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Charities that permit gift annuity donors to designate how the residua of their annuities will be used must adopt a method of tracking the values of each of their annuities. The Uniform Prudent Management of Institutional Funds Act (UPMIFA), which has been adopted in all states except Pennsylvania, imposes a legal requirement to use restricted gifts in accordance with the instructions specified by the donor. So for gift annuities, this means that if donors are allowed to designate or restrict the use of their gift annuity residua, the issuing charity has a legal obligation to track the market value of each gift annuity.

Even if a charity does not permit gift restrictions on its gift annuities, tracking gift annuity market values allows the charity to monitor the health of its gift annuity program on a gift-by-gift basis, as well as on a pool-wide basis. Gift-by-gift tracking of market values enables a charity to identify individual problem annuities and, once identified, to consider possibilities for ameliorating their negative effect on the performance of the gift annuity program overall.

There are two general approaches to tracking gift annuity market values: Fund Accounting and Unitization.

### **Fund Accounting**

Fund accounting credits each gift annuity at its original contribution value, increased or decreased by the annuity's pro rata share of investment performance, and decreased by annuity payments and the annuity's pro rata share of expenses.

Gift annuity rates are established with an assumption that the projected residua of a gift annuity will be 50% of the original contribution. However, if gift annuity reserves experience high expenses or poor investment performance, or the annuitants outlive their life expectancy, an annuity may run dry. In other words, the residuum (balance in the account) will reach zero before the death of the sole or surviving annuitant. Nevertheless, the payments must continue for the life of the annuitant. Assuming some gift annuities are unrestricted and have surplus reserves, some of those assets could be used to continue payments on the failed gift annuity. The more difficult challenge is to find money to continue the payments if all of a charity's gift annuities are restricted.

A charity could transfer sufficient cash from its general funds to continue payments, but this will not be a popular solution when the administration has precious little discretionary money at its disposal. Another solution is for the charity to assess all gift annuities with an administrative fee to build a contingency fund with some of the money derived from this fee and then make payments on a failed annuity from its contingency fund.

### **Unitization**

There are 2 different approaches to unitization. One approach is to account for each gift's specific payment amount and therefore buy/sell units each pay period. The other approach keeps the number of units held by each gift steady. The latter approach is presented here.

The unitization tracking system treats gift annuity reserves as a risk pool. Unitization assigns units to each annuity in the pool based on the size of the gift and the value of units at the time of the gift. The value of each unit is tracked. Importantly, the aggregate payments made each year reduces the value of the pool, hence the value of each annuity, but not in proportion to payments actually made for each annuity.

On a pool-wide basis, unitization allows sharing the risk and reward of the performance of the fund across the entire program. However, the unitization system, by essentially socializing gift annuity payments, disadvantages younger annuitants with respect to the amount of their gift that is eventually available for their intended charitable purpose. Donors of new annuities, in particular, may expect less of their contributions to support the charity's mission that interests them because they are subsidizing the high payments from existing annuities funded years ago.

For example, the annuity rate for a 72 year-old is 5.4%. Because of market losses and high historical annuity rates, the effective payout rate of a unitized annuity program relative to the value of the annuity pool will be substantially higher than 5.4%, often in excess of 10%, or even in some cases 20%. Since investment returns are unitized across all contracts, the low payout annuities will be substantially eroded by the older high rate annuities. Another negative of the unitization method is that it's impossible to identify weak gifts. Identifying weak gifts can help understand and potentially modify policies and practices.

The major advantage of unitization is that no annuity can run dry unless the entire gift annuity reserve fund is exhausted. Many charities have adequate reserves to

cover all of their payment obligations, but were they to allocate reserves to certain of their annuities, they might become exhausted before those specific payment obligations terminate. If many or all of the annuities are for designated charitable purposes, it is not possible to use surplus reserves from one annuity to cover the payments on another. Hence, the charity has no recourse except to transfer some of the institution's general, unrestricted funds to cover the payments - a decidedly unpopular course of action when unrestricted funds are so precious. Unitization where the total of all payments is divided across all the annuities avoids this situation.

The major disadvantage of unitization is that the value of each individual annuity is not as accurate and therefore it's more difficult to identify weak gifts and/or program policies.

Unitization causes some of the assets of a new annuity accepted for a particular purpose to be siphoned off to support older annuities established for other purposes. This practice seems to violate UPMIFA's requirement to honor donor restrictions. Nonetheless, unitization may still satisfy UPMIFA if the practice is fully disclosed to donors prior to making the gift. The disclosure should explain that when an annuity terminates the units attributable to the donor's contract may be higher or lower than the original gift amount or what would have existed if each annuity had been invested separately.

## **Conclusion**

Fund accounting allows for a more nuanced picture of the health of an annuity program. Each annuity bears the risk and reward of market performance and life expectancy. Fund accounting requires each annuity to stand on its own, but tracking market values this way requires a plan for how the charity would underwrite underwater annuities.

Unitization allows sharing the risk and benefit of investment returns and mortality experience across the entire program. While this approach eliminates the possibility of an annuity's balance going into the red, it also can mask the underperformance of particular annuities. In addition, the infusion of new annuities underwrites the cost of older annuities with a corresponding depletion of the residua from those newer annuities.

Whether your charity tracks gift annuity market values using fund accounting or unitization, tracking gift annuity market values will help it monitor the health of each

of its gift annuities.

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