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The calculation of the deferred annuity payout and the charitable income tax deduction.

In this second of a three part series on gift annuity deductions and taxation, we examine the calculation of the deferred annuity payout and the charitable income tax deduction.

There has been unprecedented interest lately in deferred gift annuities because of the recent low discount rates. Why? Because some immediate payment gift annuities fail to produce a deduction of at least 10% of the principal, creating unwelcome tax consequences for the issuing charity. Gifts that do pass the 10% test generate a relatively small deduction. The deferred gift annuity can be a good solution for many donors, however, as it provides a higher annuity rate and typically a larger deduction than the immediate payment gift annuity.

Calculation of the Deferred Gift Annuity Payout

The ACGA suggests a two-step process for computing the payout rate for a deferred gift annuity.

1. Determine the unadjusted payout rate suggested by the ACGA based on the annuitant birth dates and the gift's annuity start date. (The annuity start date is the first day of the payment period that ends with the annuitant's first payment.) The unadjusted payout rate is the amount to which the donor would be entitled for an immediate payment gift annuity on the annuity start date. In PGM, the Gift Options follow-up window for the deferred gift annuity displays this unadjusted payout rate.
2. Multiply the unadjusted payout rate by the interest factor suggested by the ACGA. The interest factor under the ACGA 2012 rates equals an assumed annual interest rate of 3.25%. PGM applies the interest factor when you answer "Yes" when prompted "Recalculate this annuity to allow for the deferral of payments?" Different interest factors apply to prior ACGA gift annuity rate tables and are computed automatically when you use any of these prior tables.

We have included an example of the calculation of the deferred gift annuity payout rate at the end of this article.

Calculation of the Deferred Gift Annuity Income Tax Deduction

PGM computes the charitable deduction for a deferred gift annuity by first determining the present value of the annuity stream to the annuitants and then subtracting this value from the gift amount to determine the value of the gift to the charity. The relevant variables are the ages of the income beneficiaries, applicable discount rate, amount of the gift principal, payout rate, payment frequency, payment timing, and date of first payment.

PGM uses the above information to compute a deferred discount factor, line 7(d) in PGM's Actuarial Calculations chart. The deferred discount factor is the number by which the adjusted value of a dollar is multiplied to reflect the reduced present value of a deferred annuity. The factor reflects: (1) the likelihood that the annuitant(s) will die before receiving a payment and (2) the discounted value of an annuity that is deferred for a number of years rather than begun immediately. Because PGM uses algorithms to generate its numbers, rather than picking numbers off tables, the deferred discount factor cannot be reproduced by you by hand in two-life cases.

Line 7(e) on the Actuarial Chart, "Value of $1 Deferred," equals the present value to the annuitants of receiving one dollar a year for their life expectancies, given the annuitant ages at first payment, the number of years payments are deferred, and the payment schedule.

Once you have calculated the value of a dollar deferred, you can calculate the value of the donor's life interest in the contract, the investment in contract, by merely multiplying the value of a dollar deferred by the annuity amount. The donor's charitable deduction for the deferred annuity equals the principal donated minus this investment in contract.

Example of the calculation of the deferred gift annuity payout rate

Joe Donor funds a deferred gift annuity on 12/15/2012 that will make its first quarterly payment on 3/31/2015. Payments are made at the end of each period. Joe will be the sole annuitant and was born on 6/20/1948. To compute the payout rate to offer Joe based on the ACGA's recommendations:

Determine Joe's age on his closest birthday to 1/1/2015, the annuity starting date for an annuity that pays quarterly, starting on 3/31/2015. Joe's closest birthday to

1/1/2013 is 6/20/2015 and he will be 67 on that birthday. The unadjusted ACGA rate for a single 67 year-old is 4.8%.

1. The number of years from the date of gift, 12/15/2012, to the annuity starting date, 1/1/2015, is 2.0464 years.
2. The interest factor suggested by the ACGA for 2.0464 years of deferral is: ((1.0325) ^ 2.0464) = 1.0676
3. 4.8% x 1.0676 = 5.1% after rounding to the nearest 0.1%. The payout rate suggested by the ACGA for Joe's deferred gift annuity is 5.1%.

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