Lessons Learned From Gift Annuity Mistakes

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Presenter: Jeff Lydenberg
Vice President, Consulting
PG Calc Incorporated

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Agenda

- Best practices with gift annuities
  - Establishment
  - Administration
- Mistakes made before or at time gift is made
  - Lessons learned in setting up annuities
- Mistakes made in administration of annuities
  - Lessons learned during annuity term

Best Practices In Gift Annuity Administration

- Gift annuity application
  - Donor and annuitant names and contact information
    - Dates of birth (Not ages!)
    - Relationship to donor (Self? Spouse? Other?)
    - How payments are to be made, one life or two; successive or concurrent
  - Asset donated
    - Cash
    - Appreciated property
      - Ownership
      - Cost basis

Best Practices In Gift Annuity Administration

- Annuity type
  - Immediate?
  - Deferred?
    - Date of first payment
    - If flexible deferred, range of years payments may begin
  - Payment frequency?
- Purpose
  - Gift restriction, if any

Best Practices In Gift Annuity Administration

- Contact person
  - "Please provide the name, address, and phone number of a relative, friend, attorney or other business acquaintance with whom charity may communicate with each annuitant if charity is unable to contact the annuitant."
- Contemplates the deceased or missing annuitant
- Who will know how to find the annuitant?

Best Practices In Gift Annuity Administration

- Maintain data
- Payments
- Tax reporting
- Maintain market values
- Accounting and compliance

Mistakes Made Before or At Time of Gift

The cases that follow entail mistakes made before or at the time a gift annuity is funded.

Mistake 1:
Revaluation of Appreciated Assets

- Securities
  - – Average of high and low on date of transfer
- Mistakes
  - – Valued using net proceeds instead of gross
  - – Valued using closing price only
  - – Valued on the incorrect date
    - When did securities leave donor’s ownership and control?

Mistake 1: Revaluation of Appreciated Assets

- If no payments made, return not yet filed:
  - Issue corrected calculations and new contract
- If payments made, but caught before year end:
  - Issue corrected calculations and new contract
  - Adjust remaining payments to reflect correct annuity
- If 1099-R issued and deduction claimed
  - Issue corrected calculations and new contract
  - Issue corrected 1099-R and donor amends return

Mistake 1: Revaluation of Appreciated Assets

- **Lessons learned:**
  - Written gift administration procedures describe how to value gifts of securities
  - Procedures should identify resources to obtain valuation data
  - Administration should be double-checked at each step

Mistake 2:
Gift Annuity Funded with Loss Property

- Marketing materials encourage contribution of securities to fund CGAs
- If worth more than when purchased, can reduce capital gain income
- Gain attributable to gift is forgiven
- Balance of gain reported pro-rata if donor = annuitant

Mistake 2:
Gift Annuity Funded with Loss Property

- Capital loss property
  - Worth less than what donor paid
  - Capital losses can be netted against capital gains
- Donor should sell loss property, donate proceeds
- Can't unring this bell
- **Lesson learned:** gift annuity application can help prevent accepting loss property

Mistake 3: Annuitant and Donor Not the Same Person

- Annuities typically for benefit of donor
- Donor (money giver)
- Annuitant (money getter)
- If donor not annuitant:
  - Gift tax issues
  - Capital gain issues

Mistake 3: Annuitant and Donor Not the Same Person

- Gift taxes
  - Gifts between persons subject to tax
  - $14,000 annual exemption in 2014
  - Unlimited marital exemption
  - $5.34 million gift and estate tax exemption in 2014
- Gift tax return requirement
  - Not required if interest under $14,000
  - In excess of a $14,000 interest, reportable
  - No tax unless exemption exhausted

Mistake 3:
Annuitant and Donor Not the Same Person

- Capital gain taxes
  - Appreciated property funding annuity
  - Gain attributable to gift forgiven
  - Balance of gain reportable
- Reporting of gain
  - Reported pro-rata over life expectancy if donor and annuitant same person
  - Reported in year of gift if donor not the annuitant

Mistake 3: Annuitant and Donor Not the Same Person

- Gift of separate property to two-life annuity
  - Gain reported over only one life
  - Accelerates rate of capital gain reporting
  - Crowds out tax-free
- If donor not annuitant
  - Reportable gain reduced compared to sale (discount)
  - Reportable gain offset by income tax deduction

Mistake 3: Annuitant and Donor Not the Same Person

- **Lessons learned:**
  - Application distinguishes donor from annuitant
  - Application discloses “unexpected capital gain…”
  - Revocation clause can make gift incomplete
    - Income interest subject to taxation, not entire gift
    - Completed gifts to the extent of payments made
  - Transfer appreciated property to joint ownership for married couple annuity
  - Transfer appreciated property to annuitant spouse if one-life annuity

Mistake 4: Donor or Annuitant not a U.S. Taxpayer

- Does donor or annuitant file a U.S. return?
  - U.S. residence not dispositive
- If yes, situation similar to U.S. donor/annuitant
- If no:
  - What is donor/annuitant's country of residence?
  - Payments subject to withholding by charity
  - Withholding rate varies with applicable tax treaty

Mistake 4:
Donor or Annuitant not a U.S. Taxpayer

- **Lesson learned:**
  - Does application indicate a non-U.S. donor or annuitant? Foreign address? No social security number?
  - Contract and rates same as other cases
  - If not a U.S. taxpayer, consult advisors and Publication 515 to determine withholding requirement

Mistake 5: Gift Annuity for One Spouse

- Rate shoppers find one-life rates are better than two-life
- One spouse establishes annuity, often the eldest of the two
- Annuitant passes and survivor is left without payments

Mistake 5: Gift Annuity for One Spouse

- Proceed with caution in this case
  - "Does your spouse know…"
  - "What have you told your family…"
- Consider disclosure letter
  - "We understand that…"
  - Not bullet proof
- **Lesson Learned:** Ensure donors understand consequences of gift

Mistake 6:
Payment Frequency is Incorrect

- Default frequency for most is quarterly
- Annuitant may not indicate a preference at time of gift
- Frequency may be wrong from outset
- Annuitant may want to change frequency

Mistake 6:
Payment Frequency is Incorrect

- Deduction is affected by payment frequency
- Less frequent payment, higher deduction
  - Inverse is also true
- Adjustment of payment frequency must result in same present value of payments
- Payment amount adjusted, not other variables

Mistake 6: Payment Frequency is Incorrect

- **Lessons learned:**
  - If payments less frequent, no adjustment to payment required
  - If payments more frequent, payment amount must be reduced
  - If frequency same, but date of payment in period different, no adjustment
  - Gift annuity application signed by donor can prevent if it was a mistake

Mistakes Made In Administration

The cases that follow entail mistakes made during the administration of existing gift annuity contracts.

Mistake 1: Failure to Track Market Values

- Annuities unlimited obligation to pay
- Performance of pool vs. individual contracts
- Restricted annuities
- Unrestricted annuities
- Sufficiency of reserves

Mistake 1: Failure to Track Market Values

- Fund accounting for gift annuities
  - Investment returns, losses, and fees allocated pro-rata across all annuities
  - Balance reduced by payments to annuitants
  - Are terminations left in pool?
  - Are returns allocated to terminated annuities?
  - Permits tracking profitability of program

Mistake 1:
Failure to Track Market Values

- **Lessons learned:**
  - Restricted annuities require tracking market values
  - Inform donor that annuities are a shrinking fund
    - Naming recognition may require supplementing residua
  - Market values can be estimated if not tracked previously
  - Tracking market values can identify how to make program more profitable

Mistake 2:
Failure to Make Payments

- Deferred gift annuity
  – Lax oversight and administration
  – Date of first payment comes and goes
- Successor annuitants
- Immediate annuity
  – Confusion whether outright gift or for annuity
  – Annuitant inquires as to status of payments

Mistake 2:
Failure to Make Payments

- If caught before first year of payments ends:
  - Issue missed payments and begin regular installments
  - Interest?
- If caught after first year of payments:
  - Issue missed payments and begin regular installments
  - Issue 1099-R including lump sum of missed payments
  - Interest?

Mistake 2:
Failure to Make Payments

- **Lessons learned:**
  - Annuity application clarifies donor intent
  - Verify gift entered into system at inception
  - Check for successor annuitant at death of any annuitant
  - Establish tickler system to incorporate deferred annuities

Mistake 3: Married Annuitants Divorce

- Effect of divorce on a CGA contract
  - Joint property, successive payments
  - Joint property, concurrent payments
  - Separate property
- Revocation clause
- Divorce may not become known until long after the event

Mistake 3:
Married Annuitants Divorce

- Joint property, concurrent payments
  - 50% of payments to each
  - Adjust taxation and two 1099-Rs
- Court could order 100% of payments to only one spouse
- Adjustment of taxation may be required

Mistake 3: Married Annuitants Divorce

- Divorce decree or property settlement may not address the annuity
- Revocation may not be executed
- **Lesson learned:** Follow contract unless valid revocation exercised or otherwise ordered by court

Mistake 4:
Offering Higher Than ACGA Rates

- Some charities compete on “price”
- Rates higher than ACGA put annuities at risk
- Compliance in some states requires filing rate schedule and adherence
- Increases amount required to maintain reserve in regulated states

Mistake 4: Offering Higher Than ACGA Rates

- Rates higher than ACGA #1 reason annuities exhaust
- **Lessons learned:**
  - Follow ACGA rates consistently
  - Annuitant could surrender income, additional deduction
  - Annuitant could reassign income to charity

Mistake 5: An Annuitant has Gone Missing

- Comes to attention of charity when:
  - Checks are returned
  - Checks are uncashed
  - EFTs are returned due to closed account
- Is annuitant dead or missing?
- Check SSDI and other sources

Mistake 5:
An Annuitant has Gone Missing

- Obligation to continue payments
  - Some states want payments to continue even if annuitant ceases taking payments
  - Some states let charity stop making payments, but must make up payments if annuitant located
  - Some states require including missing annuitants in reserve reports

Mistake 5:
An Annuitant has Gone Missing

- **Lessons learned:**
  - Annuity application requests whom might we contact if unable to reach you
  - IRS expects 1099-Rs to be filed for years when annuitant is missing
  - May or may not need to amend 1099-Rs if annuitant located
  - Be alert to fraudulent acceptance of annuity payments

Mistake 6:
The Commuted Annuity That Couldn’t

- Commuted or “college” annuity
  - Deferred annuity
  - Allows annuitant commute (exchange) lifetime payments for payments over period of years
- Value of annuity payments influenced by discount rate in effect at time of commutation
- Unexpected consequences of wide separation between gift date and commutation date

Mistake 6:
The Commuted Annuity That Couldn't

- Case study
  - 2007 gift, annuitant age 12, gift amount $20,000
  - Discount rate 5.8%
  - If commuted at gift, four installments of $4,968 a year
- Commutation exercised in 2013
  - Discount rate 1.2%
  - Four installments of $9,916 a year
  - Principal dwindled to $7,000

Mistake 6:
The Commuted Annuity That Couldn't

- **Lessons learned:**
  - Commuted annuity may not be best college plan for annuitant or charity
  - Exercise of commutation at time of gift removes unexpected results
  - Careful investments required to make deferred annuities profitable

Conclusion

- Some mistakes avoidable
- Some mistakes aren’t anticipated
- Gift acceptance and administration procedures can avoid most mistakes

Questions and Answers

Still Have a Question?

Contact: Jeff Lydenberg
Vice President, Consulting
PG Calc Incorporated

E-mail: jeff@pgcalc.com