The Bad and the Ugly: Lessons Learned from Gift Annuity Mistakes

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I. INTRODUCTION

Gift annuities are often touted as a "simple" contract, easy for the donor to establish, easy for the charity to administer. What could go wrong? Plenty. The details of establishing and administering gift annuities are nuanced and can be complicated. There are lessons to be learned from others mistakes. Some of these mistakes are made at the time of the gift and others are made during the administration and even at the termination of gift annuity contracts.

Some mistakes are easily fixed. A missing signature can be added, incorrect payments can be adjusted. Some mistakes are more difficult to resolve. What happens if the tax reporting is found to be incorrect years after the annuitant has filed a return? What do you do if a gift annuity is funded with appreciated property but reported for taxation purposes as a cash gift? Some mistakes are easier to fix if caught early, but get worse with the passage of time if not corrected immediately.

II. BEST PRACTICES IN GIFT ANNUITY ADMINISTRATION

A complete review of all of the things to do in the establishment and administration of gift annuities is beyond the scope of this paper. PG Calc has published white papers, webinars and speeches on the topic. That being said, a brief review of the process is in order as a refresher.

A. Completing a Gift Annuity Contract

Many of the mistakes made at the time an annuity is established can be avoided by simply using checklists and forms to organize the process. A gift annuity application like the one attached as Appendix A can ensure all of the information required of the donor and annuitant are correct. Keep in mind, that the donor and annuitant may not be the same person. The charity has certain duties upon accepting a gift annuity to set the gift up for making payments, tax reporting and compliance. Appendix B is an example of a checklist for use of the administrator to ensure everything is set up properly at the beginning.

Checklists and forms can't anticipate every variation that gift annuity mistakes might take. Oversight of the process should include a process for each step to be reviewed by at least one other person. The gift administrator doesn't have to be a lawyer or an accountant. It is good practice to have access to experts if a problem comes up that the administrator encounters something unusual. For example, a charity might engage a planned giving consultant or asset manager to assist in avoiding problems and fixing mistakes once they are discovered. The expert doesn't have to be on staff, just available when needed.

B. Administration of Gift Annuity Contracts

1. **Maintain data:** Charitable gift annuities (CGAs) are governed by a contract between the charity and the donor. The charity is responsible for making payments to one or

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two beneficiaries (the annuitant(s)) over their remaining lives. The first and most basic requirement of administering CGAs is to maintain the relevant information pertaining to the gift arrangement – the amount and date of the gift, payout rate, payment frequency and timing, annuitant name, address, social security number, etc. -- in a secure and reliable database. Because gift annuities can and frequently do go on for decades, the maintenance of data is the foundation upon which all other administration is built. If the essential data is not maintained correctly, no other aspect of the administration can succeed.

2. **Prepare for payments:** CGAs pay a fixed amount according to the contract, and they make payments on a monthly, quarterly, semi-annual or annual basis. Ideally, the charity establishes consistent policies regarding payment dates that help facilitate the efficient handling of payments down the line – for example, many charities offer payments only on the last day of the month, or on the first day of the month. This allows the charity to anticipate the flow of payments over each month; in turn, the investment manager can plan for cash needs on a consistent and predictable schedule.

3. **Make payments:** It is not unusual for charities to make gift annuity payments slightly before the contractual payment date, which helps to ensure that the annuitants receive their payments "on time" or even early. In addition, there has been a steady transition away from the issuance of conventional checks toward the more recent alternative of electronic payments ("EFT" or "direct deposit"); this trend does not affect the overall planning and timing of payments but it may have a slight effect on the day-by-day steps involved in the overall payment process.

4. **Reconcile and reissue:** Typically, a charity maintains a separate checking account specifically for the issuance of gift annuity payments; whatever the type of account used, the charity should reconcile the account monthly to identify checks not cashed; after a certain amount of time, the charity should reissue payments to annuitants, in conjunction with some type of communication with the annuitant. Multiple uncashed checks for one beneficiary indicate the possibility of relocation or death and should be investigated within a reasonable amount of time.

5. **Tax Reporting:** Tax reporting requirements for CGAs are straightforward -- the charity (or its administrator) must provide a Form 1099-R for each annuitant upon the conclusion of each calendar year. Form 1099-Rs for CGAs must be produced and mailed by January 31 with no exceptions. The aggregate reporting of 1099 information for all gift annuitants must be sent to the IRS by the end of March; depending on the number of annuitants, this may be done either with paper copies or by electronic means.

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6. **Maintain Market Values:** Technically there is no requirement to maintain individual market values for gift annuities – the underlying assets for a charity's gift annuity program are usually held in one or a small number of investment portfolio accounts, and the payment obligations are not tied in any way to market values; but charities are increasingly recognizing the benefits of determining the individual market values for each annuity on a frequent and ongoing basis. There may be internal interest in knowing these values for purposes of future resource planning and reporting back to donors; but more importantly, upon the death of an annuitant -- unless there is a successor annuitant -- the charity will need to know the ending market value of the specific gift annuity; the remainder value or "residuum" is the amount that the charity removes from the investment account and allocates for use as intended by the donor.

7. **General reporting and financial accounting:** Charities have a responsibility, to their donors and to the public in general, to report consistently and on a regular basis the charitable contributions received and the assets maintained. Each charitable gift annuity consists of a charitable gift component and a non-charitable component; the latter represents a liability on the part of the charity to a specific individual. Charities typically follow the specifications of the Financial Accounting Standards Board (FASB) to compute the estimated present value of the total future liability for each CGA.

8. **State reporting and compliance**: A number of states require reserve calculations and information reporting for charitable gift annuities on an annual basis. California, New Jersey, New York, and Washington are some of the more familiar examples, but there are several more. We will cover this reporting and compliance in greater detail in the second part of this presentation, but it is significant to note that the process is one of the major components of gift annuity administration for many charities.

III. MISTAKES AT THE TIME AN ANNUITY IS ESTABLISHED

1. Mistake: Revaluation of Appreciated Assets

a. Gifts of appreciated property are valued as of the date that ownership and control of the property passes to the charity. In most cases, the appreciated property to fund a gift annuity is publicly traded securities. Once the market closes on the day the securities hit the charity's account, the gift value is the average of the high and the low prices for the security on that day. Once the gift value is owned the charity prepares the contract and final calculations for signature.

   For a variety of reasons, the calculation of the value of the assets is sometimes computed incorrectly. Subsequent to the gift, it may be found that the calculation was done incorrectly, either using the wrong values or the wrong date. Sometimes the charity's finance department may not be familiar with the correct procedure. It

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is also common to mistakenly value the gift as the net proceeds of the sale after the payment of commissions. The costs of sale of the securities are an expense of the charity, not the donor.

If the asset valuation is incorrect there are three mistakes that result. The deduction for the annuity could be higher or lower than originally computed, the payments made could be lower or higher than the annuitant is entitled to and if a 1099-R has been issued before the mistake is discovered, the tax reporting will be wrong.

b. **Lesson learned:** If the mistake in valuation is discovered before the donor has claimed a tax deduction for the annuity, the charity can produce a new gift annuity contract with the correct asset value and the correct annuity amount. The payments for the first year must be corrected to reflect the actual amount due the annuitant and the accuracy of the 1099-R should be confirmed.

If the mistake is discovered after the donor has claimed a deduction and reported income from the annuity, the solution is more complicated. The payments in the year the mistake is discovered must be corrected to match the amounts that should have been paid to the annuitant. The charity should issue a corrected 1099-R. The donor should consult tax counsel to decide whether to amend tax returns for prior years that were reported incorrectly.

2. Mistake: Gift annuity is funded with loss property

a. Promotional literature for gift annuities often tout the benefits of funding gift annuities with appreciated securities. Not only does the donor get the benefit of the deduction and annuity payments, there is favorable capital gain treatment of gift annuities funded with appreciated property. If the donor is also the annuitant, a portion of the potential capital gain is avoided and the rest is reported pro rata over the annuitant's life expectancy. Even if the donor is not also the annuitant, the capital gain realized is less than what would otherwise be due if the donor had sold the securities. The reportable gain in that case must all be reported for the tax year of the gift.

In most cases, securities contributed for a charitable gift annuity are sold immediately by the charity. What might happen if no one asks the donor how much they paid for the securities before the gift is made? After the gift is made, the charity finally gets around to gathering information to document the gift and it turns out the stock was worth less than donor had paid for it. In other words, the securities constituted loss property.

b. **Lesson learned:** There is no fix for this mistake. The securities can't be returned to the donor, the charity sold them immediately. The crux of the problem is that securities that are sold for less than the price paid for them can be used to offset realized capital gains. The securities are considered a capital loss and can be netted against capital gains. There is even a five year carry over if the donor can't use the

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loss in the year of the gift. The donor should have sold the securities, and reported the capital loss on his taxes. But it is too late for the donor in this scenario.

If there is a fix to this mistake, it lies in good gift acceptance procedures. The gift annuity application attached as Appendix A asks whether the funding asset is cash or appreciated property. If appreciated property, it asks for the donor's basis. If it turns out the securities being considered for the gift are loss property, the mistake can be caught before the securities are donated.

3. Mistake: You didn't know that the donor is not the same person as the annuitant.

a. Even though for the most part donors establish gift annuities to benefit solely themselves, 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 (the person transferring the assets to fund the annuity) who may or may not be the annuitant (the person to whom payments will be made.)

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

Whenever an annuity is funded by one person or persons (the donor) and the income beneficiary is not the same person who will be receiving the payments (the annuitant) several issues arise. This can be true even when the donor and the annuitant are a married couple.

Transfer Taxes

Gratuitous transfers of assets (gifts) between individuals are subject to potential tax in the form of a gift or estate tax. Most Americans are unaware of the existence of the gift or estate tax because of generous exemptions that make these taxes applicable to only the very wealthy. Gifts between spouses are generally completely exempt from gift and estate tax. Only gifts to non-spouses in excess of $14,000 to any one person in a single tax year are taxable. This is the annual exclusion amount that is adjusted for inflation. Gifts in excess of the available annual exclusion must be reported to the IRS on gift tax return.

Since 2011, gift and estate taxes have become a nonissue for most Americans because of historically high exemption amounts adopted at that time. The exemption is $5.34 million currently and adjusted for inflation in the years to come. Nonetheless, 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" is a good idea.

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Capital Gain Taxes
If a gift annuity is to be funded with appreciated property, a gift planner must keep in mind that the taxable portion of the gain can be spread over the life expectancy of the donor only so long as he or she will be the annuitant as well 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.

If the donor is not an annuitant, reportable capital gain from an annuity funded with appreciated property must be paid in the year of the gift.

b. **Lesson learned:** The gift planner should be vigilant in any case where the donor (the money giver) is not the same as the annuitant (the money getter.) Attention to the distinct tax consequences of such an annuity at the time the gift is established will avoid potential negative tax consequences and donor relations issues.

The making of a large taxable gift to a non-donor annuitant can be postponed until the donor's death by inserting a provision in the annuity contract reserving the donor's right to revoke that annuitant's payments. 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 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

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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, disclosure to the non-annuitant donor of the potential capital gains tax issue may or may not persuade the donor to make the gift with cash instead of appreciated property. The donor may still choose to fund the annuity with appreciated property, however. Depending on the donor's tax situation, appreciated property may still be a good choice for funding the annuity in this situation. The capital gain attributable to the gift portion of the annuity is completely forgiven, reducing the amount of capital gain income realized. In addition, depending on the amount of gain reportable, the income tax charitable deduction may be sufficient to offset the capital gain income.

A non-annuitant spouse can use separately owned appreciated property to fund an annuity for an annuitant spouse and avoid any capital gain tax liability. The solution is for the non-annuitant donor to transfer ownership of the appreciated property to the annuitant spouse. Because of the unlimited gift tax deduction between spouses, there are no gift tax concerns. The annuitant spouse then funds the annuity with appreciated property now owned by them. If the non-annuitant spouse transfers appreciated property to fund an annuity for an annuitant spouse, the consequence will be that taxable capital gain will be recognized by the non-annuitant donor in the year of the gift.

The lesson learned from this mistake is to have good gift acceptance procedures. The gift annuity application attached as Appendix A points out to the applicant that, "If donor is not the annuitant or if securities are not jointly owned by donors or community property, there may be unexpected capital gain tax consequences." If the gift officer and the applicant are paying attention, and ask the right questions, this mistake is avoidable.

4. **Mistake: An annuity is completed with a donor or annuitant who does not file a U.S. tax return**

   a. 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

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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.

b. **Lesson learned:** When issuing a gift annuity involving a foreign donor or annuitant, a charity can proceed in some respects 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 ages of the annuitants. Similarly, going forward the charity would – to the extent applicable – take the annuity into account in meeting state reserve account requirements.

   Notwithstanding the similarity of an annuity with a non-U.S. annuitant, in other respects, the charity should depart from standard practice. 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.

5. Mistake: Annuity established for only one spouse

a. Gift annuity prospects are frequently shopping for the "best deal" on an annuity rate. These prospects may ask for illustrations of two-life annuities and one-life annuities if established for only one of the couple. The single life annuity rate will always be higher than the two-life annuity rate. The two-life rate is lower because the combination of two ages lengthens the time the annuity might be paid so the rate the charity can offer will be lower than if for only one life. When the prospect sees the figures, the one-life rate for the oldest of the couple will produce the highest payment. The older spouse is likely to be male and generally will not survive his wife. The annuity is funded with joint property but payable only to one spouse.

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There is no record that the non-annuitant spouse consented to the contribution of jointly owned property. The annuitant dies, and payments stop. There are no payments due the surviving spouse.

At that time, the widowed surviving spouse or perhaps her children challenge the CGA, saying the surviving spouse has no money and the annuity should have been set up as a two-life annuity. The argument runs that the gift was made using joint assets and should not have been accepted without the written consent of the second spouse. There is usually nothing in the charity's records to indicate that the charity ever asked whether the assets being contributed were the donor's separate property or were joint/community property. There is probably nothing in the file that documents that the charity warned the annuitant that the surviving spouse would not receive payments at his or her death. The problem is compounded if the annuity is for a sizeable amount.

b. **Lesson learned:** An annuity at this point can't just convert to a 2-life annuity. The annuity rate being paid would be too high and the income tax charitable deduction originally claimed would be incorrect.

   If anything is to be given to the surviving spouse, it would be a settlement resolving a dispute. The charity bears some responsibility for not confirming the nature of the property and/or not having the non-annuitant spouse sign the agreement. One lesson is to proceed with caution when a prospect with a spouse enters into a one-life annuity contract. Two questions to ask the prospect are "Does your spouse know that he or she will not receive payments on your passing?" and "Have you told your family about how you have decided to establish this annuity?" Don't be surprised if the prospect replies that it's none of your business.

   Regardless of the answer, ask the non-annuitant spouse to sign a letter acknowledging that they will not receive payments upon the death of their annuitant spouse. Don't be under the illusion that such a document will inoculate the charity against later claims. The consent could be challenged on lack of capacity, undue influence and other allegations of misconduct. Nonetheless, the consent will be good evidence that the consequences of the gift were disclosed to the parties.

6. **Mistake: An annuity is established and the payment frequency is not what the annuitant wanted.**

   a. 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. It's not a problem to change an annuity's payment frequency, 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

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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.

b. **Lesson learned:** Good gift processing can prevent misunderstandings regarding payment frequency, payment method, addresses and tax consequences. Mistakes as to payment frequency are fairly common and relatively easy to fix. That is no excuse for the time wasted and donor relations tested for a mistake that shouldn't happen in the first place if good procedures are in place. A gift annuity application like the one attached as Appendix A can prevent such a misunderstanding.

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 equal to the decrease in the present value of the annuity stream).

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 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

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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.

i. 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.
ii. 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.
iii. 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.
iv. 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.

IV. MISTAKES MADE IN ADMINISTRATION

1. Mistake: Not tracking market values of restricted gift annuities

Some charities do not permit an annuitant to designate how the charity will use the residua of a completed annuity. The charity can leave the residua in their CGA pool after an annuitant dies or take a withdrawal for their general purposes. Charities that follow this practice may not track the market values of individual annuities.

Some charities permit annuity donors to restrict how the residua from an annuity will be used after the death of the final annuitant. In these cases, there must be a system of fund accounting in place to track the market values of individual annuities. Without tracking market values for each contract, the distribution of

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residua at the termination of an annuity will be an estimate at best. The charity has a duty to distribute any residua according to the donor's wishes. Heirs disgruntled by what they perceive as sloppy accounting could complain to the attorney general of their state.

a. **Lesson learned:** It is possible to estimate the market value of terminated annuities even if those values have not been tracked. Note that in most cases these calculations will be only an estimate, but they are a good faith effort.

   To estimate market values for an existing annuity pool the charity will need investment performance figures for the annuity pool on at least an annual basis for the prior years. The date of gift, date of death and initial annuity amount for completed annuities will help make the estimate more accurate. Finally, there should be records of any distributions in prior years will also be factored into the calculation. Armed with this data, there can be a calculation of a reasonable estimate of the current market values for each contract. Obviously going forward, the charity must adopt a system of fund accounting to track the market values of restricted annuities in the future.

2. **Mistake: Failure to make payments on immediate or deferred annuities or failure to make payments to successor annuitants**

   a. Despite the best intentions, there are cases where a charity will "forget" to make payments due an annuitant. The most common scenario is the date of first payment for a deferred annuity comes and goes, and payments are not made. The charity and the annuitant have forgotten about the contract. While less common, the same failure to make payments occurs with immediate annuities. Eventually, either the annuitant, the charity or the asset manager discovers they have not made payments or tax reporting that were due.

      Occasionally in the case of a two- life gift annuity with a successor annuitant, the first annuitant dies, but somehow the fact that there is a successor annuitant is overlooked and payments do not continue. Eventually the successor annuitant surfaces having discovered paperwork indicating their entitlement to payments from the annuity.

   b. **Lesson learned:** The solution when payments have been missed is generally straightforward. Missed payments should be made up in a lump sum to the annuitant as soon as the mistake is discovered. It's not clear whether state law would require the charity to pay compound interest for the missed payments. Regardless of what the law requires, good donor relations suggests the charity should pay interest as a goodwill gesture to the annuitant. The tax reporting for the year in which the make-up payments are made will likely require special attention to assure the accuracy of the 1099-R for the irregular year.

      The ultimate fix to this mistake are good gift administration procedures. Two-life annuities must be accurately entered so as to note the existence of the successor annuitant. Good procedures at the time of recording the death of an annuitant

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should include verification as to whether there is a successor beneficiary. Particular care must be taken in this situation if the successor annuitant is not the first annuitant's spouse. The successor annuitant may be a friend, a relative or anyone not residing with the first annuitant. The gift annuity application attached as Appendix A asks for the primary and secondary annuitants, "Please provide the name, address, and phone number of a relative, attorney or business acquaintance with whom Charity may communicate with each annuitant if Charity is unable to contact an annuitant." This gives the charity a way to track down successor annuitants who may have moved or passed away since the application was completed.

3. Mistake: Married annuitants divorce

a. While not strictly speaking a mistake, married annuitants who subsequently divorce can create headaches for gift annuity administrators. The lessons learned from these situations suggest there are some things that can be done to prevent problems, but often the situation has to be dealt with after the fact.

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 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.

The contract may or may not contain a revocation clause. The annuitant may or may not notify the charity of the divorce. The divorce decree may or may not (but typically may not) address how to handle the annuity.

Whether the contract contains a revocation clause is relevant in a divorce situation. Annuities for a married couple are most frequently made with joint property owned by both donors and payments are made first to one annuitant and then to the survivor. In this situation, both donors own a 50% interest in the income from the annuity. A revocation clause in this fact pattern is actually not common. Nonetheless, the contract might reserve the power to each annuitant to revoke the annuity payments for the other annuitant attributable to the donor's one-half interest in the joint or community property donated to fund the annuity.

Annuities established by married couples could take multiple forms besides the typical situation described above. The annuity may be deferred, 50% of the annuity payments may be paid to each spouse during life, and one spouse could be the donor and the spouse the only annuitant. Divorce when these annuities are involved present unique complications.

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b. **Lessons learned:** Very occasionally at the time of divorce the annuitants will inform the charity of the divorce. In that case, 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.

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.

More commonly, charity learns of the divorce upon the death of the primary annuitant. If the power of revocation was exercised by the primary annuitant or the divorce decree or property settlement covers the annuity, the successor annuitant is entitled to 50% of the annuity payment for life.

It may also be the case that the primary annuitant dies without exercising the right to revoke. On top of that, the divorce decree may not address disposition of the annuity. Absent a revocation document or a court order, the surviving annuitant is entitled to 100% of the annuity payments for the rest of his or her life.

4. Mistake: Offering annuity rates higher than the ACGA suggested maximum rates

a. This challenge occurs relatively infrequently because most charities adhere to the maximum rates suggested by the American Council on Gift Annuities (ACGA).

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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.

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.

b. **Lesson learned:** Issuing an annuity at a higher rate than those recommended by the ACGA can cause an annuity to exhaust the principal donated before the payment obligation terminates. Offering unsustainably high gift annuity rates is one of the main reasons that a gift annuity pool will lose money on individual annuities. It is also the main reason the charity may need to transfer assets into a gift annuity pool to ensure there are sufficient reserves to meet state imposed requirements.

An annuity program may have offered rates higher than the ACGA recommendations but has subsequently mended its ways and now closely adheres to the ACGA rates. There are lessons learned on how to address annuities that are under water or in danger of exhaustion. These solutions all require the cooperation of the annuitant and may not work for every organization.

A charity may ask annuitants to surrender their income interest in a gift annuity in favor of the charity. The charity is released from its payment obligation and the annuitant may be entitled to an additional income tax charitable deduction for giving up their payments. It usually takes an understanding and forgiving annuitant to agree to such a solution, but surrendering annuity interests is surprisingly common.

Another solution is to ask the annuitant to consider using their annuity payments to sustain their annual giving. An annuitant who is worried they may need the income later could direct the payments to the charity to be added to the annuity reserves.

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The annuitant will still have to report the taxable portion of their payments but they would be entitled to an offsetting income tax charitable deduction. The annuitant can always decide later to keep the payments if he or she needs the money.

5. **Mistake: An annuitant has gone missing**

   a. 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.

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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).

b. **Lesson learned:** As with many difficulties encountered during the administration of a gift annuity, dealing with missing annuitants can be made easier by using good practices at the time the gift is established. The gift annuity application attached as Appendix A asks the applicant, "Please provide the name, address, and phone number of a relative, attorney or business acquaintance with whom Charity may communicate with each annuitant if Charity is unable to contact the annuitant." This information could be invaluable in situations where an annuitant goes missing whether they have gone into assisted living or have died.

Despite best efforts to maintain a way to stay in contact with annuitants, there will always be situations where the annuitant can't be located or confirmed as dead. What to do in 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.

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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.

6. Mistake: The commuted payment (college) annuity that couldn't

a. The commuted payment gift annuity is more commonly known as the college annuity. In the case of the college annuity, a donor initially contributes assets for a deferred annuity naming a child as annuitant with life payments to begin at age 18. Prior to the annuity starting date the annuity is commuted to a series of installments to be received over the course of four or more years. Thus, instead of receiving very modest payments for life beginning at age 18, the annuitant receives large installments during the college years. The installments would have the same present value as the life payments.

The commuted payment annuity gets its name from the provision in the annuity contract that allows commuting (exchanging) the right to lifetime payments to payments over a fixed period of years. In most instances the annuitant (or guardian) exercises the commutation right immediately after the annuity is funded. While commutation and funding should not be simultaneous, a period of weeks or even days should suffice to make the two events adequately distinct.

If the commutation is delayed until later, the payments could be higher or lower, depending on the discount rate and mortality tables in effect at the time. The consequences of misjudging the fluctuations in discount rate and mortality tables can be dramatic.

For an example of the negative consequences of not electing commutation at time of the gift, assume a college annuity for a 12 year old established in February 2007. The funding amount was $20,000 and the discount rate in effect at that time was 5.8% and the life expectancy table in effect was 90 CM. Had payments been commuted around the time of the gift, the annuitant would have been entitled to four payments of $4,968.

The commutation clause was not exercised until February 2013 when the annuitant turned 18. The discount rate at the time of commutation was 1.2% and the life expectancy table in effect was 2000CM and the commutation period was four years.

The calculation in 2013 of the commuted payment involved calculating the value of the life interest of deferred annuity established in 2007 for the life of a 12 year-old and beginning to make payments in 2013. The present value of the annuitant's life

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interest was calculated using a 1.2% discount rate. Next, the value of that amount was valued as if made in four annual installments beginning in 2013. The commuted annuity payments that resulted were $9,916.36 a year for 4 years for a total of $39,665.44, nearly double the contribution for the annuity.

If the payments had been commuted at the time of the gift using the discount rate and mortality tables in effect in 2007, the total payments would have been $19,872. Had the charity experienced even modest returns, there should have been some residua left after payments from the annuity stop in 2017. Unfortunately, the gift was victimized by the impact of the great recession. The market suffered a significant drop immediately following the gift creating a deficit that was never recovered. In 2013, the market value attributable to the annuity was only $7,000.

b. **Lesson learned:** Before analyzing the disastrous mistakes with the gift described above, a review of commuted annuities is in order. In essence, the commuted annuity is a regular deferred gift annuity that promises to make payments to the annuitant for life commencing on a future date. The difference is, this deferred annuity contains a provision that allows exchanging the right to lifetime payments for payments over a fixed number of years.

Consider the advantages and disadvantages of using a commuted annuity used to pay for college expenses. On the plus side, a college annuity enables a donor to receive an income tax charitable deduction while providing for the education of a descendant or the child of a friend. There is tax-free growth within the annuity, the payments are taxed at the student's lower tax rate, and a portion of the payments to the student will be tax-free and prorated over the commutation period.

On the other hand, the college annuity has a number of disadvantages. The return of state sponsored 529 education plans or other alternative education plans could be higher. The donor immediately recognizes the capital gain attributable to the present value of the annuity, if the annuity is funded with appreciated property. The 10-percent penalty tax per IRC Sec. 72(q) apparently applies to the taxable portion of term payments started before the annuitant reaches age 59½. This tax would be in addition to whatever income tax the student would pay on the installments. The penalty tax does not apply after a person attains age 59½ or when the person receives life payments, whatever the age of the person when those payments begin. Finally, since payments are made directly to the student, the money could be used for any purpose the 18 year-old recipient chooses. Need we elaborate on the problem here?

There are many variations on how selection of the commutation period can be structured. The contract can say the commutation could be as early as X date and as late as Y date. The contract could say that the number of years over which the payments may be commuted can be no less than X and no more than Y. Until the commutation clause is exercised and the period of commutation selected, the payments due the annuitant are subject to change.

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The lesson learned from the mistakes in the case cited is that early commutation of these annuities eliminates the uncertainty that can be associated with these plans. Because of that uncertainty, it is to the benefit of both the charity and the annuitant to exercise the commutation right very soon after completion of the gift. In the example above, suppose the discount rate had gone to 11% in 2013, (the discount rate for June 1990) the commuted payment due the annuitant would have gone down, not up.

SUMMARY

Many of the thorny issues that I see arise with gift annuities could be avoided with attentive planning before the gift is made. Others, such as the divorce of married annuitants, while not avoidable, can go smoothly if handled thoughtfully and with care. Having well-organized and thorough procedures regarding the issuing and administration of gift annuities will go a long way toward minimizing the problems that can crop up with this simplest of life income plans.

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APPENDIX A

GIFT ANNUITY APPLICATION

I hereby apply for an Charitable Gift Annuity Agreement as follows:

Donor(s) (Enter both names if property is jointly-owned or community property; otherwise enter one name)

Name ___________________________________ Name_________________________________

Date of birth __________ Date of birth____________

Address ____

City___________ State _______ ZIP _________City ________________ State _______ ZIP ________

Daytime phone (___) ______________ Daytime phone (___) ______________

Annuitants

Check one:

___ One annuitant

___ Two annuitants, joint-and-survivorship (payments to both jointly, continuing to the survivor)

___ Two successive annuitants (payments to one, then to the survivor)

If annuitant(s) is(are) other than the donor(s), complete the following:

First annuitant ____ Date of birth ________________

Street address ____

City _______________________________________ State _________ ZIP __________________

Relationship to donor(s) __________________________

Second annuitant ____ Date of birth____________

Street address ____

City ____________________________________ State __________ ZIP ____________________

Relationship to donor(s) __________________________

Contribution

Cash: **Anticipated dollar value:** $___________

Securities (include details if known; otherwise, estimate fair market value and indicate the cost basis)

If donor is not the annuitant or if securities are not jointly owned by donors or community property, there may be unexpected capital gain tax consequences.

Description ____

____

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Cost basis ___________ Estimated fair market value: $___________

Other Property:

Description ____

____

Cost basis ___________ Estimated fair market value: $___________

Total estimated value of all assets contributed: $___________

Annuity type:

Will payment of the annuity be immediate or deferred? ___ Immediate payment. ___ Deferred payment.

If deferred, check and complete either (a) or (b) below:

(a) Payments are to begin on this specific date: ______________________.

(b) Payments may begin on _____________ in any year during the period ______________ and
(indicate month/day) (1st possible year)
______________ .
(last possible year)

Payment frequency. Check one:

___ Monthly ___ Quarterly ___ Semi-annually ___ Annually

Purpose:

Indicate the purpose to which gift is to be directed. Undesignated contributions will be used for general purposes.

____

Contact Person

Please provide the name, address, and phone number of a relative, attorney or business acquaintance with whom Charity may communicate with each annuitant if Charity is unable to contact the annuitant..

____

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APPENDIX B

STEPS FOR ESTABLISHING AN ANNUITY FOR ADMINISTRATION

Once an annuity has been completed the gift must be prepared for administration. This will be in cooperation with the gift annuity administrator selected by Charity. Below is a list of steps required to set up a gift annuity for administration. The actual procedure will be negotiated with the administrator and assumes the Charity's donor database is Raiser's Edge, but this is a typical procedure.

- CGA Application completed by donor, copy sent to administrator

- CGA Agreement signed by financial office & copies sent to donor & mailed to Administrator

- Tax Acknowledgement, Disclosure Statement & IRS election statement (if needed), PG Thank You sent to donor

- Calculations & Confirmation received from administrator

- Calculations saved as csv file to facilitate automated gift entry into Raiser's Edge

- Gift Entry Form & Acknowledgement Letter info (w/administrator confirmation) submitted to Gift Processing

- President's Thank You mailed. A letter welcoming the donor to the Legacy Society should be mailed if the donor is a new life-income donor and does not meet the giving threshold for a President's letter. If CGA meets minimum threshold, PG Officer should be sure that the Presidents letter references a welcome to the Legacy Society.

- Code Donor's Record as Legacy Society – Life Income Gift & date.

- CGA Agreement uploaded into the Media tab of the donor's Raiser's Edge

- Gift Wrap Key received from administrator and entered as an attribute on gift screen (Gift Wrap Key: _______)

GIFT PROCESSING PROCEDURE FOR A GIFT ANNUITY

1. Donor commits to funding a CGA and completes annuity application
2. Charity sends completed application to Gift Annuity Administrator
3. Donor forwards assets to Charity or Gift Annuity Administrator.
4. Charity forwards assets to Gift Annuity Administrator
5. Gift Annuity Administrator values assets as of date of gift and notifies Charity of value

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6. Charity sends annuity contract and ACH form (if applicable) to donor
7. Donor signs gift annuity contract and completes ACH form (if applicable) and returns to Charity
8. Charity sends copy of fully executed gift annuity contract and ACH form (if applicable) to Gift Annuity Administrator

   Gift Annuity Administrator sells securities if funded as such and invests assets. Gift Annuity Administrator sends check or direct deposits to annuitant's account

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