Jeffrey Frye - Sun, 9/15/2024 - 10:00

We’ve been hearing quite a bit about the Federal Reserve system (“the Fed”) likely cutting the Fed Funds rate – the key interest rate that it controls – at its next Open Market Committee meeting, which is September 17-18. The Fed aggressively hiked the Fed Funds rate from February 2022 to August 2023 in a determined effort to bring down inflation, which peaked at over 9% in 2022. It has kept the Fed Funds rate at the same relatively high level for the past year. Lately, however, there have been various reports showing that the economy is showing signs of slowing down, and inflation in recent months has approached the Fed’s 2% target, leading the Fed to signal it is finally comfortable with reducing interest rates.

When the Fed cuts the Fed Funds rate, other interest rates tend to follow suit – especially short-term and medium-term interest rates. Even long-term interest rates, such as mortgage rates, are eventually affected. And that brings us to the topic of charitable gift annuities (CGAs). We’ve been receiving calls over the past few weeks from gift officers questioning if, how, and when the declining interest rates in the economy will affect CGAs. Our client organizations are asking, should they be promoting gift annuities at current rates – so donors can “get in” before an overall reduction in payout rates?

Effect on Annuity Rates

That’s a great question and something worth talking about. Let’s start by clarifying how gift annuity payout rates are determined. In general, gift annuity payout rates are determined by each charitable organization that issues gift annuities – the governing body of the charity decides to offer gift annuities, and also decides what payout rates to follow. In practice, 96% of U.S. charities choose to offer the annuity rates suggested by the American Council on Gift Annuities (ACGA), so we will focus on how the ACGA determines its suggested rates.

A key component of the ACGA’s methodology for determining its suggested annuity rates is its annual investment return assumption. To determine this value, the ACGA assumes a model portfolio that is 5% cash (13-week rolling average of the 3-month Treasury Bill yield), 40% stock (average return of the S&P 500 since 1926 minus 2%) and 55% bonds (13-week and 26-week rolling average of the 10-year Treasury bond yield). Consequently, the yield on the 10-year Treasury bond has the greatest effect on the ACGA's investment return assumption. When the Fed begins a sustained effort to reduce interest rates by cuts to the Fed Funds rate, the 10-year Treasury bond yield will run a parallel course. When changes in this yield are large enough and continue long enough, the ACGA will adjust its suggested rates in response. We published an article in February that explores this relationship.

www.pgcalc.com/insight-training/pg-calc-featured-articles/have-gift-annuity-benefits-peaked

Generally speaking, when the ACGA revises its suggested annuity rates, the new rates have gone into effect on either January 1 or July 1. If the Fed initiates a sustained series of reductions of the Fed Funds rate later this week, it could well be July 2025 before the ACGA adjusts its suggested annuity rates downward in response.

The ACGA website provides a wealth of information about the thoughtful rationale behind its suggested annuity rates. The underlying premise of the recommended rates is to provide the charity, on average, with a residuum (charitable remainder) equal to 50% of the original funding amount.

www.acga-web.org/current-gift-annuity-rates

Effect on Deduction

Unlike gift annuity payout rates, there is an aspect of gift annuities that does, in fact, change with little delay when interest rates are falling: the charitable deduction amount. The charitable deduction for a gift annuity is based on several assumptions: the amount of the funding, the age(s) of the annuitant(s), the payout rate, the frequency and timing of payments, and the IRS discount rate.

Also known as the AFR or Applicable Federal Rate, the IRS discount rate is the IRS's assumption of the annual rate of return that the gift assets will enjoy during the gift term. The IRS discount rate is published monthly and reflects the annualized average yield of Treasury instruments over the past 30 days that have remaining maturities of 3-9 years.

The higher the IRS discount rate, the higher the deduction for charitable gift annuities. Conversely, the lower the discount rate, the lower the deduction. If the IRS discount rate is based on the annualized average yield of Treasury bonds with 3-year to 9-year maturities, how does that yield compare to the Fed Funds rate? It turns out there is a high correlation between the two rates. When the Fed lowers the Fed Funds rate, the average mid-term rate tends to go down as well.

As is evident, there is a chain reaction after the Fed lowers the Fed Funds rate – this action in turn affects the average mid-term rate, which directly affects the IRS discount rate. So, when interest rates go up, the charitable deductions for gift annuities go up, and when interest rates go down, the opposite occurs. Given the option for a donor to use the IRS discount rate for the month of their gift or either of the prior two months, their deduction can be affected within three months of interest rates trending downward. Usually the change is not significant, but with repeated movement over time in one direction or another, the sustained effect will become noticeable.

Description	Payout Rate	Month and Year	IRS Discount Rate	Charitable Deduction
$10,000 CGA for 72-Year-Old	6.6%	July 2024	5.4%	$3,943.40
$10,000 CGA for 72-Year-Old	6.6%	August 2024	5.2%	$3,859.50
$10,000 CGA for 72-Year-Old	6.6%	September 2024	4.8%	$3,686.30
[With quarterly payments at the end of each quarter]				

As we can see, one change in the discount rate – by 0.2% – does not change the charitable deduction very much, but with two consecutive instances of discount rates going down, with a total combined change of 0.6%, the effect of lower interest rates starts to become apparent. A sustained Fed effort to reduce interest rates could lead to a decline in the IRS discount rate of far more than 0.6% over the next year, with gift annuity deductions declining accordingly.

There is one consolation for gift annuity donors when their deduction goes down: the proportion of their annuity payments that will be tax-free during their life expectancy goes up.

Conclusion

In conclusion, when interest rates are trending downward, it seems virtually inevitable that the ACGA's suggested annuity rates will eventually follow suit. The big unknowns are when they will change, and how much they will change. We'll have to wait and watch for an announcement in the coming months. PG Calc will be sure to share that information as soon as it becomes available.

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