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Planned Giving offers donors a variety of gift vehicles to support their favorite charitable organizations in the long run; moreover, it offers donors the chance to obtain significant financial benefit for themselves in the short run. The most popular planned giving vehicles, after bequest-type gifts, are life income gift arrangements: Charitable Gift Annuities (CGAs), Charitable Remainder Trusts (CRTs), and Pooled Income Funds (PIFs). These vehicles are widely used by philanthropic individuals to achieve their charitable objectives while establishing a stream of income for life and / or a period of years. But are all planned gifts – and more specifically, are all life income gifts – truly beneficial for the nonprofit organization? Are some of these gifts better than others? And how does a charity attempt to measure the relative merit of a prospective life income gift arrangement?

Most organizations have, at minimum, some basic rules and limitations pertaining to the types of gifts they will accept, in the form of a Gift Acceptance Policy. Especially for CGAs, the charity can easily specify certain aspects like minimum gift size, minimum age for annuitants, and types of assets accepted. Most PIFs haven't seen much gift activity in recent years, but the governing trust documents generally establish the ground rules for any new gifts. CRTs, on the other hand, come in several different incarnations and it can be challenging for the charity to anticipate all of the appropriate rules and restrictions. Regardless of the gift vehicle, however, the gift planner and the development group in general should be comfortable with looking at a prospective gift objectively and determining its relative merit. We'll take a look in this article at how a planned giving professional might approach the challenge of determining whether or not a prospective planned gift – in particular, a life income gift arrangement – would be truly beneficial for the organization in the long run.

CGAs are fairly straightforward and easy to create. The donor makes a contribution, and the charity executes a simple contract – a charitable gift annuity agreement – based on the donor's age, the amount of the funding, the current IRS discount rate, and the frequency of payments. CRTs, on the other hand, are more complex by nature – before anything else can be decided or arranged, the donor has to determine who will serve as Trustee. In some cases, the charity is not willing or able to serve as Trustee. The charity may be happy to oblige with calculations and

illustrations, but the donor has to look elsewhere for a legal caretaker.

In other cases, the charity is able to serve as trustee, but whether it will be willing to serve as trustee will depend on the characteristics of the trust. There may be a situation in which the charity decides to accept a gift, even if it falls outside of the parameters of the Gift Acceptance Policy; alternatively, the charity may decide NOT to accept a gift even if it DOES meet all of the defined limitations. Regardless of whether or not the gift conforms to the Gift Acceptance Policy, the charity will be well-served to know a few ways of estimating the approximate long-term value of a complex gift arrangement.

One of the most obvious limitations with life income gifts is the issue of age – the end result of this type of gift is the charity receiving the residuum, or remainder, of the principal upon the death of the last beneficiary. In theory, the older the beneficiary, the sooner the charity receives the benefit. We'll look at gift annuities first because they are a little simpler in nature than trust arrangements. A gift annuity written for an individual who is 78 is clearly more beneficial to the charity than one written for someone who is 68, all other things being equal. Charities frequently dictate that standard gift annuities (with payments commencing right away) cannot be written for individuals younger than 60 or 65. If a donor is younger than the minimum age, the gift annuity must be written as a deferred gift annuity, with payment to begin no earlier than the date upon which the donor reaches that specified minimum age. But some charities don't have a minimum age for establishing a deferred gift annuity. Does a deferred gift annuity written now for an individual who is 43 – with payments starting at age 65 – really make sense?

Let's review the numbers for this example. When we run the calculations, we can determine the 43-year-old's life expectancy – or more specifically, we can determine the average remaining life expectancy for a person of that age based on the census data collected for the entire population. There is a strong sentiment in the planned giving community that planned giving donors tend to have longer lifespans, on average, than the population as a whole. This is likely due to a number of factors, including income level, education level, and access to health care that are greater than average, as well as, and maintaining generally healthier lifestyles. The standard charitable deduction calculation for a 43-year-old shows the average remaining life expectancy to be 39.5 years, but this is for the entire U.S. population. A planned giving donor of this age might live another 45 or even 50 years. Is it really beneficial

for a charity to issue a deferred gift annuity for someone who is going to live another 40 or 50 years? There is no right or wrong answer, but any particular charity might base its response, at least in part, on the amount of the funding principal.

Does the size of the gift matter? Obviously, the larger the funding principal, the larger the gift benefit will be to the charity, but what about minimum size requirements? It can be helpful to use examples with real numbers. If the charity follows the recommended payout rates of the American Council on Gift Annuities, it is expected that the typical residuum will be at least 50% of the original funding amount. For a gift annuity established with \$50,000 in cash, the eventual receipt of \$25,000 is probably a reasonably attractive gift for the charity. But what about a gift annuity funded with \$25,000? If the charity likely will not receive the residuum until 40 or 50 years from now, is the eventual receipt of \$12,500 worth the years of accounting, payment processing, and tax reporting? The time value of money should be considered in cases like this; in simple terms, the concept means that a dollar to be received in the future is worth something less than a dollar today; each year spent waiting for a sum in the future renders that sum worth less in the present. Based on the sample calculations we have run in Planned Giving Manager (PGM), and assuming an annual investment return of approximately 4.9%, the charity is projected to receive \$47,282 in 45 years; but the rate of inflation is estimated to be 3% each year, so the present value of that future amount is about \$12,500. Is the charity really deriving benefit from a gift of that amount after 45 years of administration costs?

Charitable Remainder Trusts, as mentioned earlier, tend to raise the greatest number of questions regarding the true value of the charitable benefit. If the charity doesn't serve as Trustee, the only involvement the charity might have is to provide a forum for exploring the trust, to provide the donor with calculations of the tax consequences, and possibly to provide the donor with boiler-plate sample trust documents. These efforts result in relatively little cost to the charity in exchange for a gift at some point in the future; however, when the donor appoints a trustee other than the charity, the charity may be somewhat at a disadvantage. In those cases, typically the charity will have less knowledge about the trust, and the charity's beneficial interest may be less secure. Those entities we call "Outside-Managed Trusts" (OMTs) frequently allow for the donor to change the charitable remainder beneficiary, and the trust may be managed in a way that does not adequately protect the interest of the charity.

If the charity is able and willing to serve as Trustee, the development professionals may end up spending considerable time discussing the potential trust and providing assistance with the creation of the trust. That initial period will be followed by years of managing the trust, which includes not only the asset management, but also the custody of the assets, the issuance of payments to the beneficiary(ies), and the tax reporting process, which encompasses both the preparation and filing of the tax return(s) and the preparation and mailing of the Form K-1(s). These activities can take up considerable resources within the charitable organization, or they can cost the charity significant dollars if outsourced. If we take the gift example used above and suppose it were a CRT instead of a CGA, what would the true benefit look like for a charity that was considering being named as Trustee?

Let's say that the donor – a 70-year-old woman – is a longtime supporter of your organization, and has already made substantial outright gifts in addition to establishing a few CGAs for herself. She is concerned about the long-term well-being of her 43-year-old son who is disabled. Assuming that your organization routinely serves as Trustee for CRTs (so long as it is named the irrevocable remainder beneficiary), would you recommend accepting a trust established by this donor for the lifetime benefit of her son?<sup>1</sup>

As we mentioned above, there is a considerable life expectancy for a 43-year-old, even if we don't assume the additional longevity for individuals associated with life income gift arrangements. The donor is willing to establish a trust – a 5% standard CRUT – with \$250,000 of cash and securities to meet your minimum funding requirement. Using a moderately optimistic assumption of an average 7% total investment return, at first blush, it would appear that this trust would be of significant benefit to your organization. If it earns 7% and pays out 5%, it's actually going to gain in value over time, right? At a net growth rate of 2% each year over 40 years, the nominal value of the trust principal grows to \$541,186 over the projected life expectancy.

But now let's take a trip back to the real world. There is always some level of inflation, and there are significant costs in managing a split-interest trust for 40 years. If we overlay an estimate of long-term inflation over the 40-year projection, we will come out with a much lower projected benefit to the remainder charity. Let's assume that the inflation rate is, on average, 2.5%. What is the "real value" of the \$541,186 if we have to wait 40 years to receive it? We can modify this projection in PGM to demonstrate the long-term effect of inflation, to come up with a reasonable

estimate of the present value of the future remainder – which turns out to be \$206,593. Clearly, in today’s dollars, with even a modest estimate of inflation, the projected value of the charitable residuum is considerably lower than the nominal amount expected in the future. It’s still a good gift, right? It provides significant benefit both to the lifetime beneficiary and to the remainder charity, but is it still worth encouraging? Perhaps, but let’s take our analysis a step further.

In addition to the ramifications of inflation, there are significant costs involved in maintaining life income gift arrangements, as described previously with the CGA example. In the case of a CRUT, the management of assets, issuance of payments, and compliance with the tax reporting aspects require considerably more effort on the part of the Trustee. It has been standard practice in recent years to assume the costs of running a trust to be in the vicinity of 1% of the total value of the assets (as long as it’s above an assumed minimum size of approximately \$100,000). If we factor in the costs of running this potential trust, the numbers start to look less compelling. When we add management costs of 1% to the projections in PGM, the projected nominal value of the remainder is \$362,181, but the estimated present value of that future amount – after adjusting for inflation – drops to \$138,259. If the “real” value of the trust is at this level, does it still make sense for the charity to encourage it? Probably yes, but one might want to consider the possibility that any of the variables in reality will become more detrimental to the value of the residuum. If the average annual investment return is only 6%, for example, the nominal value of the projected remainder drops to \$246,610, and the estimated present value of that remainder falls to \$94,141. At this point, the gift is looking significantly less beneficial to the charity, but it’s still a favorable outcome, right?

Let’s tweak the numbers a little more to capture the possibility that long-term inflation is going to be at the level of 3% instead of 2.5%. We still get a projected remainder of \$246,610 (no changes to the investment assumptions), but the estimated present value is now only \$77,868. That’s an extremely different outcome than the original, unadjusted value of \$541,186. Does this mean that you should discourage the donor from establishing this trust for her son? There is no easy answer, no one-size-fits-all response, but you probably would be inclined to encourage the gift arrangement. It will provide substantial lifetime income to the donor’s son, and even a \$77,868 gift is a significant benefit to your organization. You might want to explain to the donor that, since the gift vehicle is a Charitable Remainder Unitrust, she can make additions to it both during lifetime and at death.

The point we are making here is that, generally speaking, the gift planner would be well-served to use the tools available to estimate a number of possible outcomes for a potential life income gift arrangement. We can't predict how long the beneficiary will live, or what the investment results will be; we can't foresee what the inflation rate will be, or even what the "carrying costs" will be in the long run; but we can run a series of relatively simple projections to give us a range of reasonable estimates for the value of the ultimate benefit to the charity.

In summary, life income gift arrangements are complex financial vehicles whose eventual outcome is unknown. We can make use of guidelines, restrictions, and rules through a Gift Acceptance Policy to rule out models that are clearly not appropriate or reasonable; we can have minimum gift sizes, minimum ages, and limitations on types of funding assets; but in addition, we always need to have some ability to estimate the true benefit to the charity of a particular proposed gift arrangement. Going beyond the individual gift, we also need that ability to review gift parameters at the aggregate level, when creating or updating a Gift Acceptance Policy. Clearly, we have seen that the anticipated investment results, the expected inflation rate, and the costs of managing the gift arrangement over the long run have tremendous impact on the real value of the benefit to the charity.

*1 Please note, we are not addressing the impact of potential transfer (gift) taxes in this example, but in a real situation, the gift planner should always caution the donor about the possibility of those taxes whenever a donor creates a life income gift arrangement for the benefit of another person.*

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