THE ESSENTIAL GIFT ANNUITY: 7 THINGS YOU NEED TO KNOW

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OVERVIEW OF GIFT ANNUITIES

There are several stages in the operation of a gift annuity program: promoting the gift vehicle to prospective donors, receiving the contribution, and issuing the gift annuity contract, and handling administrative tasks such as payments and regulatory compliance. Taking a deep dive into all stages would require more than a single paper.* The focus here is on seven essential elements that form a base of knowledge for operating a successful program.

* See instead Charitable Gift Annuities: The Complete Resource Manual

A. Description of a Gift Annuity (#1)

A gift annuity is a contract under which a charity, in return for a transfer of cash or other property, agrees to pay a fixed sum of money for a period measured by one or two lives. A person who receives payments is called an "annuitant" or "beneficiary." The contributed property becomes part of the charity's assets, and the payments are a general obligation of the charity. The annuity is backed by all of the charity's assets, not just by the property contributed.

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

When assets are contributed for a gift annuity, it might feel like that full amount is the gift to the organization. That amount may be what's used in giving credit to the donor, and it may also be what's credited to the gift planner for purposes of their fundraising goals. While this may make sense in those contexts – the donor has in fact parted with that amount – it is important to remember that the contribution is offset by a liability for which the charity is responsible until the annuity terminates.

B. Types of Gift Annuities

1. Immediate Gift Annuity

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

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The annual annuity is determined by multiplying the amount contributed by the annuity rate. For example, if a person, age 65, contributes $10,000 and the charity follows the current American Council on Gift Annuities (ACGA) suggested rate of 4.8 percent, the annual annuity would be $10,000 × 4.8% = $480. If quarterly payments have been selected, the annuitant would receive $120 for each full quarter.

2. Deferred Gift Annuity

With a deferred gift annuity, the annuitant starts receiving payments at a future time, which must be more than one year after the date of the contribution. As with immediate gift annuities, payments can be made monthly, quarterly, semi-annually, or annually.

C. Gift Annuity or Charitable Remainder Trust (#2)

A gift annuity is a contractual arrangement between the charity and the donor(s). With a charitable remainder trust the contribution is made not to a charity directly but instead to a separate legal entity, which then makes payments to one or more income beneficiaries throughout the duration of the trust. Despite the fact that a charity may serve as trustee of such a trust, the charity typically receives nothing in its own right until the trust has ended. Likewise, until that time, ensuring that payments are made to income beneficiaries is the responsibility of the trustee, not that of any charitable remainder beneficiary.

There are certain distinctions between a gift annuity and a charitable remainder trust that, given the circumstances or desires of the donor will dictate one vehicle over another. Sometimes that will be a matter of the charity's policy and sometimes a matter of applicable law. For example, contribution minimums to establish a gift annuity are often set by charities as low as $10,000, whereas the minimum for a trust will be at least $100,000 (likely only if the charity is serving as trustee) and most often significantly higher. If the donor envisions having payments go to several family members a gift annuity would not work, as such gifts are limited to two beneficiaries.

Often the choices to be made between gift vehicles will find the donor's and the charity's interests aligned. But there are instances where the donor may prefer one arrangement whereas the charity prefers the other. For example, a donor may want to use real estate to establish a life income stream and prefer the fixed nature of payments and ease of establishing a gift annuity, whereas a charity may have decided not to accept real estate for such gifts. When discussing options with a prospective donor a charity should be clear in stating policy limitations that may affect the choice of vehicle. It should also be reluctant to vary those limitations solely for the purposes of not "losing" the gift; variance should only be done when doing so is not detrimental to the charity.

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

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TAX ASPECTS OF GIFT ANNUITIES (#3)

A. Allowance of Charitable Deduction

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

B. Determination of the Charitable Deduction

The amount of the deduction depends on the following factors:

1. The amount contributed.
2. The age of the annuitants.
3. The annuity rate paid by the charity.
4. The frequency of the installments – i.e., whether they are paid annually, semi-annually, quarterly, or monthly. The more frequent the installments, the smaller the deduction.
5. The Charitable Midterm Federal Rate ("CMFR"). The CMFR is 120 percent of the annually compounded Applicable Federal Rate ("AFR") for mid-term federal obligations, rounded to the nearest .2 percent. The CMFR (also called the "discount rate") is determined for each month and published. The donor has the option of using the CMFR for the current month or for either of the two preceding months. The higher the applicable rate, the larger the charitable deduction. Internal Revenue Code ("IRC") Section 7520 deals with this discount rate.

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

   Most gift planners use a software program, such as PG Calc's *PGM Anywhere* or *Planned Giving Manager*, to determine the deduction though the deduction can be calculated manually using the tables in IRS Publication 1457.

C. Taxation of Annuity Payments

1. Contribution of Cash

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

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each annuity payment that is construed to be a return of your capital investment is not taxed, while the balance, which is the earnings on the capital, is taxed.

The computer software program will calculate for you the taxable and tax-free portions of the annuity payments, though you could also do this manually using tables in the Regulations. [Use Table V of Reg. Sec. 1.72-9 for a single life, Table VI of Reg. Sec. 1.72-9 for two lives, and make adjustments if payments are made less frequently than monthly or if the first payment will cover a partial period, per Reg. Sec. 1.72-5(a)(2)(i).]

Example: *Ms. Palmer, age 74, contributes $100,000 cash for a gift annuity. The charity to which she makes the gift uses the ACGA rate (7/1/22 schedule) of 5.8%, and the discount rate is 5.2%.*

PRESENT VALUE OF ANNUITY	***GIFT VALUE***
A	***B***
$47,164	*$52,836*

Annual payment $5,800

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

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

According to the tables in the Regulations, Ms. Palmer's life expectancy (using 2000CM table) is 13.1 years, and during that period the amount of her capital returned each full year is $3,602. This portion of her annual payment is tax-free. The balance of her annuity payment ($2,198) is taxed as ordinary income. At the end of her life expectancy the entire capital will have been returned and, thereafter, the annuity payments are fully taxable as ordinary income.

2. Contribution of Long-Term Capital Gain Property.

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

If the following conditions are met, that gain need not be recognized in the year of the gift but can be reported ratably over the life expectancy of the annuitant. [See Reg. Sec. 1.1011-2(a)(4)(ii).]

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

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

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

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

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

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

PRESENT VALUE OF ANNUITY $47,164		***GIFT VALUE $52,836***	
A	***B***	***C***	***D***
$ 18,866	*$28,298*	*$21,134*	*$31,702*

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

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

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

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

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D *is the capital gain allocated to the charitable gift, and it is not taxed.*

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

Tax-free	$1,441
Capital gain	2,161
Ordinary income (the balance of the payment)	2,198
	$5,800

At the end of her life expectancy the entire capital will have been returned, and the entire taxable gain will have been reported. Thereafter, the annuity payments are fully taxable as ordinary income. If Ms. Palmer dies prior to the end of her actuarial life expectancy, any unreported capital gain will not be taxed.

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

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

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

D. Gift and Estate Tax Implications

A donor who funds a gift annuity and names an annuitant in addition to, or instead of, himself or herself makes two gifts: one to the charity and one to the annuitant. Depending on the circumstances, the gifts may or may not be reportable and taxable. The tax consequences depend on a variety of circumstances, and the impact for a particular donor should be determined by that person's advisors. However, understanding some key points is helpful for the gift planner:

- The gift tax marital deduction is available if the non-donor annuitant is a spouse and a US citizen *and* if payments to such annuitant begin immediately. If it is a deferred annuity, or if it is a successor annuitant situation, the marital deduction is not available.

- Inclusion of revocation language in the gift annuity agreement may eliminate or postpone a taxable gift. Its inclusion turns the present value of a lifetime annuity

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stream, which may exceed the annual gift exclusion amount, into a series of annual payments that most likely will fall within the annual exclusion. However, if the donor predeceases the annuitant without having revoked payments, the present value of the annuitant's payments, determined as of the ate of the donor's death, will be included in the donor's estate.

Note that most donors will not be affected by the federal gift and estate tax because their estates are below the federal gift and estate tax exemption. That could change if the exemption were significantly reduced from current levels ($12.92 million per individual in 2023).

GIFT ANNUITY RATES (#4)

According to the 2021 ACGA survey, 96 percent of charities always or usually follow the maximum rates suggested by the ACGA, a result consistent with prior surveys. Beyond use of the ACGA rates, it is important to understand the assumptions that underlie them.

Following are the assumptions underlying the July 1, 2022 rates:

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

2. Life expectancies are based on the 2012 Individual Annuity Reserving Table with a 45-55 blend of the 2012 IAR male and female mortality with no age setback.

3. Annual expenses for investment of gift annuity funds and administration of gift annuities are assumed to be 1 percent of those funds.

4. The total annual return on gift annuity reserves is 4.5 percent.

5. The rates for the oldest ages are somewhat lower than the rates that would follow from

While a primary goal is to achieve at least a 50% residuum, that result is not the most probable outcome for any given annuity. Why? Because no individual annuity is likely to perform exactly per the assumptions (particularly those relating to mortality and investment earnings). Instead, some annuitants will die earlier and some will live much longer than "expected." And investment returns will go up and down through the years – sometimes they will be higher in the years immediately following a gift and then drop, while other times they will drop (sometimes precipitously) right after the gift is made and (hopefully) rebound later. As noted previously, these "timing" issues are completely out of control of the charity – you cannot forecast when someone will die, nor can you know with certainty what will happen with investment returns.

However, the average performance of a program overall will come much closer to the ACGA's assumptions presuming, of course, that actions of a program are in line with the

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assumptions. If a charity's policies and practices differ from those assumptions, it should be expected that the results will also differ. For example, if a charity spends a portion of the gift annuity contribution up front, or if its expenses or investment returns differ from the assumptions underlying the rates, the charity should not be surprised when its residuum differs from the 50-percent assumption that underlies the ACGA rates.

If a charity elects to issue at a higher rate than the ACGA suggests, it will need to realize a higher net return on investments (or have lower expenses or annuitants dying earlier) in order to realize a 50-percent residuum. If it does not, then the residuum will be lower than 50 percent. The problem with higher rates can be compounded by the fact that a rate schedule is determined by looking at what is *currently* happening as well as what *has* happened with market-wide investment returns. What *will* happen with these returns after issuance of an annuity is unknown. If what happens after is better than what came before (i.e., investment returns are higher), the charity may well receive a residuum greater than 50 percent (depending on how long an annuitant lives). If, on the other hand, what happens in the market after issuance is worse than what came before, the charity may receive a residuum under 50 percent (again, depending on how long an annuitant lives).

Apart from decreasing the residuum and increasing the risk of exhaustion, 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, Tennessee, and Washington – 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. Beginning in 2020, offering rates higher than ACGA rates in New York became impossible at many ages, given that the state's maximum allowed rates were lower than ACGA's suggested maximums. While that discrepancy eased in 2022, it is something that should still be monitored. 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.

Note: In certain instances, donors are looking to enhance the charitable benefit of a gift annuity – and their charitable deduction - and will accept a lower annuity rate than the applicable rate based on the charity's published schedule. In those circumstances, there should be documentation that the donor was made aware of the standard rate and voluntarily accepted the lower rate. California requires an addendum to the agreement signed by both the donor and a charity representative. This would be a good practice in every situation where a donor accepts a lower annuity rate than published rates.

Since most organizations adopt the ACGA's suggested rate schedule, the decision to offer a higher rate usually arises in the context of making an exception for a specific gift. Typically, this is prompted by a donor's request, and often in the context of an exceptionally large contribution amount – precisely when you *don't* want to increase the risk to the organization. However, there are some charities that want to establish a rate schedule different from the ACGA's. If it were to be lower rates, the charity might simply lower the rates by a set amount across the schedule (i.e.,

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reduce the rates by two-tenths of a percent (0.2%), or cap the rates at a lower amount). If, on the other hand, a charity wishes to create a schedule of rates higher than ACGA's, it would be wise to create its own set of assumptions and use those to determine the rates. To just randomly increase the rates by a certain amount, without understanding the expected outcome, is to put the charity at greater risk of having a low performing program and an increased number of underwater annuities.

COMPLIANCE WITH FEDERAL AND STATE REGULATIONS (#5)

A. Federal Regulations

1. Disclosure Statement

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

2. Reporting Requirements

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

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

B. State Regulations

1. Disclosure

Numerous states mandate that a charity's gift annuity agreements include specific language advising donors regarding the extent, if any, to which gift annuities are regulated under state law. The states of California, Oklahoma, and South Dakota also require that certain disclosures be made in materials that promote gift annuities. In addition, a charity offering gift annuities to Oklahoma donors must include a particular disclosure statement in the gift annuity application, if the charity makes use of an application.

Alabama and Arizona are the two states that have specific requirements relating to a disclosure statement and its content. Such requirements can be integrated with the federal disclosure statement noted above, to avoid having to provide donors in these states with two separate disclosure statements,

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2. Registration

   At their essence, the state laws governing issuance of charitable gift annuities are providing an exemption from the insurance code (except in Alabama, where it is instead regulated by the state securities commission). To fall under that exemption, a charity must comply with all the requirements set forth in the statute. If it does not, then it has no exemption from the insurance code; and, since the charity is unlikely to have registered as an insurance company, by issuing gift annuities without the exemption it is technically operating as an unauthorized insurance company.

   The gift annuity-specific registrations are distinct from those relating generally to charitable solicitation, and most typically are handled by different state agencies. A charity should complete all registrations that are applicable to its charitable activity in a given state. And while some states provide exemptions from solicitation registration for certain types of charities (e.g., religious or educational), no such categorical exemptions exist with respect to gift annuity registrations.

   At the present time:

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

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

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

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

   (See *Appendix B* for an overview of state requirements.)

CONTROLLING RISK TO THE CHARITY (#6)

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 disappointing 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, it should be understood that even the most robust gift annuity programs occasionally lose money on a gift

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annuity. Such a program can absorb those losses without a material effect on the program as a whole.

Weaker programs generally suffer from the related risk that the financial benefits being derived from the gift annuity program are 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 maximum gift annuity rates. (In 2011, a 20-percent-presentvalue target was added, meaning that at the time the gift is established the present value of the targeted residuum must be at least 20 percent of the contribution.) Because the overwhelming majority of U.S. charities offering gift annuities follow the ACGA rates, achieving the targeted residuum would likely be an organizational expectation. Results from the recurring surveys conducted by the ACGA since 1994 reveal that charities on average do wind up with more than half of what was contributed for each annuity, though the percentage has decreased over the years, from a high of 98 percent in 1999 to 66 percent in the most recent survey (2021).

No charity can completely eliminate the risks associated with gift annuities, particularly when it comes to factors beyond its control, such as market fluctuations and how long its annuitants live. However, risk can be reduced by establishing and adhering to sensible policies and procedures related to those factors over which a charity does have a control. One of those factors, offering gift annuity rates that are too high, was discussed earlier in this paper. Other factors that can create a weaker gift annuity program are discussed in the following pages.

Policies Regarding Annuitant Age and Contribution Amount

Gift acceptance policies in general serve a number of important purposes, providing a roadmap as to the assets and gift vehicles a charity is willing to accept and ensuring that a charity accepts only gifts that advance its mission and match the risk tolerance of its board. Given that gift annuities subject the charity to a payment liability, a prime intent of the policies that govern them is to protect the charity.

While 65 is the most common minimum age (30 percent) for annuitants of an immediate payment gift annuity per the 2021 ACGA survey, a combined 43 percent had a minimum set younger, and a surprising 21 percent of respondents indicated they had no minimum age. A problem that arises with younger annuitants is the length of time before the gift is realized, resulting in a lower present value of the residuum. An annuity with a projected large face value residuum, but attached to a young annuitant with a long life expectancy, may have a lower present value than an annuity with a lower face value and an annuitant with a shorter life expectancy. For example, a projected $15,000 residuum for someone with a 30-year life expectancy has a present value of $6,180, assuming an investment return of 3 percent. A projected residuum of $10,000 for someone with a 10-year life expectancy, on the other hand, has a present value of $7,441.

Issuing to younger annuitants can also lead to increased risk; while other factors, such as poor investment performance or payout rates that exceed ACGA suggested maximums, are more likely to be direct causes of an underperforming gift annuity, issuance to younger donors can exacerbate the problem. In such a situation, a long payout period can increase the likelihood

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of such a gift going underwater, requiring more years of out-of-pocket payments and costs of administration if it does. Although a charity won't have full control over everything that happens during the life of an annuity, it can determine the anticipated time horizon that is acceptable before a gift is realized.

For deferred annuities, the earliest date for starting payments should be the same as for immediate annuities. It is common for the minimum age at time of contribution to be set at 10 years younger, so that with a minimum age of 65 for immediate annuities, 55 would be the youngest age at which a contribution could be received for a deferred annuity. For a two-life annuity, both annuitants should meet the age minimum.

As with minimum ages, the concern with small contributions is primarily a matter of considering the present value of the residuum that is to be realized years in the future; that low value may be eaten up by administrative costs. The minimum contribution amount reported in ACGA surveys has been increasing over time; in 2021, 77 percent of charities had a minimum of $10,000 or higher, compared to 61 percent with such minimums in 2009. Organizations with a minimum of less than $5,000 decreased from 10 percent in 2009 to 4 percent in 2021. For comparison, a $2,500 contribution, projecting a 50-percent residuum of $1,250 in 10 years, provides a present value of the residuum of $930. In contrast, a $5,000 contribution with the same assumptions provides a present value of the residuum of $1,860, while a $10,000 contribution provides a present value of the residuum of $3,720.

Charities might also consider whether to establish a policy for a maximum contribution amount (something only 11 percent of respondents to the 2021 survey had done). The healthiest gift annuity programs will have large numbers of annuities issued in relatively similar amounts to distinct individuals. Whether the result of a single large contribution, or smaller repeat gifts, the concentration of large payments to any one individual results in increased risk to the charity. Should the annuity(ies) attributable to that person suffer significant investment losses, or should the person live well beyond life expectancy, there is a greater potential to negatively affect the entire program. This can be offset by setting a maximum amount that can be contributed by any one individual, or by deciding to reinsure any amount that exceeds that maximum. The acceptable amount will vary depending on the size of the charity's program and the charity's risk tolerance. In fact, it may not even be a fixed dollar amount, but rather a percentage of the overall gift annuity pool at the time the gift is contemplated. For example, a charity may decide that it will review any contribution that would have an individual receiving 10 percent or more of its total annual gift annuity payments (an exception might be made when starting a program, when new gifts are often larger than 10 percent of the other gifts, but care should still be exercised to avoid concentration by one gift). Consider risk control strategies for these large annuities such as asking the annuitant to accept a lower annuity rate or reinsurance of some or all of the annuity.

Investment returns/expenses

As noted previously, underlying the January 1, 2022 ACGA rates is a net investment return of 3.5 percent. This consists of a 4.5 gross return, less 1 percent for expenses. Either higher than expected expenses or lower than expected returns would result in a lower net return. It is important to keep in mind the underlying 50 percent residuum target. It is not realistic for a

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charity to expect to earn each year the amount that needs to be paid in connection with all its annuities for that year; some of the annuity payments will come out of principal.

It is, however, important to be aware of how the investment allocation of gift annuity assets, and their actual return, will affect the residua a charity receives; investing reserves prudently is the number one way to limit risk. The asset allocation used for the endowment or for charitable remainder unitrusts is generally not appropriate for gift annuity reserves. This is because when equity exposure is too high and values plummet, a charity will have difficulty restoring reserves to an acceptable level because annuity payments, unlike distributions from an endowment or charitable remainder unitrust, are not reduced when market values decrease. At the opposite end of the spectrum are charities that are overly conservative and see a steady erosion of reserves because the resulting meager return is below the return on which ACGA rates are based.

The ACGA uses an assumed asset allocation to determine the gross return figure (40 percent equities, 55 percent 10-year Treasury Notes, and five percent cash). While this allocation is not intended to be a specific recommendation as to how reserves should be invested, it can serve as a guide for the percentage of equities in a prudent portfolio. The ideal portfolio for reserves will include both equity and fixed-income investments. The appropriate percentages of each depend, in part, on the financial situation of the charity and the total amount of gift annuity reserves. For example, a large university with significant surplus reserves could prudently invest more in equities than could a smaller charity with modest reserves. In general, though, fixed-income investments should comprise a higher percentage of gift annuity reserves than of endowed funds. Diversification, of course, is advised whatever the portfolio. The fixed-income portion, for example, might include corporate as well as government obligations, and the equity component of stocks in different-sized companies.

Depending on the states in which the charity issues gift annuities, it may also need to account for investment restrictions imposed by the state. Currently just two states (California and Florida) place specific limitations on how the segregated reserve fund is invested; other states are either silent on the matter or direct investment in accordance with a prudent investor standard. In general, the investment restrictions are:

- Corporate bonds generally limited only as to the percentage in any one company, except in California the limit on publicly traded securities applies to corporate bonds as well;
- Stock limited to 50 percent of required reserve assets;
- Mutual funds limited to no more than 10-percent in any one fund (Florida), or considered as part of the stock limitation (California);
- Real estate not permitted as a reserve investment in California and limited to 5 percent by Florida.

Ultimately the appropriate allocation for a given charity should consider the fixed nature and length of its payment obligations, as well as the charity's risk tolerance. In creating a prudent investment strategy, a charity should consider an asset allocation that strikes the proper balance between risk and potential return, diversification within each asset class, and selection of investments based on expected cash flow needs.

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Along with selecting an appropriate asset allocation, it is also important to make sure that expenses charged to the reserve fund are not excessively high. If a charity pays a vendor 100 basis points for investing and administration and charges the reserve fund an additional 75 basis points for internal costs, it will need to have a gross return of 5.25 percent (rather than ACGA's assumed 4.5 percent) to realize a 3.5 percent net return. Before deciding on fees, a charity should compare its expected net returns (after subtracting all expenses from a conservatively estimated gross return on reserves) with the net return underlying the ACGA rates. If it uses a different schedule of rates, it should do the comparison using the net return assumed by that schedule.

Whether handled in-house or outsourced, investment returns and expenses should be reviewed at least annually, and adjustments made as needed. While a charity cannot control market fluctuations, it can control the allocation of the assets backing its gift annuities.

Marketing Gift Annuities

Just as a charity is unlikely to be successful in timing the stock market, "timing" the issuance of gift annuities is also not likely to be a successful strategy. There is no way to know what will happen with a particular gift annuity based on what happened before it was issued. Many charities opted to put a stop, at least temporarily, on issuing gift annuities after the market events of 2008-09 as they watched the value of their gift annuity reserves drop. However, in the wake of the Great Recession gift annuity rates were lowered and investment returns rebounded. For charities that continued with their gift annuity marketing efforts, the annuities issued during that time have, in fact, turned out to have among the best results. Choosing to pull back can, in essence, "lock in" lower residual, and result in missed opportunities from gifts issued under what turn out to be more favorable circumstances.

In the 2017 ACGA survey, an analysis was made between rapidly growing programs (those that saw an increase of 50 percent or more when comparing the dollar volume of gift annuities in 2017 with that in 2013) and rapidly contracting programs – those that saw a decrease of 50 percent or more. (Such an analysis was not part of the 2021 survey report.) Contracting programs were more likely to report that limitations had been placed on the ability to market gift annuities, or that more restrictive administrative procedures had been put in place that hindered issuance.

The larger the pool of gift annuities and the more evenly spread the timing of when its annuities were funded, the better it can achieve an economy of scale where the results will average out closer to the assumptions. A small pool feels the effects of each individual annuity much more. Consistent marketing efforts and continued issuance over time will balance the risk of the overall gift annuity pool.

Tracking Individual Market Values

Technically there is no requirement to track and maintain a record of the individual market value for each gift annuity contract. Payment obligations are fixed, and thus not dependent on the current market value of a particular contract. Still, tracking market values is common for charities that allow donors to restrict the gift annuity residuum to a specific purpose, so that there will be a known ending value to be withdrawn when the annuity terminates and is utilized for the stated purpose.

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Even if all of a charity's annuities are designated for its general purposes, tracking individual values is beneficial for two primary reasons: 1) it allows for accurate withdrawal of funds when an annuity terminates, and 2) it allows for better monitoring of the overall health and profitability of the gift annuity program.

Absent actual market values, the amount to be withdrawn at termination must be determined through some other method. If the charity is subject to state reserve requirements, sometimes it will use the reserve liability as the withdrawal figure; but this calculated liability simply determines how much must be held to meet, at a given point in time, the future payment obligation, given the annuity rate, the annuitant's age, and a specified mortality table and interest rate. It is disconnected from what has transpired as far as actual earnings (or losses) and whether the person has lived longer than was expected at the time of the gift. Thus, using the reserve liability to withdraw at termination can result in too much or too little being taken out. Sometimes the charity will instead periodically take a distribution of the excess above what in aggregate it is required to hold in the reserve fund. But this, too, makes it likely that for any given annuity the amount being distributed is too much or too little. While for the purpose of an unrestricted gift this may not matter, it does make a difference in assessing the health of the program.

If a charity is taking out too much when annuities terminate, it is withdrawing funds that are in part attributable to annuities that are still in force. This can increase the likelihood that a charity at some point will need to pull general assets later to meet state reserve requirements or to make annuity payments. It can also skew the perception of the health of the program; funds previously taken are often forgotten, and all that is remembered is that general assets were needed to bolster the program. On the other hand, taking out too little when annuities terminate can also skew the perception of the program, giving the perhaps mistaken impression that it is not performing well. It also means the charity is not utilizing the funds in support of its mission as desired by the donors.

As noted above, some charities use state reserve requirements to determine the amount to be withdrawn. Another requirement of certain states is that a charity hold its gift annuity assets in a segregated fund. This practice also provides for better monitoring of the program. Without a segregated account, the contributed assets are frequently placed in one account, while the annuity payments are made from a different account, often without any recognition of the connection between the asset and the liability. Without this connection, it is difficult to document the effectiveness of the program, which can again lead to an incorrect assumption that it is operating poorly and thus should be shut down, or that it is operating smoothly, when in fact there may be policy or procedural issues that could be addressed to make it more successful.

It should be noted that while maintaining adequate reserves to meet applicable state reserve requirements is a positive indicator, doing so does not provide the same detail about the program as tracking individual values. Reserves may be adequate, while still resulting in disappointing residue. A focus on state requirements can also skew the perception of the program in two other ways. The first relates to a charity that does not place the full amount of the contribution into reserve. These "early withdrawals" are often not tracked. When an annuity terminates, the charity may be disappointed in the residuum available at that time; and, if the reserve fund drops

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below the required level and assets must be added later, it may feel its program is a drain on the charity, forgetting that some of the reserve dollars were taken earlier.

The second issue that can arise from focusing on state requirements (rather than tracking individual values) is the decision to take no distributions when annuities terminate. Sometimes circumstances will dictate this action in order to maintain adequate reserves; this was the case in late 2008 and early 2009 when account balances seemed to drop by the day. However, sometimes a charity can become overly fixated on the state requirement and decide that the more retained in the account the better. Such a build-up of excess reserves related to terminated (as opposed to active) annuities is unnecessary and runs counter to the ultimate goal of the program, which is to use each contribution to further the mission of the charity, as intended by the donor.

GIFT ANNUITIES: SIMPLE OR COMPLEX? (#7)

Charitable gift annuities are commonly thought of as a relatively simple, straightforward gift vehicle, and in many ways they are. While a donor should always be encouraged to seek the advice of their own advisors in any gifting situation that may have tax or estate planning implications, a gift annuity does not require an attorney to draft documents as would be the case with a charitable remainder trust. Most gift annuities also involve contributions of cash or publicly traded securities, and generally involve a one life annuity with the donor also being the annuitant, or a two-life annuity with two donors being the joint annuitants.

But gift annuities can and do give rise to more unusual situations. While not an exhaustive list, here are some things that should be on a gift planner's radar:

Deduction When the Sole or Last Annuitant Dies Prior to End of Life Expectancy

An annuitant of a one-life annuity who dies before the end of his/her life expectancy – or the surviving annuitant of a two-life annuity who dies prior to the end of the applicable joint life expectancy – is entitled to a posthumous income tax deduction for the unrecovered investment in the contract. See IRC Sec. 72(b)(3)(A). The annuitant is entitled to this deduction for use on the final income tax return regardless of whether the annuitant or another person funded the annuity. See IRC Sec. 72(b)(3)(B).

Changing the Frequency of Annuity Payments

Occasionally, an annuitant wants to change the schedule of payments. For example, an annuitant may want to receive quarterly payments rather than the semi-annual payments stipulated in the original agreement. Changing the payment frequency should be permissible so long as the new schedule of payments does not result in a higher present value of the annuity payments.

Whenever payment frequency is changed, whoever is administering the charity's gift annuities should be informed of the change. Moreover, the ideal timing is for the change to take effect with the first payment to be made in a calendar year, in order to simplify preparation of IRS Form 1099-R.

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Contributing the Right to Annuity Payments to the Charity

Some annuitants, discovering that they do not need the annuity payments, are willing to forfeit permanently their future right to them. Once an annuitant assigns his or her right to payments, the charity's obligation under the contract will terminate, and it will be free to use the residuum.

A gift annuity agreement will often include language such as the following: "This annuity is irrevocable and non-assignable, except that it may be assigned to the charity." Clearly, this wording would allow an annuitant to assign his or her interest to the charity. 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 of the annuity interest to the charity could be inferred or would at least be legally defensible.

The amount of the gift is the present value of the remaining annuity payments as of the date of assignment. The donor may be entitled to a charitable deduction, though it may be less than the amount of the gift.

Cash-out of a Gift Annuity

Rather than gifting their annuity interest to charity, an annuitant may wish to obtain a lump sum payment in lieu of continuing to receive lifetime payments. This should be possible provided the cash settlement does not exceed the present value of the annuity payments determined as of the date of settlement. The annuitant would be exchanging one property right (fixed payments for life) for another property right (a cash sum) of equivalent or lesser value. Here, as in the case of the sale of the income interest of a charitable remainder trust, it is advisable to secure an affidavit from a physician certifying under penalties of perjury that the annuitant has no known medical condition that could result in a shorter-than normal life expectancy.

Divorcing Annuitants

When a charity learns that annuitant spouses have divorced, adjustments in its administration of the annuity will depend on the terms of the agreement itself, the terms of the divorce decree if it was specifically addressed in that document, and/or any applicable state law. Commonly the gift annuity will have been established as joint and survivor, with each party being entitled to one-half of the annuity payment, though from an administrative perspective a single payment has been made and a single Form 1099-R is issued under one Social Security number.

Assuming no other arrangement has been specified in the divorce decree, the charity should begin sending a payment of one-half of the full amount to each of the annuitants, and there would be two Forms 1099-R, one to each of them reflecting their half. If the annuity had been set up with successive rather than joint payments, then the payments would continue in accordance with the agreement, unless otherwise indicated in the final property settlement. Regardless of whether the charity had 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.

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Contributions of Illiquid Assets Other Than Stock

Most gift annuities are funded with either cash or marketable securities. Certainly, a charity is less at risk when it accepts only these types of assets for a gift annuity. On the other hand, a charity may foreclose opportunities for some significant gifts when it refuses to consider different assets. Among other assets that could potentially be contributed for a gift annuity are real estate, tangible personal property, a life insurance policy or commercial annuity, or closely held stock.

Before contributing such assets, the donor needs to be fully informed about the tax consequences. Sometimes the deduction may be less than expected, and in some cases the donor may even incur a net cost because the tax on the recognized gain exceeds the tax savings from the deduction. Apart from the immediate tax consequences, the gift could still be advantageous considering the future stream of payments.

Likewise, the charity must evaluate each of these gifts on a case-by-case basis to make sure they are in its best interest. The charity might ask itself two questions in particular:

1. If the asset is accepted, will the charity be able to meet the reserve requirements of various regulated states where it is registered?

   Certain states limit the type of investments in the required segregated reserve fund. Real estate, closely held stock, and tangible personal property are not on the approved list in some of those states. It does not follow that a gift annuity cannot be funded with these assets. Rather, it simply means that they cannot be included in the investments of the required reserve fund. So long as the charity maintains in the reserve fund sufficient qualifying assets to back outstanding annuities, it can accept any kind of asset it wishes. However, if it accepts an asset such as real estate, and the property is not readily sold, the charity might have to move some if its general assets into the reserve fund to maintain it at the required level.

2. Does acceptance of the asset make good business sense?

   While some assets are more equivalent to gifts of cash and thus entail no additional risk to the charity, other assets do entail risk. Consequently, the charity should evaluate them very carefully, looking at marketability, the price range at which they may sell, holding costs, and selling costs. In many instances it may take certain steps to reduce risk, such as offering a lower annuity rate than it would for an annuity funded with cash or marketable securities.

CONCLUSION

Donors and charities will continue to appreciate the ease of supporting the organization via a charitable gift annuity. But remember that beneath the simplicity of the transaction there are requirements and decision points. Take time to make sure you understand the essential elements and let those inform the operation of your gift annuity program. You will be better prepared to respond to donor questions and your program will be on stronger footing.

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APPENDIX A

COMPARISON OF GIFT ANNUITIES AND CHARITABLE REMAINDER TRUSTS

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

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

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APPENDIX B

STATE REGULATORY CATEGORIES

1. State law requires segregated reserve, annual reporting, and/or detailed application (11):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Investment limitations	Other registrations
AL[1]	—	—	yes	yes	—	—
AR	5	yes	—	yes[2]	yes[3]	—
CA	10	yes	yes	yes[4]	yes[4]	—
FL	5	—	yes	yes[5]	yes	—
HI[6]	10 in HI	—	yes	yes	—[7]	—
MD	10 in MD	—	yes[8]	yes	—[7]	—
NJ	10	yes	—	yes	—[7]	yes[9]
NY	10	yes	—	yes	—[7]	—
ND	—	—	—	yes	—	—
TN	—	—	yes[8]	yes[10]	—[7]	—
WA[11]	3	—	—	yes	—[7]	yes[12]

NOTES:

[1] Regulated by Securities Dept. rather than Insurance
[2] May elect to segregate AR annuitants
[3] Prudent investor standard allowed
[4] CA annuitants only
[5] May elect to segregate FL annuitants
[6] Law requires $200,000 of assets in Hawaii
[7] Prudent investor standard
[8] If signed, or in separate signed document
[9] Registration with NJ Div. of Revenue and NJ Dept. of Law and Public Safety
[10] TN-only fund allowed but no longer mandated
[11] Organization must have $500,000 in unrestricted net assets
[12] Registration with WA Secretary of State

2. State law provides for exemption - Notification required (14):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Available assets	Other registrations
AK	3	—	yes	—	$300k	—
CT	3	—	yes	—	$300k	—
GA[13]	3	—	yes	—	$300k	—
ID	3	—	yes	—	$100k	—
IA	3	—	yes	—	$300k	—
MS	3	—	yes	—	$300k	yes[14]
MO	3	—	yes	—	$100k	—
NV	3	—	yes	—	$300k	—
NH[15, 16]	3	—	yes	yes	$300k	yes[17]
NM	3	—	yes	—	$300k[18]	—
NC	3	—	yes	—	$100k	—
OK[13]	3	—	yes	—	$100k	—
TX	3	—	yes	—	$100k	—
WV	3	—	yes	—	$300k	—

NOTES:

[13] Annual reporting: submission of audited financial statement
[14] Registration with MS Secretary of State (as charitable organization)
[15] Annual reporting: re-notification
[16] Annuity rates must not exceed ACGA suggested rates
[17] General registration with NH Dept. of Justice in some instances
[18] Either in unrestricted assets or reserve fund

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3. State law provides for exemption - No notification required (22):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Available assets	Other registrations
AZ	3	—	—[19]	—	$300k	—
CO	3	—	yes	—	—	—
DE	—	—	—	—	—	—
IL	20[20]	—	—	—	$2 mil.[20]	—
IN	—	—	—	—	—	—
KS	—	—	—	—	—	—
KY	—	—	—	—	—	yes[21]
LA	—	—	—	—	—	—
ME	5	—	—	—	—	yes[22]
MA	—	—	—	—	—	—
MI	—	—	—	—	—	—
MN	—	—	—	—	—	—
MT	3[20]	—	—	yes[20]	$100K[20,23]	—
NE	3	—	—	—	—	—
OR	5	—	—[24]	yes	$300k	—
PA	3	—	yes	—	$100k[25]	yes[26]
SC	5	—	—	—	—	—
SD	10	—	yes	—	$500k	yes[27]
UT	—	—	—	—	—	—
VA	3	—	yes	—	$100k	—
VT	3	—	yes	—	$300k	—
WI	3	—	yes[28]	—	—	—

NOTES:

[19] Detailed disclosure statement to donor prior to gift

[20] Waived if annuities reinsured

[21] Certain charities must file copy of Form 990 with KY Attorney General

[22] Registration with ME Secretary of State (qualified as foreign corporation)

[23] $100k in unrestricted assets or $300k net worth

[24] Content-specific written disclosure, in agreement or other document

[25] Plus one-half principal value of then outstanding annuities

[26] Certain charities must register with PA Dept. of State (general solicitation law)

[27] Registration with SD Secretary of State (qualified as foreign corporation)

[28] Language modified when law changed 4/18/14

4. State law does not specifically address gift annuities (4):

DC, OH [29], RI, WY

NOTES:

[29] OH previously provided for an exemption from securities law under now rescinded administrative rule. OH Court of Appeals case decided in 2002 held gift annuities not subject to insurance regulation (OH Supreme Court declined to hear appeal).

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