in the treaty.

Finally, a charity must be especially alert to the tax issues associated with any two-life annuity featuring an initial annuitant who is a U.S. citizen and a successor annuitant who is not. Such an annuity will start out being administered like any other but could require special attention once the first annuitant dies.

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How to Address the Challenge

When issuing a gift annuity involving a foreign donor or annuitant, a charity can proceed just as it would with any other annuity. In particular, the gift annuity agreement would be worded the same, and the charity would offer an annuity rate based on the age(s) of the annuitant(s). Similarly, going forward the charity would – to the extent applicable – take the annuity into account in meeting state reserve account requirements.

In other respects, however, the charity needs to be prepared to depart from its standard practices. In the case of a foreign donor, the gift planning staff (working with any advisors the donor may have) will need to devote extra attention to making sure the donor knows the tax implications of setting up a gift annuity. In the case of a foreign annuitant, the charity may well need to get up to speed on withholding rates and forms and then actually perform the withholding and send the money to the IRS.

D. A donor proposes to contribute two or more different types of assets.

Discussion of the Challenge

The majority of gift annuities are established strictly with cash. Most of the others are established strictly with long-term appreciated publicly-traded securities. In the relatively uncommon instance in which the overall contribution consists of more than one type of asset (including a combination of cash and long-term appreciated publicly-traded securities), one or more sets of special issues can arise.

First, different assets may fall into different tax categories. For example, a gift annuity funded partly with long-term appreciated securities and partly with long-term appreciated real estate not held by the donor as inventory is ultimately going to be simply one funded with long-term capital gain assets. By contrast, when the deduction for one type of contributed asset will be a function of its fair market value (for example, long term appreciated property) and the deduction for another type of contributed asset will be a function of its cost basis (for example, short term appreciated property), additional care will need to be devoted to sorting out the tax implications. The same holds true when any increase in value in one type of asset is treated as long-term capital gain while any increase in the value of another type of asset is treated as ordinary income.

Next, because the process for transferring an asset can vary from one type of asset to another, it is often the case that when a charity receives two different types of assets, they are received on different days. Thinking again of a gift annuity funded partly with long-term appreciated securities and partly with long-term appreciated real estate, one should not automatically expect the charity to receive both assets on the same day. Of course, differing contribution dates can occur even when two assets of the same type are contributed: e.g., 50 shares of ABC Corporation stock arrive on day one and 100 Shares of XYZ Enterprises, Inc. stock arrive on day two.

Finally, if a gift annuity is funded partly with cash or readily marketable assets such as publicly-traded securities, and partly with illiquid assets such as real estate, the issuing charity may choose to reduce somewhat the annuity rate it offers to account for the increased costs and uncertainty attributable to the illiquid assets. The amount of the reduction will mostly be a

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function of the relative values of liquid and illiquid assets, plus any characteristics unique to the illiquid assets in question.

How to Address the Challenge

The tax issues that can accompany a gift annuity funded with two or more types of assets are best confronted by being aware of the ways different types of assets are taxed in the context of a gift annuity and then providing the donor with an appropriate analysis before he or she commits to establishing the annuity. For example, in almost all instances in which a donor is considering a contribution of property owned at a loss, the donor will conclude that it makes more sense to look at either contributing different assets or selling the property, capturing the loss, and then contributing some or all of the cash resulting from the sale.

If a gift annuity is funded with assets received by the charity on two (or more) different days, the preferred approach is to have a separate gift annuity agreement for each day a contribution takes place. This will always be acceptable from a legal standpoint. As an alternative, depending on the nature of the understanding between the donor(s) and the charity, a single gift annuity agreement could be executed.

If, for example, publicly-traded securities are involved and if the charity wishes to sell each security as soon as it is received, then for purposes of calculating the amount of the total contribution, each of the assets transferred is valued as of the date of its contribution. Nevertheless, if the charity and the donor(s) concur, the obligation to pay the annuity can commence on the date of the last transfer. In that case, the annuity agreement would be made effective on the date of the last transfer, and, assuming an immediate gift annuity is being established and the initial payment would be prorated, the proration would be from that date to the end of the period. The agreement should also recite that the value of each asset contributed for the gift annuity is determined as of the date it was received.

If publicly-traded securities are involved but the charity and the donor(s) decide that the charity – acting as agent for the donor(s) – will retain the securities until all of them have been received, the securities would be valued as of the date of the last transfer. (Once all the securities have been transferred, the agency arrangement would cease and the charity would be free to sell the securities in its own right.) The obligation to pay the annuity would commence on the date of the last transfer. This approach will result in a single gift annuity agreement, dated as of the date of the last transfer. The charitable deduction will be calculated using the date of the last transfer as the gift date and the amount of the total contribution (valued as described earlier in this paragraph) as the gift amount.

Before settling on a single-agreement approach in connection with receipt of any type of assets on two or more days, the charity should consult its legal counsel. Even if that person sees the approach as basically viable under applicable state law, the longer the span of time involved the more that viability may be compromised. Moreover, the multiple agreement approach should always be used if between the date of the first transfer and the date of the last transfer there is a change in (1) the calendar year, (2) the nearest age of an annuitant, or (3) the federal discount rate.

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Whichever method the charity settles upon, it should alert the donor early on to the issues involved. If a donor does not understand why two or more agreements would need to be signed for what in the mind of the donor is a single gift, it may help to assure the donor that the periodic payments made pursuant to each agreement can be combined in a single check or direct deposit and that the annuitant's annual tax information can be similarly combined in a single 1099-R form.

E. A contribution will be made from, or annuity payments will be made to, a revocable living trust.

Discussion of the Challenge

With the typical revocable living trust, the person who established the trust, i.e., the trustor, will be its sole initial beneficiary for life. Even though technically the trust – rather than its trustor-beneficiary – owns all assets transferred into it, for tax purposes the trust is transparent. Thus, so long as the only beneficiary of the trust is also the only living trustor, any trust assets transferred from the trust to a charity at the direction of that person should be treated for tax purposes as though they were contributed directly by him or her. Still, the transfer needs to be documented properly. **Note**: In some cases a married couple will establish a single revocable living trust, and the two spouses will be the trust's sole initial beneficiaries on a joint-and-survivor basis.

In addition, regardless of whether a gift annuity was funded with assets transferred from a revocable living trust, an annuitant may want to have the annuity payments be made to the trust. This, too, should be possible, provided once again that the arrangement is properly documented.

How to Address the Challenge

The failsafe approach for using assets in a revocable living trust to establish a gift annuity is for the donor, in his or her capacity as the trustor-beneficiary, to have the trust first transfer the assets in question out of the trust and back into his or her name as legal owner. The donor then contributes those assets to the charity just as any other individual would do with his or her own property. If a donor is cautious by nature or if his or her legal counsel recommends this course of action so that there will be no question about the tax consequences of establishing the gift annuity (especially if long-term appreciated capital assets are contributed), then this is what the donor should do.

Many donors and their legal counsel are comfortable, however, in having the contributed assets transferred from the trust directly to the charity. If this route is taken, the gift annuity agreement should clearly recite that the trustor-beneficiary himself or herself (rather than the trust) is the donor, although he or she could be further identified with additional language: e.g., "John Smith, individually and in his capacity as trustor and beneficiary of the John Smith Trust, hereinafter referred to as 'the donor' . . ." As an alternative, so long as the gift annuity agreement makes clear that the contribution was made by the donor, he or she could sign separate documentation confirming that even though the assets in question came from his or her living trust, this was done merely for convenience.

Likewise, even if it is known at the time a gift annuity is established that the annuitant would like the payments to be made to his or her revocable living trust, this should not be recited in the gift

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annuity agreement. Instead, the agreement should identify the annuitant as an individual and make clear that the charity's payment obligation is to that individual. Nevertheless, in a separate letter or other document, the annuitant would request that – again, for the sake of convenience – the charity make payments to his or her trust, rather than to him or her individually. The document would go on to confirm that the annuitant is aware that he or she will be taxed on the payments just as though they were made to him or her directly. Finally, the document should make clear the annuitant has the ability to request at any time that some or all of each payment henceforth be made to him or her directly, not to the trust.

IV. Challenges That Can Arise as Time Passes

A. An annuitant wants to change the frequency or timing of the annuity payments.

Discussion of the Challenge

Occasionally, an annuitant will inquire about changing the frequency of annuity payments. For instance, he or she may want to receive payments quarterly in lieu of the semi-annual payments specified in the gift annuity agreement. This should be permissible, so long as the new schedule of payments does not result in an increase in the present value of the annuity and so long as the charity and the annuitant document that they have agreed to a new payment frequency

Similarly, an annuitant may want to alter the timing of the annuity payments, perhaps beginning to receive monthly payments on the 15th of each month, rather than on the last day of the month as called for in the gift annuity agreement. Here again, it would be necessary to make certain that the present value of the annuity as calculated according to the new payment timing did not exceed the present value of the annuity as calculated using the timing set forth in the gift annuity agreement. The acceptability of the new timing to both parties would also need to be documented.

How to Address the Challenge

If payments will be made less frequently – quarterly instead of monthly, semi-annually instead of quarterly, etc. – and the total amount paid each full year remains the same, then the present value of the annuity under the new arrangement will actually be lower than it had been. Since the annuitant receives no added benefit, the new arrangement poses no problem (and, at least in theory, would entitle the annuitant to a small income tax charitable deduction).

If the charity and the annuitant agree to have payments made with the same frequency but at a later date (e.g., quarterly payments made on the last day of each calendar quarter, rather than on the 15th day of the last month of each calendar quarter as provided for in the gift annuity agreement), no reduction in the total amount paid annually would be necessary. This is because the annuitant would not be accelerating his or her receipt of money, an outcome that would increase slightly the present value of the annuity.

If, however, the annuitant wants payments to be made more frequently, the present value of the annuity will increase if the total amount paid annually remains unchanged. Such a result would be inconsistent with the charitable deduction claimed by the donor when the gift annuity was

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established. Consequently, when annuity payments are made more frequently, it is necessary to reduce the total amount paid annually in order to keep the present value of the annuity the same. Consider the following example:

An annuitant whose date of birth is September 22, 1927 receives an annuity of $7,800.00 in installments of $1,950.00 made on the last day of each calendar quarter in connection with a gift annuity established on December 15, 2006 with a contribution of assets worth $100,000. On October 1, 2013 she and the charity enter into a written agreement that starting on October 31, 2013 the charity will pay the annuity in monthly installments of $648.71 at the end of each calendar month. The $648.71 was arrived at with the assistance of PG Calc's Planned Giving Manager software through a process with several steps.

1. *Calculate the present value factor for $1.00 per year paid in quarterly installments over the annuitant's current life expectancy (as determined using the applicable IRS adjusted expected return multiple for a person the annuitant's age) using the October 2013 federal discount rate of 2.4% and October 1, 2013 as the date of the gift. This figure is 5.2491.*

2. *Calculate the present value factor for of $1.00 per year paid in monthly installments over the annuitant's current life expectancy using the same method as in Step 1. This figure is 5.2595.*

3. *Divide the Step 1 figure by the Step 2 figure and multiply the result by $7,800.00. The result is $7,784.58, which will be the new total amount to be paid each full year.*

4. *Divide the Step 3 figure by 12, as henceforth the annuity will be paid in 12 equal monthly installments. The result, rounded down to the nearest penny, is $648.71. This is just slightly less than the $650.00 one would get if one simply divided the $1,950.00 quarterly payment by three.*

Note that in making the calculations, the discount rate must be the one for the month in which the new payment frequency takes effect (in this case, October 2013). There is no option to select a discount rate from either of the two prior months, as the calculation is not being performed in the context of an arrangement that will produce a charitable deduction. Also, the lower the discount rate, the smaller the reduction in the total amount paid annually when payments become more frequent.

Finally, with regard to the taxation of annuity payments going forward, when the payment frequency is changed and, as a result, the total amount paid each year becomes somewhat smaller, the ordinary income portion of what is paid each year needs to be reduced by the difference between the old annual amount and the new annual amount. Any portions that are tax-free or taxed as capital gain do not change.

B. Two married annuitants get divorced.

<u>Discussion of the Challenge</u>

When a charity learns that a husband and wife who are both annuitants under a gift annuity agreement have divorced, adjustments in the charity's administration of the annuity will depend

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on the terms of the agreement itself unless perhaps the annuity has been specifically addressed in the divorce decree or property settlement agreement. Usually spouses have established a joint and survivor annuity, with each party being entitled to one-half of the annuity payment. However, from an administrative perspective, typically with such annuities a single payment is made to the two spouses and a single Form 1099-R is issued under one spouse's social security number.

How to Address the Challenge

Assuming no other arrangement has been specified in the divorce decree or property settlement agreement, the charity should begin sending a payment of one-half of the full amount to each of the annuitants, and issuing two Forms 1099-R, one to each ex-spouse reflecting their half. Upon the death of the first of the two annuitants to die, the full annuity amount should be paid to the survivor for life, again unless a divorce decree or property settlement agreement directs otherwise or the annuitant who dies first is also a donor and has retained and exercised a power to revoke the other annuitant's survivorship interest in the portion of the payments attributable to the deceased annuitant's share of the property used to establish the gift annuity. If the annuity was set up with successive rather than joint payments, then the payments would simply continue in accordance with the gift annuity agreement, unless otherwise indicated in the divorce decree or property settlement agreement or unless modified by a donor's exercise of a power of revocation.

Regardless of whether the charity has heard from both parties with respect to the divorce or just one, it is advisable for the charity to communicate in writing with both individuals regarding its understanding of the situation and how payments are to be made going forward. In addition, the charity would do well to confirm its understanding of the new arrangement in a document that is signed by both annuitants.

The way in which annuity payments will be taxed going forward depends partly on how such taxation was calculated originally and partly on how the payments are to be made once the divorce becomes final, as well as on whether the gift annuity in question was a deferred annuity and the deferral period has not ended. For example, if as the result of a divorce a joint-and-survivor annuity benefiting both spouses becomes payable solely to one of them, the remaining investment in the contract will thereafter need to be returned over the life expectancy of the spouse who is now the sole annuitant, whereas initially it was to be returned over the joint-and-survivor life expectancy of both spouses. As a result, during the life expectancy of the now sole annuitant the portion of the payments treated as ordinary income will decrease and the portion treated as tax-free return of principal or capital gain income will increase. On the other hand, the year in which the annuity will become entirely ordinary income will occur sooner.

Note: Even if two annuitants of a deferred annuity who are married to each other remain married, if one of them dies during the deferral period, the taxation of the future payments to the surviving spouse will need to be recalculated based on the survivor's age and the remaining deferral period.

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C. An annuitant can no longer be contacted.

Discussion of the Challenge

More often than one might expect, charities find themselves unable to determine the whereabouts of certain annuitants. The problem typically comes to light when, if annuity payments are made by check, a check has been returned with no forwarding address. Likewise, if payments are made electronically, the charity sometimes learns that the account in which payments have heretofore been deposited has suddenly been closed.

Either of these events may be an indication the annuitant has died, in which case the charity will need to confirm the death by one means or another. If applicable, the charity must then secure the return of any payments that may have been made inadvertently. It will also have to complete the host of tasks that become relevant even when timely notice of an annuitant's death has been received.

In other cases, a bit of research reveals the annuitant to be alive and well, likely meaning that all the charity will need to do is revise its arrangements for making payments to the annuitant. Nevertheless, in certain instances no amount of investigation results in any light being shed on the situation.

How the charity should proceed is a matter of applicable state law, although determining what is "applicable" can be something of a challenge. Consider this scenario. Charity is domiciled in State A. Donor, who is a lifelong resident of State B, many years ago established a gift annuity with Charity for the benefit of Annuitant, who lives in State C and who now appears to have achieved missing person status. Furthermore, Charity also holds certificates authorizing it to issue gift annuities in States D and E. Unfortunately, Charity may have to determine what the law of each of these states has to say on the matter. In addition, the inquiry will likely need to focus not only on what is required under statutes and regulations applicable to gift annuities, but also under those dealing with financial accounting and unclaimed property.

Fortunately, consensus may exist on certain issues, depending on the states involved. For example, inquiries made of a few state insurance departments have indicated that at the least a charity would not be obligated to keep sending payments to an annuitant who, although not yet confirmed to have died, has ceased taking receipt of payments. Once the mystery surrounding the person's status is solved, however, the regulators polled said the charity would be expected to make any back payments still owing, based on whether the annuitant remains alive or, if not, when he or she died.

Yet on other matters the states diverge. Thus, one of the states polled requires a charity to continue to include the annuity in its reserve report for a period of years, whereas another allows the charity to delete the annuity from its reserve report (subject to adding the annuity back at some later point if the annuitant is found to be alive).

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How to Address the Challenge

Basically, the particulars of each situation will need to be analyzed. In addition to perhaps bringing the situation to the attention of relevant state authorities, the charity may be well advised to involve its legal counsel. The safest approach is to regard the payment obligation as continuing to exist, even if payments have been halted for the time being, until all applicable legal authority confirms that the obligation can be regarded as terminated.

Separately, with respect to federal requirements, the IRS has indicated it expects a charity to file a Form 1099-R for all annuitants including those who are “missing.” In other words, taxable income is reportable in the year it is payable, regardless of whether it is actually received by a taxpayer. If the charity subsequently locates a missing annuitant and a payment is made to cover all prior amounts that were not received by the annuitant, there will be no Form 1099-R filing requirement with regard to those amounts, as that requirement will already have been met. If, on the other hand, the charity subsequently learns that an annuitant deemed to be missing has died, the charity may need to amend Form 1099-R for one or more years, depending on when the annuitant died.

A charity can work to minimize the possibility any annuitant will drift off its radar screen. To some extent, this can be accomplished through rigorous stewardship practices and processes that mandate periodic (at least annual) direct contact with all annuitants, even if those annuitants are not donors. A related approach is to ask each annuitant for the name and contact information of someone who can be reached in an emergency, with such persons in turn being contacted by the charity regularly to ensure that *they* are not dead or incommunicado. Another technique is to be in touch with the Social Security Administration (whether directly or through a commercial service) on an ongoing basis to identify annuitants who have died.

A charity that simply assumes an annuitant is still alive because checks continue to be cashed or deposits continue to post is not being sufficiently proactive. Unfortunately, crooked or merely naïve persons with access to a deceased annuitant’s financial arrangements will sometimes make no effort to contact the charity. In effect, they are stealing from the organization, and whatever they receive improperly will need to be returned to the charity, as a result of legal action if necessary.

D. An annuitant or the charity wants to terminate a gift annuity.

Discussion of the Challenge

Even though a gift annuity is an irrevocable arrangement, an annuitant’s right to receive payments is something of value that can be drawn upon if he or she wants to terminate the annuity, as well as something that must continue to be honored in one way or another if the charity wants to cease making payments. Thus, in some cases, it is possible either to terminate a gift annuity completely or to have another party step in and take over the charity’s payment obligation. This could become relevant if the annuity’s residuum is dwindling to nothing of if the annuitant no longer wants or needs payments that continue for life.

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Sometimes the wording of the gift annuity agreement will pose a threshold challenge to an annuitant who wants to terminate the arrangement. Fortunately, a gift annuity agreement will often include language such as the following: "This annuity is irrevocable and non-assignable, except that if may be assigned to the charity." Clearly, this wording would allow an annuitant to terminate the gift annuity by assigning to the charity his or her right to receive payments.

If, however, the agreement were to say simply, "This annuity is irrevocable and non-assignable," then an assignment likely would not be possible, unless legal counsel for the annuitant and for the charity concluded that an exception permitting assignment to the charity of the annuitant's right to payments could be inferred or would at least be legally defensible. As an alternative, sometimes an annuitant's giving up of his or her right to payments will be styled not as an assignment of that right to the charity but as a "relinquishment," a "surrender," or a "disclaimer."

The options available to the annuitant and to the charity will differ. In particular, some of the charity's options entail not terminating the annuity itself but, rather, terminating its role as the payer.

How to Address the Challenge from the Donor's Standpoint

An annuitant's assignment to the charity of his or her right to receive any further annuity payments can take the form of either a gift or a commutation. If a gift annuity has two annuitants, they will need to coordinate their actions in terminating the annuity.

In the case of a gift, the annuitant will be making a contribution to the charity. In return, he or she will be entitled to an income tax charitable deduction equal to the lesser of the present value of the remaining payments or whatever portion of the original investment in the contract has not already been returned in the form of payments. In the case of a commutation, the charity will be paying the annuitant a lump sum equal to the present value of the remaining payments. The following example provides some specific numbers on which to focus.

On July 23, 2008, Ms. Allen, who was born on June 12, 1929, contributed $10,000 cash to XYZ Charity for a gift annuity making payments to her alone at the end of each calendar quarter for life. In establishing the gift annuity, her income tax charitable deduction was $4,860.40, based on the July 2008 federal discount rate of 4.2%. This means her original investment in the contract was $5,139.60 (i.e., $10,000.00 minus $4,860.40), and it was to be returned to her tax-free in the form of payments as follows:

	Tax-free Portion	*Ordinary Income*	*Total Annuity*
2008 to 2008	*228.68*	*97.08*	*325.76*
2009 to 2017	*519.48*	*220.52*	*740.00*
2018 to 2018	*235.60*	*504.40*	*740.00*
2019 onward	*0.00*	*740.00*	*740.00*

If on October 31, 2013 Ms. Allen were to contribute to XYZ Charity her right to the remaining annuity payments, their present value would be $4,360.00, based on the October 2013 federal discount rate of 2.4%. The portion of the original investment in the contract not already returned

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to her tax free would be $2,443.39 (i.e., $5,139.60 minus the $2,696.21 total of the $228.68 tax-free amount for 2008, the $519.48 tax-free amount for each of the years 2009 through 2012, and the $389.61 tax-free amount paid for the first three calendar quarters of 2013). Thus, her income tax deduction would be $2,443.39. **Note:** If she were to wait until, say, April 2019 to assign her annuity interest to XYZ Charity as a charitable gift, her deduction would be zero whatever the present value of her right to receive the remaining annuity payments were, as by then all of the original investment in the contract would have been returned to her.

If Ms. Allen were instead to commute her right to payments, XYZ Charity would pay her a lump sum of $4,360.00. Of this amount, $2,443.39 would be tax free, and the remaining $1,916.61 would be taxed as ordinary income. There would no charitable element to the arrangement, so she would not be entitled to any charitable deduction.

Of course, regardless of whether she makes a charitable gift of her remaining right to annuity payments or commutes that right for a lump sum, Ms. Allen is not able to act unilaterally. XYZ Charity will need to agree to whichever of the two courses of action she proposes to take. Usually, a charity will readily allow an annuitant to make a gift of his or her remaining right to payments. Even so, a charity's agreement to such an arrangement is best made explicit in writing, and the annuitant's assignment must definitely be in writing.

By contrast, especially in a low-discount rate environment such as that prevailing currently, XYZ Charity probably would not be willing to pay Ms. Allen in a lump sum the present value of her remaining annuity payments. If she agreed, however, it could pay her something less than the present value, although this would effectively result in a bargain sale. Accordingly, she should be entitled to an income tax charitable deduction for the difference between the present value of the annuity interest and the cash payment, reduced by any ordinary income attributable to that difference.

Even if a gift annuity was funded with an asset other than cash, either a gift or a commutation should be an option, although the tax analysis becomes slightly more complex. Also, it is technically possible for an annuitant to exchange his or her right to the payments associated with an existing gift annuity for the right to payments from a new gift annuity. This will seldom be attractive to the annuitant unless the existing annuity is a deferred annuity and the present value of the payments is high relative to what it was initially. Once again, the charity would need to agree to any such arrangement.

How to Address the Challenge from the Charity's Standpoint

If a charity wishes to cease making payments in connection with a particular gift annuity, it could always approach the annuitant to see if he or she would be willing to terminate the annuity by making a gift of the right to the remaining payments or by accepting a lump sum in lieu of life payments. Obviously, at least with respect to proposing that the annuitant make a gift, any such inquiry would need to be made delicately and only if the charity had a fairly strong sense the annuitant could afford to part with the payments, as the annuitant should not be made to feel any pressure to terminate the annuity. While an annuitant might find receipt of a lump sum payment to be more acceptable, the charity may well deem the cost to be unacceptable and therefore not even mention the possibility to the annuitant.

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A charity will be more likely to have the annuity remain in force but have some other party make the remaining payments. In pursuing such a course of action, the charity will incur a cost, probably a substantial one. The more frequent approach is for the charity to reinsure its annuity payment obligation by acquiring from an insurance company a commercial annuity that pays the same amount called for in the gift annuity agreement. Occasionally, however, a charity will be able to transfer its payment obligation to another charity.

While reinsurance is typically employed by a charity at the time a gift annuity is established, sometimes several years will pass before the charity turns its attention to this option. Unless the portion of the donor's contribution remaining at the time reinsurance is being considered is more than the premium for a commercial annuity, the charity will lose money if it reinsures. Also, if the charity's gift annuity program is subject to regulation by any of several states, the reinsurance of any gift annuity will need to meet certain requirements before the charity will be able to reduce the level of assets it must maintain in a segregated reserve account. Moreover, if for some reason the insurance company were to cease making the payments called for in the commercial annuity contract, the charity's obligation under the gift annuity agreement (which, technically, remains in effect all the while) would require it to resume making annuity payments.

The transfer of a gift annuity payment obligation from one charity to another usually occurs in connection with a merger of two charitable organizations. Nevertheless, if for instance Charity A and Charity B will remain separate entities but Charity B agrees to accept one of Charity A's annuity obligations, certain conditions will need to be met. First, Charity A will almost certainly need to transfer to Charity B a sum of money. As in the case of reinsurance, that sum may be more than the portion of the donor's contribution remaining at the time of the contemplated transfer, in which case Charity A may choose not to proceed with the transfer. In addition, the annuitant should at least be notified of the transfer and, ideally, consent to it in writing. Indeed such consent may be just one of the requirements a state regulatory agency will insist be met before it will permit a transfer, with another being Charity B having the authority to issue gift annuities in the state in question. Quite often, the governing boards of Charity A and Charity B will need to give specific approval to the transfer as well.

V. Conclusion

Especially given that the twelve challenges selected for examination in this paper represent simply some of what a charity might encounter in offering, structuring, and administering gift annuities, the more those who work for and on behalf of a charity are familiar with the legal and tax aspects of gift annuities, the better. Of course, such a familiarity can take years to acquire, so it makes sense to identify reliable sources of expertise, whether experienced members of one's local planned giving council, vendors who work with gift annuities frequently, or professional advisors.

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