Jeffrey Frye - Fri, 6/17/2016 - 00:00

Here's the situation: a gift officer at one of our client organizations - a not-for-profit entity using *Planned Giving Manager* – calls PG Calc Support and asks if there is something wrong with the calculations for deferred charitable gift annuities. "How can the payout rates possibly be as high as 15 or 20% - surely that's a mistake! Is there something wrong with the software? If not, then, does anybody really write these annuities?"

It turns out there is nothing wrong with the software – the payout rates, as they are expressed, are correct. And yes, charities really do issue these annuities. The problem is in the way the payout rates are quoted. There is an enormous difference between the *nominal payout rate* of a deferred gift annuity and the *effective payout rate* of a deferred gift annuity. Let's take a closer look at how these payout rates work and try to make some sense of it.

With a standard charitable gift annuity (immediate payments), the payout rates are easy to understand and certainly appear to be reasonable. Assuming we follow the rates recommended by the American Council on Gift Annuities (ACGA), the payout rate for a 70-year-old on a one-life arrangement is 5.1% (using the most recent rate table that was released in 2012). *The older the annuitant, the higher the payout rate.* So, for an 80-year-old annuitant, the payout rate would be 6.8%, and for a 90-year-old annuitant, the payout rate would be 9.0%. In fact, 9.0% is the *highest possible payout rate* for organizations who follow the ACGA recommendations; for any annuitant who is 90 or older, the rate tops out at 9.0%. Keeping in mind that most organizations won't issue immediate gift annuities for annuitants below age 60, that means the payout rates for all new gift annuities will fall somewhere in the range of 4.4% to 9.0%. And many organizations have a minimum annuitant age of 65 or older, which brings the lowest possible rate up to 4.7%. With a minimum annuitant age of 70, the range of payouts would be 5.1% to 9.0%.

Rates for deferred gift annuities, on the other hand, are not as simple to understand, and appear to be dramatically higher. Let's take that 60-year-old, whose immediate payout rate would be 4.4%. If the donor is willing to wait 5 years before starting to receive payments, the payout rate goes up to 5.5%. That doesn't sound unreasonable. But if the deferral period is 10 years instead of 5, the payout rate jumps to 7%. And a deferral period of 15 years will result in a payout rate of 9.3% -

this is when our friends in Finance begin to get nervous! [In this article, we are using the term “deferred gift annuities” to encompass flexible deferred gift annuities and commuted payment annuities as well.]

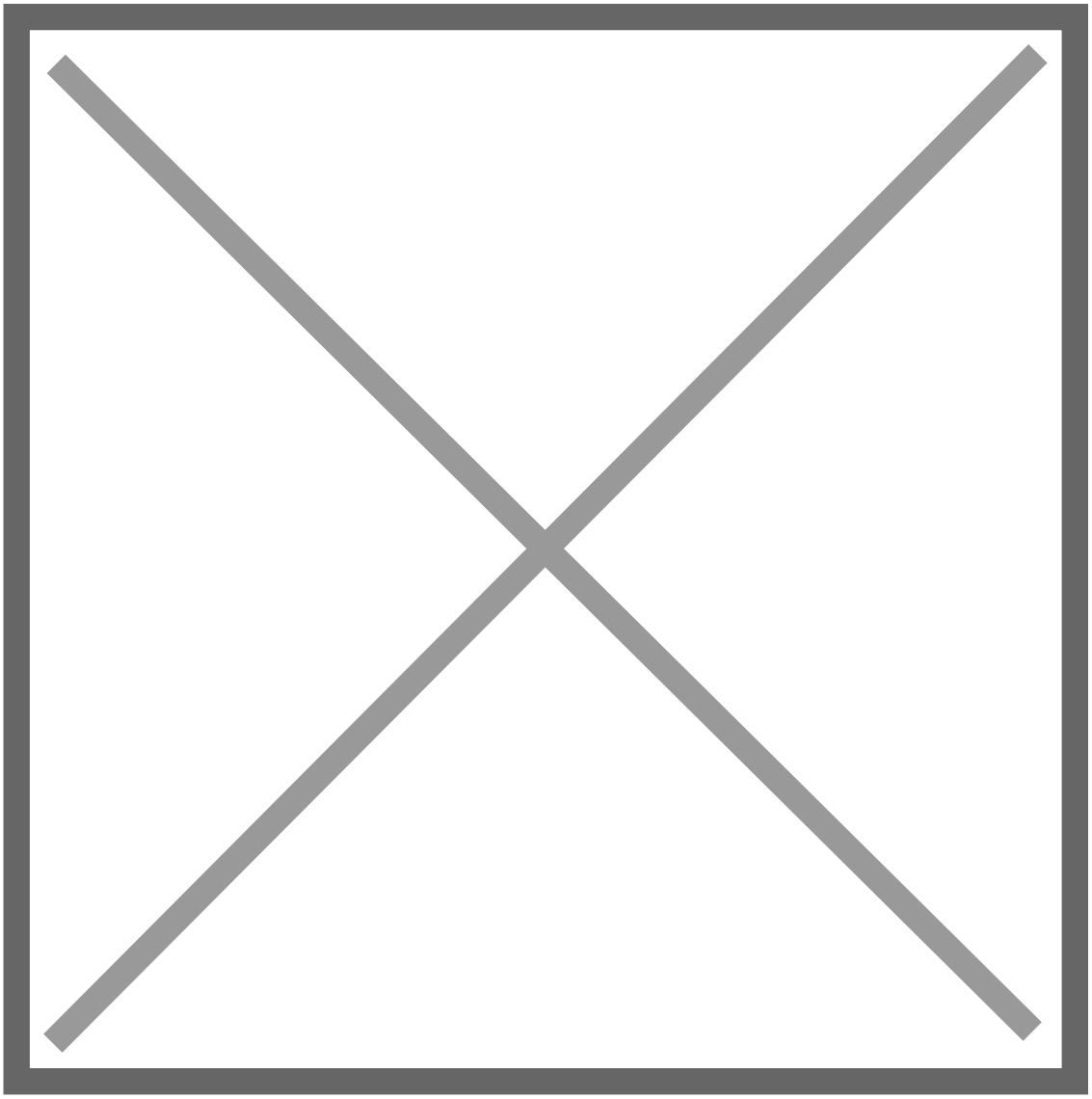
Now let’s push the example to the extreme. We’ll assume that the organization will issue deferred gift annuities for individuals beginning at age 55, provided the annuitants will not start receiving payments until they are 65. And let’s say our particular donor is a typical baby boomer who doesn’t know when she is going to retire, so she wants a *flexible deferred gift annuity* instead of a *regular deferred gift annuity.* How far out should we offer the deferral? This is where it gets really interesting. From both the donor’s and the charity’s perspective there is no harm in allowing the option for deferral to extend 15 or 20, or even 30 years into the future – the only price for the huge degree of flexibility may be a somewhat lower charitable deduction for the donor. But what are the rates like in the far-away years?

Let’s pause for a moment and reflect on the differences between a regular deferred gift annuity and a flexible deferred gift annuity. The regular deferred gift annuity has a fixed starting payment date, and that date must be at least 365 days after the date of funding. Because the starting payment date is known, the payout rate is also known. The payout rate is higher than the payout rate on a standard (immediate) gift annuity, and there are two components of the upward adjustment. First, the annuitant will be older when payments start, so he or she is entitled to the appropriate payout rate for his or her age at the start of payments. Second, the donor has contributed the gift money or property at least 365 days prior to the start of payments. As a result, the charity can invest the gift funds for at least a year, or for however many years the payments are deferred, and *the payout rate is adjusted even higher to compensate for the deferral period*.

The flexible deferred gift annuity is a variation on the regular deferred gift annuity. The minimum deferral period is 365 days, but the starting date for payments is flexible. The gift annuity agreement specifies all of the possible payment starting dates, typically in successive one-year intervals, and the annuitant has the option to choose the actual payment starting date at some point in the future. *The longer the annuitant chooses to defer payments, the higher the payout rate will be.* Because the potential deferral range must be specified at the outset, the donor typically chooses to allow for a fairly extensive range of possible deferral years.

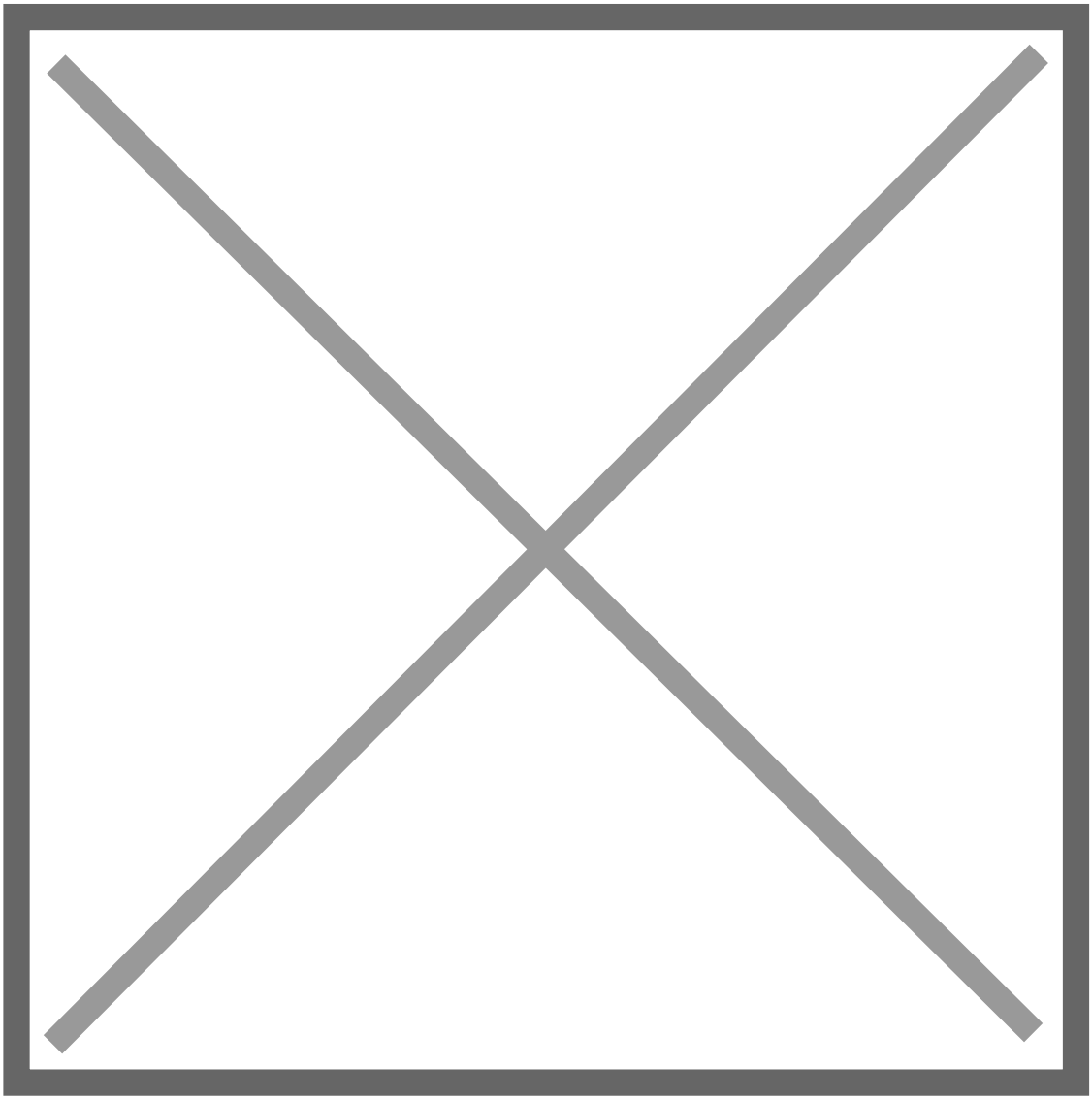
Flexible deferred gift annuities have special appeal to many baby boomers because of their uncertainty about the specific timing of retirement. Here’s what the payout

rates would be, and what the corresponding annuity amounts would be at 5-year intervals, for a 55-year-old donor naming herself as the annuitant on a flexible deferred gift annuity that allowed deferral for up to 30 years:



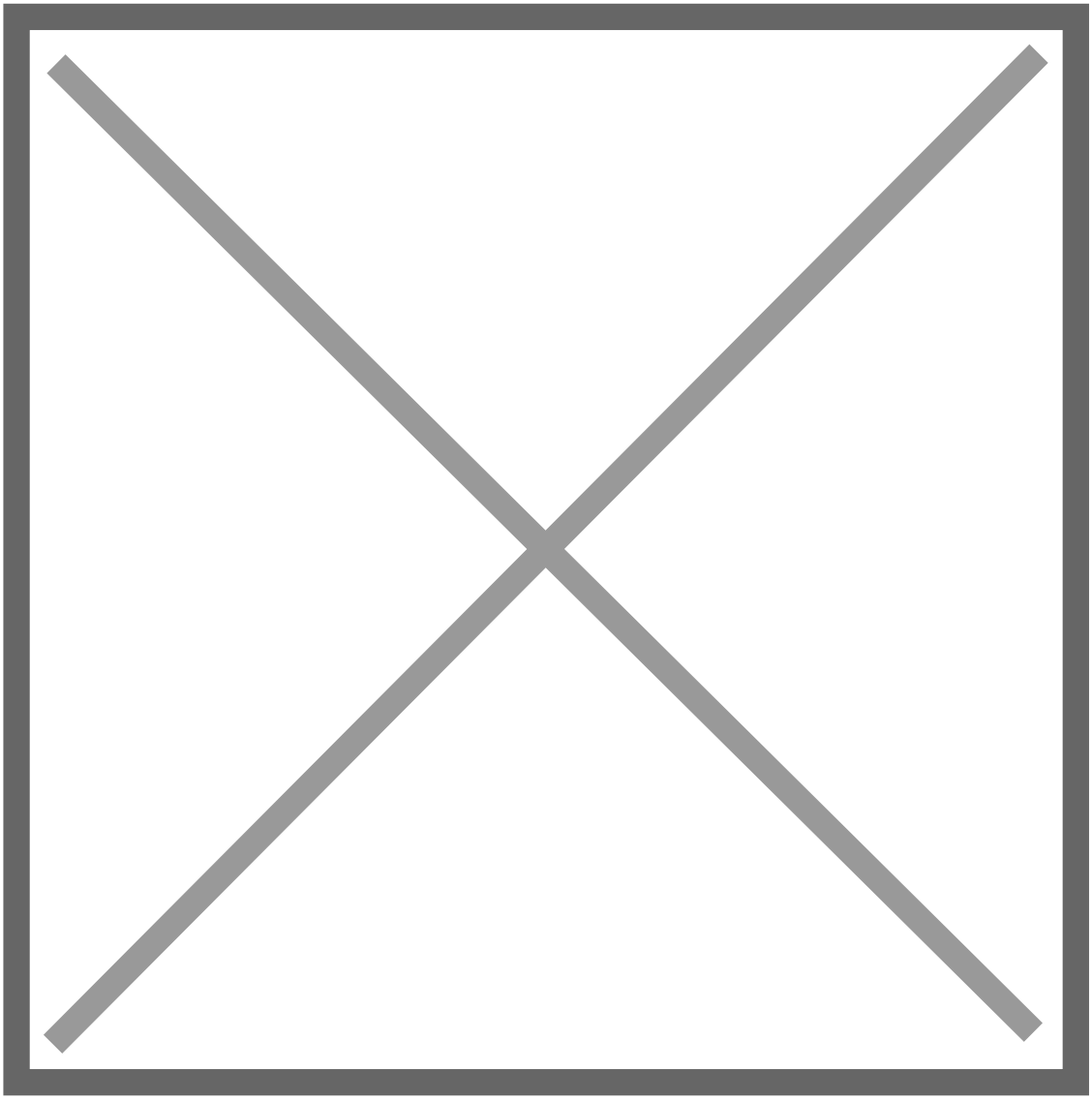
As one client recently exclaimed, “Those rates are crazy! We would never issue gift annuities that paid rates like that!” But are those rates really crazy? Although the nominal rate on the far end of the optional deferral period would be 20.2%, let’s think about that for a minute. The donor contributes the $10,000 now, and what does the charity do with that money? The answer, of course, is that the charity invests the gift funds in its aggregate portfolio for the entire gift annuity program. If the donor waits 30 years to begin taking payments, won’t that gift money grow over time, from a combination of investment earnings and reinvestments?

Let’s look at projecting the numbers over time using a conservative approach. The IRS discount rate recently has been stuck at 1.8%. Even though that number is based on average interest rates for medium-term bonds, the IRS methodology mandates using that number as the assumption for future investment earnings when computing the charitable income tax deductions for gift annuities. If we assume our investments will return no more than 1.8% each year on average, and we assume that all earnings are reinvested over the next 30 years, our $10,000 of gift money turns into a much larger amount. *And when we measure the future payout rates against those future amounts of principal, the effective payout rates are much lower than the nominal payout rates:*



Keep in mind, these numbers are using the *very conservative assumption* of projecting average investment returns of only 1.8% each year. What does it look like

if we make *a slightly more optimistic assumption,* such as using a 3.0% percent average rate of return over the next 30 years?



Wow! As you can see, there are dramatic differences in the payout rates when assuming even a modest rate of investment return *and* when measuring the future annuity amounts against the amounts the principal becomes over time. *The nominal payout rate of 15% in 2041 becomes an effective payout rate of only 7.4% for any 80 year-old!* And the seemingly-outrageous payout rate of 20.2% in 2046 becomes a still-quite-reasonableeffective payout rate of 8.6% for an 85 year-old! The differences are so stark, you may be wondering if we computed our numbers correctly. But rest assured, we did indeed compute the numbers correctly. Please note that, with no payments being made over the first 25 years of the annuity, the principal has more than doubled by the year 2041.

And remember, these numbers were tabulated using what we consider still to be modest assumptions – we have only assumed a total rate of investment return of 3.0%. Most organizations are comfortable assuming significantly higher investment rates of return in their projections – it's not unusual for clients to tell us they use 5% or higher for their assumed returns. Using somewhat higher investment return assumptions, these future principal amounts would become even higher, and the effective payout rates would become even lower.

In summary, please know that we are not suggesting that deferred gift annuities (including the flexible variations) with 20- to 30-year deferral periods are the right vehicles for *all* organizations. In some cases, the realities of managing life income gift arrangements over periods of 25 years or more are too daunting, and the likely rewards do not justify the risk and expenses. We simply want to make the point that if your organization is considering writing deferred gift annuities over long periods of deferral, it makes sense to look at the payout rates in a more realistic manner than simply focusing on the nominal payout rates. That 20.2% annuity payout rate in 30 years becomes much more attractive – especially to our friends in Finance – when we realize the *effective* payout rate is somewhere between 8 and 9%. The numbers seem appropriate when we look at them in context – *the sky isn't so high after all* – and we're not really that crazy!

We hope you find this information helpful. Please feel free to contact us if you have any questions.

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