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We've been getting a lot of client calls asking us what to do when a deferred gift annuity they want to propose to a donor doesn't pass the 10% remainder value test. Before we answer this question, let's first explore why recently this issue has been arising with greater frequency than we're used to.

ACGA Rates

Over 90% of all charities follow the gift annuity rates suggested by the American Council on Gift Annuities (ACGA) most or all of the time, so we will focus our discussion on the ACGA rates. The current ACGA rates went into effect on January 1, 2012. The ACGA reduced its suggested rates in response to a deteriorating economic outlook and an unprecedented decline in the IRS discount rate.

ACGA Suggested Annuity Rates, Effective January 1, 2012

Among the several assumptions underlying the current ACGA rates is that the total annual return on gift annuity reserves is 4.25% percent. The ACGA also assumes that annual expenses for investment and administration are 1.0% of the fair market value of gift annuity reserves. Subtracting expenses from total return gives you a net investment return of 3.25%.

The ACGA's net income assumption is significantly greater than the prevailing monthly IRS discount rate, which has hovered around 2.0% for months. Therefore, for some ages the ACGA found it necessary to adjust its current rates below those suggested by its standard assumptions in order to ensure that all of its suggested rates result in a deductible value of greater than 10% of the gift amount for IRS discount rates as low as 2.0%. Although the IRS discount rate has remained steady for much of 2013, it jumped up to 2.4% in October, and 2.2% in January 2014. Consequently, immediate payment gift annuities that follow the current ACGA rates have not been running afoul of the 10% remainder value test.

What to Do if a Deferred Annuity Fails the 10% Test?

If you run a deferred gift annuity calculation that fails the 10% test (the charitable deduction is less than 10% of the funding amount of the gift), solutions include

lowering the annuity rate below the ACGA rate or lengthening the deferral period until the deduction exceeds 10%.

If your solution is to reduce the annuity rate below the ACGA rate, be sure to disclose this fact to your donor BEFORE the gift is completed. If you are issuing the deferred annuity in California, you must include an addendum to the gift annuity agreement, signed by the donor, indicating that the donor understands what the rate ordinarily would be and is agreeing to the lower rate. While no other state requires this step, this is a good approach to take generally. At minimum, you should have documentation in the donor's file regarding the his or her understanding/agreement to the lower rate.

Technically, Section 514(c) (5) of the Internal Revenue Code requires that the present value of the annuity payments be less than 90 percent of the value of the property contributed for the gift annuity. In other words, the deductible value must be more than 10% of the value of the property contributed. If this result is not achieved, then the charity's obligation to make annuity payments will be treated as acquisition indebtedness, possibly creating unrelated business taxable income for the charity.

10% Remainder and 5% Probability Tests for CRTs Also More of a Concern

Charitable remainder unitrusts (CRUTs) and charitable remainder annuity trusts (CRATs) must pass their own slightly different 10% remainder value test in order to qualify as charitable trusts. Unitrust deductions are affected by changes in the IRS discount rate in only a very small way, so they fail at roughly the same age and payout rate combinations as they always have. Annuity trust deductions, in contrast, decline significantly with substantial reductions in the IRS discount rate. As a result, they are failing the 10% test at older ages and lower payout rates than in the past.

Now is a time to be especially wary of the 5% probability of corpus exhaustion test that is applicable to CRATs. As with the 10% test, the possibility of a CRAT failing the 5% probability test increases as the IRS discount rate falls. For example, using June 2015's rate of 2.0%, a CRAT with the minimum 5% payout fails the 5% test for annuitants under 72.

Conclusion

The current extremely low IRS discount rate environment is causing some deferred gift annuities to fail the 10% remainder value test, even when following the ACGA

recommendations, catching many gift planners by surprise. As the economy recovers and interest rates are allowed to drift upwards, the gap between the IRS discount rate and ACGA compounding assumptions may narrow and these failures will disappear. In the meantime, there are some simple approaches to resolving this situation when you encounter it: reduce the annuity rate below the ACGA rate or increase the length of deferral. If you reduce the annuity rate, be sure you disclose to your donor what you have done.

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