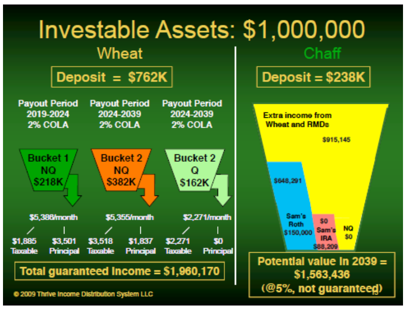
The Weird Math of Charitable Gift Annuities

By Kerry Pechter *Thu, Mar 22, 2012*

Here's how the wealthy buy lifetime income while giving zip to insurance companies, a pittance to the IRS and--unless they live a very long time--a sizable gift to charity.



Anyone who has studied the "annuity puzzle" has heard the assertion, frequently attributed to Menahem Yaari's famous 1965 paper on the subject, that a retiree with no bequest motive should annuitize all of his or her assets.

But Yaari's rule-of-thumb appears to ignore the existence of *charitable gift annuities* (CGA), which allow philanthropic, often high-net-worth retirees to meet their need for lifetime income and their desire to donate money to charity in a single contract.

Charities use CGAs as fund-raising tools. Acting like an insurance company that issues life annuities, a charity will collect a purchase premium, pay out a lifetime income to one or two people, and keep what's left when they die—either to pay surviving annuitants or as revenue.

CGAs differ from commercial annuities in a few significant ways. All else being equal, purchasers of CGA receive a lower payout rate than purchasers of commercial annuities. But, because their premium doubles as a gift, they receive a current-year tax deduction worth between, say, 10% and 40% of value of the initial premium.

In short, there's a trade-off. The reduced payout rate increases the chance that a chunk of money (technically, the "residuum") will be left over for the charitable organization when the annuitants have died. The donor's current-year tax deduction is the present value of that future chunk of money, discounted at a rate dictated by the IRS.

Standardized (but not mandatory) CGA payout rates have been established by the American Council on Gift Annuities. The suggested rate for a single 65-year-old is 4.7% (as of January 1, 2012)—as compared with almost 7% from an insurance company. Payout rates vary from charity to charity, however, as a couple of examples will show. (And, of course, the tax benefit will depend on each taxpayer's situation.)

Alan and Connie

An online hunt for information about CGAs led me to Futurefocus.net, one of whose pages provided the hypothetical example of "Alan" and "Connie," ages 74 and 76, respectively. The imaginary couple decided to take $100,000 out of a taxable money market fund yielding only $1,500 a year and purchase a CGA from XYZ Charity.

The CGA paid them $5,000 a year (or 5%, the ACGA rate) as long as either lived. It also gave them a current-year tax deduction of $34,752 (the present value of the future charitable contribution). Because the Richards are in the 35% marginal tax bracket, they reduced their tax bill by $12,163.

In addition to the current-year tax deduction, the Richards could look forward to excluding $3,980 (representing return of principal) of each year's $5,000 payout from income taxes for 16.4 years. According to the example (whose calculations I was not able to test), the Richards would have to generate $8,100 a year in earned income to replace the income from the CGA.

The real world of CGAs, it turns out, offers more price flexibility than Alan and Connie's story would imply. For example, the UJA Federation of New York recently advertised a CGA in the *New York Times* that offered a much higher payout rate but a smaller deduction than in the hypothetical above.

Using the calculator on the UJA's website, I typed in Alan and Connie's ages and premium amount. The UJA, it turned out, would pay $6,500 a year or 6.5% to the Richards—30% more per year than XYZ charity. The higher payout meant that less would be left for the UJA when the Richards died, so the Richards received a tax deduction of only $13,789. Assuming a 35% marginal tax rate, they would save just $4,826.

Why the difference in payout rates and deductions? According to Dick Kellogg of FutureFocus.net, which produced the XYZ hypothetical, some non-profit organizations choose to compete for contributions by advertising higher rates than those suggested by the ACGA. They hope to recoup in volume what they sacrifice on each sale. (That practice is a bit frowned on, Kellogg said. The ACGA created a standardized rate to encourage charities *not* to compete on rates.)

A higher rate may simply act as a teaser rather than a final offer. William Samers, vice president of Planned Giving and Endowments at UJA Federation of New York, explained that donors can choose, within limits, any blend of payout and deduction that meets their needs or preferences. "I assume they could do that with any charity," he said.

But, as a rule, only a charity with deep reserves is in a position to offer a higher rate, Samers added. With $30 million in its pool, $23 million in liabilities, plus an unrestricted endowment to draw on, UJA Federation of New York feels comfortable doing it. "If everybody lived to 120, we could still make all our payments," he said.

'Not 100% rational'

Actuaries may be interested to know the assumptions behind the ACGA's standardized payout rates. For instance, the rates are targeted toward a future charitable contribution of 50% of the initial premium, with a minimum present value equal to 20% of the initial premium. All annuitants are assumed to be female and one year younger than their actual ages.

The payout rates assume a 4.25% investment return—a decline of 75 basis points from last July. The assumed expense ratio is 1%. The current-year charitable deduction, however, is based on an IRS-prescribed discount rate, currently only 1.5%. The charities anticipate their funds to average an annual net gain of 3.25%, but the IRS isn't as optimistic (or as generous).

Of course, prospective donors could always buy a $75,000 commercial annuity and give $25,000 to charity, rather than make the charity wait for them to die. “It’s not 100% rational decision-making,” Samers said. CGA buyers—who likely comprise a separate, wealthier client segment from commercial annuity buyers—may just relish the idea of keeping their money away from both insurers and the IRS.

Is it risky to purchase a CGA? The gift annuity guarantee is based on the claims-paying ability of the charity, and charities fail more easily than insurance companies. Some charities have reportedly purchased commercial annuities as a safeguard. During the financial crisis, many small or shallow-pocketed charitable funds were said to be “underwater,” and a few actually went bankrupt. Before relying on a charity for lifetime income, do your due-diligence.