TIAA-CREF institute

# TRENDS AND ISSUES

## *The Role of Gift Annuities In a Planned Giving Program*

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October 2005

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FINANCIAL SERVICES
FOR THE GREATER GOOD℠

## EXECUTIVE SUMMARY

Planned giving programs at colleges and universities, as well as at other charitable institutions, often provide a number of giving vehicles to their alumni and other donors. Gifts are generally categorized by their timing, either present gifts or deferred gifts. Deferred gifts are becoming more popular as individuals live longer and want to make sure they don't outlive their assets. Although bequests (provisions in wills and in living trusts) constitute the greatest volume of deferred gifts, life income gifts are a significant and growing component. In recent years, gift annuities have emerged as the most popular form of life income vehicle through charities. As a brief description, 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.

Colleges and universities are appropriate institutions for offering gift annuities since many of their donors are older and would be interested in life income. They also are perceived as enduring institutions and normally have sufficient endowments and reserves to reassure donors who might be apprehensive about the safety of a gift annuity. Not surprisingly, colleges account for a large share of gift annuities, and alumni have come to expect their alma maters to offer this giving option.

This issue of Trends and Issues describes how a gift annuity accomplishes a donor's objective of making a gift to his or her college/university endowment (or other charity), while gaining important tax advantages and the security of lifetime income. Comparisons between gift annuities and other types of life income vehicles are also provided, as well as some examples of gift annuity scenarios.

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*NOTE: Frank Minton, author of this "Trends and Issues," spoke recently on gift annuities at TIAA-CREF Trust Company's biennial Planned Giving Symposium in St. Louis, MO. This article is derived from that presentation.*

## INTRODUCTION

The simplest and most common way to support a charity is through an outright gift of cash, whether in currency, by check, or by credit card. However, many people cannot or choose not to make larger gifts in this manner because they have mostly non-cash assets, they desire the greater tax benefits from giving something else, they cannot afford to surrender income-producing capital, or they want to maintain control of assets during their lifetime. A major gift might be possible for them if they could give something other than cash, they don't reduce their cash flow, and they continue to feel personally secure.

## THE RELATIONSHIP OF PLANNED AND MAJOR GIFTS

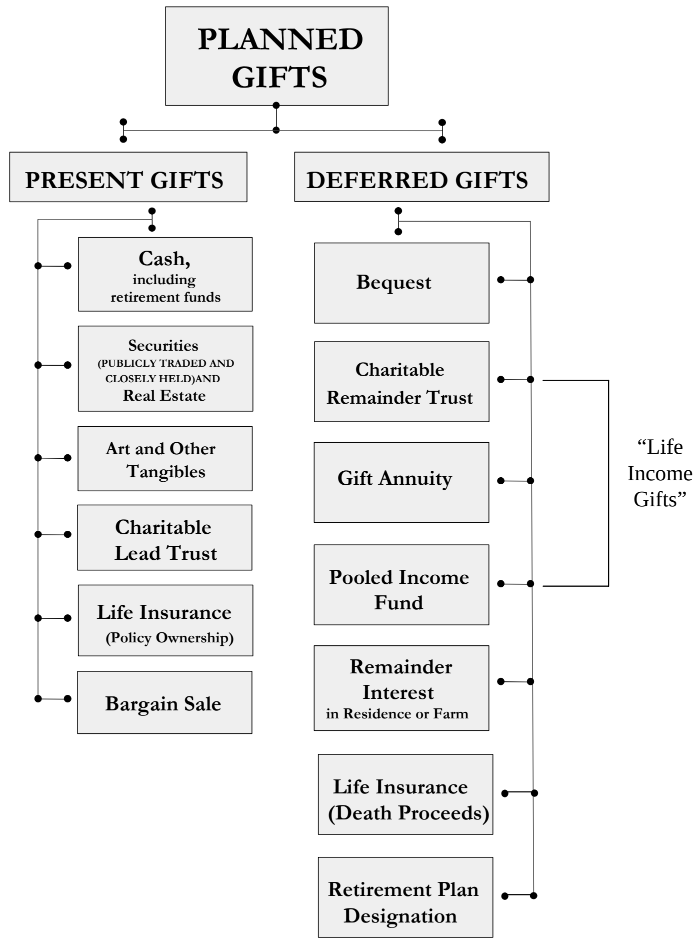
The purpose of planned giving (also known as gift planning) is to attract more major gifts by enabling people to give the right asset, in the right way, at the right time. Planned giving is based on these principles:

- Gifts are engendered by emotion.
- Building relationships is the key to securing major gifts.
- People will give more when shown ways to make a gift.

Some charities, particularly colleges and universities, have fundraisers specializing in (1) annual giving, (2) grants from corporations and foundations, (3) major gifts from individuals, and (4) planned gifts. *Major gift officers focus* on current or "outright" gifts, particularly of cash and publicly-traded securities. *Planned gift officers* focus on deferred gifts and usually also on current gifts involving complicated assets such as real estate, closely-held stock, partnership interests, and such. In some charities planned and major gifts have been merged, but the more common practice in larger charities, and especially in colleges and universities, is for planned giving to be a separate department yet for planned and major gift officers to collaborate.

## TYPES OF PLANNED GIFTS

Although major and planned gift officers focus on different kinds of gifts, it is important to keep in mind that any gift, whether current or deferred, that entails consideration of philanthropic objectives and financial consequences is a planned gift. The following diagram showing the various types of planned gifts is based on this inclusive definition.




## GROWTH OF PLANNED GIVING

Recent years have seen a significant increase in deferred gifts. One reason is the wealth transfer from the generation born between the two World Wars. Because of their experience with the Great Depression, these individuals tended to be security conscious and, consequently, many made their charitable gifts either at the end of life or through a life-income arrangement. A second, related reason is the fact that people are living longer and are seeking ways to assure income for the 20 or 30 years they might live after retirement. Still another reason is the fact that people are more aware of deferred gift options, both because of the proliferation of planned giving programs and because even more estate and financial services professionals are suggesting deferred planned gifts to clients.

Bequests (both provisions in wills and in living trusts) constitute the greatest volume of deferred gifts. For example, even in the Ivy League schools, all of which offer a full menu of planned gifts, bequests account for approximately 80 percent of deferred gift revenue. However, life income gifts are a significant and growing component. In those Ivy League Schools a total of $51,057,000 was contributed for life income plans in 2003, which is an average of $6,382,125 per institution. One Big Ten University is investing over $90 million of life income assets, mostly charitable remainder trusts and gift annuities, and one religious body has $100 million just from gift annuity contributions.

Planned gifts, both bequests and life income plans, now account for a significant percentage of total dollars raised and committed in many capital campaigns. A major consulting firm that has conducted numerous capital campaigns for colleges and universities reports that upwards of 40 percent of capital campaign gifts are planned gifts. The deferred gifts may have been counted at face value, discounted present value, or some combination of both, for not all institutions follow the guidelines for counting planned gifts that have been set forth by the Council for the Advancement and Support of Education (CASE). Whether the methodology for counting is more liberal or conservative, the fact remains that planned gifts are figuring ever more prominently in capital campaigns as well as normal fundraising.

When it comes to life income plans, the two most popular vehicles are the charitable remainder trust and the gift annuity. A third, the pooled income fund, was actively promoted in the 1970s and early 1980s. However, pooled income funds, with a few exceptions, have fallen out of favor because (1) in a low-interest environment they generally pay beneficiaries less then they would receive from a gift annuity, (2) the payments from them are fully taxable, and (3) the move from a fixed to a fluctuating IRS discount rate eliminated some of the comparative advantages pooled income funds once had over remainder trust and gift annuities with regard to the determination of the income tax charitable deduction.

For the past few years, more money has been contributed for gift annuities than for charitable remainder trusts. The total number of gift annuities established each year has always exceeded the total number of remainder trusts, but the latter accounted for more dollars in the 1990s. That is because remainder trusts are typically funded with appreciated property, partially to avoid taxation of capital gain upon the sale of the property, so there was a strong incentive to create them during a prolonged bull market when the tax on capital gains was higher. They remain very important, and a number are being funded with securities now that the stock markets have recovered somewhat. Also, they are a very appropriate way during a heated real estate market for investors to transfer appreciated real estate, lock in their gains, and receive life income as well as tax relief.

Nevertheless, gift annuities are still accounting for most life income plan activity, and for that reason the balance of this article focuses on them.

## DESCRIPTION OF A GIFT ANNUITY

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

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

The gift annuity can be either immediate or deferred. With an **immediate gift annuity**, the annuitant(s) start(s) receiving payments at the end (or beginning) of the payment period immediately following the contribution. The first payment is customarily prorated from the date of the contribution to the end of the first period. With a **deferred gift annuity**, the annuitant(s) start(s) receiving payments on a future date. In the case of a **flexible** deferred gift annuity, the annuitant(s) can decide later when the payments begin, and the longer the deferral period, the larger the payments will be.

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

## INCOME TAX BENEFITS OF GIFT ANNUITIES

The donor is allowed an income tax charitable deduction for the excess of the contribution over the present value of the payments to be received. Generally, this is 20 to 40 percent of the gift, depending on the age(s) of the annuitants, the annuity rate paid, and the IRS discount rate. (The discount rate, also called the "charitable mid-term federal rate," is what the charity is presumed to earn on the investment of gift annuity reserves.)

When cash is contributed for a gift annuity, a portion of each payment will be a tax-free return of principal, and the balance will be taxable as ordinary income for the duration of the life expectancy. If the annuitant(s) live(s) beyond life expectancy, the payments become fully taxable as ordinary income.

When long-term appreciated property is contributed, the portion of the gain attributable to the donation is not taxed. The portion attributable to the present value of the payments is taxable, but it can be reported over life expectancy if the donor is an initial annuitant. This means that part of each payment will be taxable as capital gain. Part will also be taxed as ordinary income, and a portion may be a tax-free return of principal. As in the case of a gift annuity funded with cash, if the annuitant(s) live(s) beyond life expectancy, the payments will be fully taxable as ordinary income.

## GIFT ANNUITY RATES

Most charities follow the gift annuity rates recommended by the American Council on Gift Annuities (ACGA). This encourages donors to make decisions based on the causes they want to support, rather than on which charities pay the highest rates. Older annuitants receive higher rates because of their shorter life expectancy.

The gift annuity rates are designed to leave a charity with a residuum of 50 percent of the contribution – somewhat higher in the case of annuitants over age 86 and under age 59. The 50-percent residuum will be realized if the total returns on gift annuity reserves is 6.0 percent, the expenses for investing gift annuity reserves and administering gift annuities are 1.0 percent, and annuitants live to the life expectancy of the Annuity 2000 Tables plus approximately two years. According to a national survey conducted by the ACGA in 2004, the median actual residuum realized by charities is 65.6 percent of the contribution.

## STATE REGULATION OF GIFT ANNUITIES

Before issuing gift annuities in a particular state, a charity should comply with the regulations of that state. It is not enough to comply with the regulations of the state where the charity is domiciled, for a charity is subject to the laws of the state where the donor or annuitant resides at the time the agreement is executed.

Fortunately, two-thirds of the states exempt gift annuities from most regulations, though in many instances the exemption is contingent on meeting certain requirements. For instance, a charity may have to have been in existence for a minimum number of years, maintain at all times a certain amount of unrestricted assets, disclose in the gift annuity agreement that the annuity is not backed by a state guaranty association, and notify the state of an intent to issue gift annuities. Twelve states regulate gift annuities to a greater extent, requiring a permit, a segregated reserve fund with assets invested in certain ways and sufficient to meet outstanding obligations, and/or annual reporting on gift annuity activity and reserves. Failure to comply with state law could result in a "cease and desist" order, a fine, an order to rescind annuities, or other penalties. The non-compliant charity could also be vulnerable to a lawsuit filed by a disgruntled heir or donor.

## COMPARISON OF GIFT ANNUITIES WITH CHARITABLE REMAINDER TRUSTS

The contractual nature of a gift annuity distinguishes it from a charitable reminder trust. In the case of a charitable reminder trust, the contribution is made not to the 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 trust, not that of the charitable remainder beneficiary.

As the name suggests, a **charitable remainder annuity trust** has some things in common with a gift annuity. Both of them pay a fixed amount (in the case of an annuity trust, at least 5.0 percent of the amount contributed) to the beneficiary(ies) and the charitable deduction will be the same, if the gift annuity rate and trust payout rate are the same. They are different in that the annuity trust could be for a term of years and could have more than two beneficiaries. Also, the payments are taxed differently. Whereas the taxation of gift annuity payments is known in advance, the taxation of annuity trust payments depends on the nature, extent, and timing of the income earned by the trust. While the distribution rules are complex, generally interest and dividends are distributed first, then capital gain, then tax-exempt interest, and finally tax-free distribution of trust corpus. In most cases, donors prefer a gift annuity because it is simpler and backed by all of the assets of the charity, but they might opt for an annuity trust if there are more than two beneficiaries, they want payments for a term of years, and the trust is expected to hold an asset such as municipal bonds.

The **charitable remainder unitrust** is more common and versatile. Unlike a gift annuity and an annuity trust, it pays a variable amount to beneficiaries, which is a fixed percentage (at least 5.0 percent and not more than 50 percent) of the net fair market value of trust assets re-valued annually. The unitrust appeals to those who want the potential of income growth to keep pace with inflation, though they must accept downside risk.

A variation of the unitrust makes it practical to contribute assets that would not be very appropriate for either a gift annuity or an annuity trust. That variation involves a trust provision allowing the trustee to pay the lesser of the stipulated percentage of trust assets or the actual net income of the trust, either for the duration of the trust or until the occurrence of a specific event, such as the sale of the donated property, whereupon the trust starts paying the percentage amount. With such a provision, a donor could transfer an illiquid asset, such as real estate, and the trustee could distribute only whatever net income is earned by the trust (if any) until the property sells. The "net-income" type unitrust could also be used when the beneficiary wants to use the unitrust as a source of supplemental retirement income, in which case the trustee would invest for growth during working years, generating just enough trust income to cover trust expenses.

While a deferred gift annuity could also be used as a supplemental retirement plan, the fact is that most gift annuities are established by those already retired, particularly those who have reached the stage of life when the security of fixed payments is more important than inflation protection with the attendant risks. The average age of those who contribute for a gift annuity is 78. Contributors to charitable remainder unitrusts tend to be somewhat younger. They are also likely to own appreciated securities or real estate and to be able to contribute several hundred thousand dollars. By contrast, many people who fund gift annuities are not particularly wealthy. Per the 2004 ACGA survey, the average size of a gift annuity is $59,926, and the median size is $28,027.

## EXAMPLES OF GIFT ANNUITIES

Most commonly, gift annuities are funded with either cash or publicly traded securities. Typically, there will be a single donor who is also the annuitant, or a husband and wife who contribute jointly-owned or community property for a joint and survivor annuity for the two of them. However, gift annuities may be funded with a variety of assets, such as real estate, collectibles, and the cash value of life insurance; and the annuitants are not necessarily the donors. Here are three examples, the first quite typical, the next two demonstrating the range of creative possibilities.

### *EXAMPLE ONE*

Ms. S, age 75, receives pension income plus interest from bonds and CDs. The return on her CDs is about 3.0 percent. She would like to increase her cash flow and make a charitable gift. To accomplish her objective, she contributes $50,000 from a matured CD for a gift annuity.

**Prior to the Gift:**

| | |
|---|---|
| Invested in CD | $ 50,000 |
| Interest | 1,500 |
| Income Tax on Interest (28% rate) | (420) |
| Net Spendable | $ 1,080 |

**After the Gift:**

| | |
|---|---|
| Contributed for Gift Annuity | $ 50,000 |
| Annual Payment | 3,550 |
| Taxed as Follows During Life Expectancy | |
| Ordinary Income | 1,306* |
| Tax-free | 2,244* |
| Income Tax (28% x $1,306) | (366) |
| Net Spendable | $ 3,184 |

In addition to almost tripling her cash flow, Ms. S receives a charitable deduction of $22,164, which results in tax savings of $6,206, assuming she is in the 28-percent tax bracket.

* Based on an IRS discount rate of 5.0 percent.

### *EXAMPLE TWO*

Mr. F has been subsidizing his mother, whose social security and pension income are insufficient to cover her expenses at the retirement home where she resides. He has been providing the assistance with after-tax dollars, which is an expensive way to do it, given his high tax bracket. To provide for his mother's future support in the most tax-efficient manner, he contributes stock having a fair market value of $100,000 and a cost basis of $40,000 for a gift annuity, and names his mother as annuitant.

His mother, who is 82, will receive $8,500 per year ($708.33 per month). Because he is not the annuitant, Mr. F will recognize the capital gain ($29,588) allocated to the present value of the annuity. However, his charitable deduction of $50,686* will offset the taxable gain and reduce taxes on other income. By reserving the right to revoke her payments (a right he never intends to exercise) he avoids making a taxable gift to her. A large portion of his mother's payments will be tax-free, and the tax on the taxable portion will be minimal because of her low tax bracket.

* This deduction is also based on a 5.0 percent IRS discount rate.

### *EXAMPLE THREE*

Mr. J, age 51, wants to receive supplemental income when he retires, but he does not know at this time when he will be ready to retire. He contributes stock having a fair market value of $100,000 and a cost basis of $60,000 for a gift annuity, and reserves the option to start quarterly payments on March 31 of any year during the period 2012-2022. The longer he waits to begin the payments, the larger they will be. For example, if he elects to start payments in 2012, they will total $7,600 per year, but if he waits until 2017 to begin payments, they will total $10,200 per year. Besides future payments, he receives an income tax charitable deduction of $25,450, which reduces current income tax. A portion of the capital gain will never be taxed, and the taxable portion is reported ratably over life expectancy once payments begin. This means that he pays no tax on the gain now, but a portion of the future annuity payments will be taxable gain.

## CONTROLLING THE RISK OF GIFT ANNUITIES

Some charities hesitate to offer gift annuities because of the risks involved. They are concerned about the possibility that a contribution for a gift annuity will be entirely consumed before the obligation ceases, and they will have to use general funds to continue payments. Indeed, a loss on a particular annuity is possible, but a loss on the gift annuity program as a whole is extremely unlikely if the charity:

- Does not exceed the conservative rates recommended by the ACGA,
- Invests gift annuity reserves prudently using an asset allocation that strikes a proper balance between risk and potential return,
- Does not spend any of the contribution until the obligation terminates, and
- Adopts sensible policies regarding minimum contribution levels and minimum ages of annuitants to assure that gift annuities are cost effective.

Two-thirds of charities outsource the investment of gift annuity reserves and the administration of gift annuities to a financial institution. Usually, the financial institution will have constructed portfolios specifically for gift annuity reserves that conform to any state limitations on types of investments.

Small charities, or those that are particularly risk averse, may limit expenses by reinsuring some or all of their gift annuities. However, over 90 percent of gift annuities continue to be self-insured. Either by reinsuring or by managing risk through self-insuring, charities can realize significant returns on their gift annuity programs.

## DECIDING WHICH PLANNED GIFTS TO OFFER

Every charity, with the exception of those created to meet a temporary need such as disaster relief, should encourage donors to include the charity in their wills or living trusts, to name it as beneficiary of retirement plans, and to make arrangements to accept as outright gifts assets other than cash and publicly-traded securities. For example, many people now have highly-appreciated real estate they would consider giving.

Charities that have on their development staff someone with sufficient knowledge of charitable remainder trusts and other more complicated planned gifts may expand their menu of planned gifts to include these instruments. However, charities generally should not act as trustee unless they are prepared to engage a financial institution as co-trustee or agent to administer trusts.

A charity should consider rounding out its menu with gift annuities if it has a significant number of donors over age 65, and it is financially strong. When a charity issues a gift annuity it has a moral, as well as a financial obligation to fulfill commitments in the gift annuity agreement. Thus, only charities that are able to make long-term commitments should start a gift annuity program.

Among the charities for which a gift annuity program is appropriate are colleges and universities. They generally have the right demographic and can easily identify alumni in the older age range. They also are perceived as enduring institutions and normally have sufficient endowments and reserves to reassure donors who might be apprehensive about the safety of a gift annuity. Not surprisingly, colleges account for a large share of gift annuities, and alumni have come to expect their alma maters to offer this giving option.

## ABOUT THE AUTHOR

Frank Minton, Ph.D., is founder and president of Planned Giving Services, Inc., a Seattle-based consulting firm providing gift planning services to charities and donors in the United States and Canada. Before entering consulting, Dr. Minton spent more than 10 years with the University of Washington, serving as Director of Planned Giving and Executive Director of Development. Previously, he served as Senior Estate Planning Officer and Field Director at Northwestern University and was for six years a professor at Muskingum College in Ohio. He received M.A. and Ph.D. degrees from the University of Chicago.

Dr. Minton is Vice-Chair of the American Council on Gift Annuities, directed its two nationwide surveys on gift annuities, and currently chairs its committee on gift annuity rates. He has received numerous awards for his work, including the CASE (Council for the Advancement and Support of Education) Distinguished Service Award. He is a frequent speaker at seminars and conferences, has authored many booklets and articles on planned giving topics, and is co-author of Planned Giving for Canadians (Second Edition, 1997) and the principal author of Charitable Gift Annuities: The Complete Resource Manual. Dr. Minton is on the advisory board of Planned Giving Today, and is a member of the Seattle Estate Planning Council and the Washington Planned Giving Council.

## ADDITIONAL INFORMATION

*TIAA-CREF Trust Company, FSB provides planned gift administration and investment services to colleges, universities and other not-for-profit organizations across the United States. To discuss the topics covered in this article or to find out more about the Trust Company's services, please contact Timothy J. Prosser, J.D., at tprosser@tiaa-cref.org or 888-842-9001 x5028.*