

[Jeffrey Frye](#) - Wed, 2/18/2015 - 00:00

Two longtime supporters of your organization inquire about establishing a deferred charitable gift annuity with \$25,000. They are in their early 70's but don't need additional income just yet. They established one 10 years ago that began making payments a few years ago. *The donors are surprised when your initial calculations show that the eventual payout rate of their new annuity will be lower than the payout rate for the annuity they established 10 yearss ago.* You are taken aback; how could this be? Did you make a mistake in running the calculations? Is there a problem with the software you are using?

This is a question that has come up a number of times recently with our clients. It doesn't seem right that a deferred gift annuity written now would pay less than a deferred gift annuity written many years ago for the very same donor or donors. Especially given that the donors are now 10 years older - how could they possibly be getting a lower payout rate? Yet, it may actually be correct. We need to dig into the details to understand this confusing phenomenon.

For most organizations, the contractual payout rate on a charitable gift annuity is the rate suggested by the [American Council on Gift Annuities \(ACGA\)](#). These rates are based on ages of the annuitants - the older the persons, the higher the rates. They are also based on an assumption that the charitable organization should receive a remainder equaling at least 50% of the initial funding amount. An investment return assumption (based on an assumed asset allocation) also underlies the rates, and so the gift annuity payout rates tend to increase as investment returns in general rise, and they tend to decrease when returns in general fall.

The payout rates for deferred charitable gift annuities are slightly more complex than those for immediate payment gift annuities. The ACGA doesn't actually publish a complete deferred rate schedule, but rather, suggests a compounding interest rate to be used in determining the deferral factor and calculating the rate. The deferral factor is basically the annuitants' reward for waiting to receive payments - for each year the charity holds the gift money, the payout rate is bumped up to reflect the additional value derived from the money being invested. So the computation of deferred payout rates *is in reality a 2-step process - first, the standard payout rate is*

*identified for the individuals based on their ages on their birth dates closest to the annuity starting date**; then that rate is adjusted upward to reflect the number of years payments are deferred.

* The annuity starting date is the first day of the payment period that ends on the date of first payment. For example, the annuity starting date of a deferred gift annuity that will make quarterly payments starting on 3/31/2025 is 1/1/2025. If the same annuity were to make monthly payments, the annuity starting date would be 3/1/2025.

This distinction is critical – if a gift annuity is established for someone who is 65 now but will be 69 on the annuity starting date, the payout rate in the first step of the recalculation process is the payout rate for a 69-year-old. The second part of the recalculation process applies the deferral factor to this payout rate. If the appropriate payout rate for a 69-year-old is 4.8%, and the recommended compounding interest rate is 4%, the base rate of 4.8% will be increased 4% for each full year of deferral. If the deferral period is five years, the deferral factor will be 1.04 to the 5th power, and the annuity rate will be determined by multiplying that factor by the immediate payout rate of 4.8%.

$$1.04^5 = 1.216653 \quad \text{(Deferred Interest Factor)}$$

$$1.216653 \times 0.048 = 5.84\% \quad \text{(Annuity Payout Rate)}$$

Let's take a look at a specific example: John and Mary are 72 and 70 now. Ten years ago they established a deferred gift annuity with \$25,000. They were 62 and 60 at the time, and they chose to have payments begin after 8 years of deferral. We'll assume a gift date of January 1, 2005, because it makes the math a little easier to understand. In 2005, the then current ACGA table (effective 7/1/2003) recommended a payout rate of 5.8% for two lives ages 70 and 68. *The compounding interest rate at the time was 5 %, which is another way of saying that for every full year payments are deferred, the payout rate will be increased by that amount.*

Taking 1.05 to the 8th power gives you 1.477455 – this is called the Deferred Interest Factor. You can find it on the Actuarial Calculations page produced by *Planned Giving Manager* (PGM). To find out the deferred gift annuity payout rate for John and Mary, therefore, you multiply 5.8% (the appropriate payout rate for two

people ages 70 and 78) times 1.477455 (the Deferred Interest Factor for an annuity whose payments begin eight full years after funding). That's how *PGM* comes up with the adjusted payout rate of 8.6% for John and Mary's deferred gift annuity that was established in 2005.

$$1.05^8 = 1.477455 \quad (\text{Deferred Interest Factor})$$

$$1.477455 \times 0.058 = 8.6\% \quad (\text{Annuity Payout Rate})$$

So, if John and Mary have already started receiving payments on a deferred gift annuity they established 10 years ago, what kind of payout rate will they get now if they establish a new deferred gift annuity that will start making payments eight full years from now? The answer may surprise you. But before we look at the actual numbers, the following information may help to put things in perspective.

The ACGA releases a new table of suggested payout rates when the current conditions render the existing table of rates no longer appropriate. Since 2005, the organization has released six new tables of rates – in 2006, 2008, 2009, 2010, 2011, and 2012. The general pattern during this time has been one of falling payout rates. In the 2006 table, the lowest suggested maximum rate was 3.7% and the highest suggested maximum rate was 11.3%. In the 2012 table – the most recently released version – the lowest rate is 2.0% and the highest rate is 9.0%. In addition, the compounding interest rate for deferred annuities has fallen from 5.25% in the 2006 table to 3.25% in the 2012 table. Together these changes represent dramatic changes in the landscape for deferred gift annuities.

Now let's look at what kind of payout rate John and Mary could get now for establishing a deferred gift annuity that begins making payments after 8 full years. Since they are 72 and 70 now, they will be 80 and 78 when the payments begin. According to the 2012 ACGA rate table, the appropriate payout rate for a couple at ages 80 and 78 is 5.6%. This alone is worth considering: *even though they are ten years older when establishing this second annuity, the payout rate before adjusting for the deferral is actually 0.2% lower than it was for them in 2005.*

Let's see what happens when the deferral interest rate adjustment is applied: because the rate now is 3.25% instead of 5%, the already lower base rate of 5.6% is

multiplied by 1.0325 to the 8th power – this translates into a Deferred Interest Factor of 1.291578. Compared to 10 years ago, the donors are starting out with a lower base rate in 2015, and that base rate is increased by a smaller factor each year. *The final result is that the deferred gift annuity payout rate for this new gift will pay only 7.2% after 8 full years of deferral, 1.4% less than John and Mary’s first annuity.*

$$1.0325^8 = 1.291578 \quad (\text{Deferred Interest Factor})$$

$$1.291578 \times 0.056 = 7.2\% \quad (\text{Annuity Payout Rate})$$

So it turns out that you have not made a mistake running the initial calculations for John and Mary, and there isn’t a flaw with the software you use either. The lower payout rate is simply the result of two separate forces acting in combination: the base payout rate is lower than it was 10 years ago, and the compounding interest rate adjustment is also lower than it was in 2005. *Despite the donors being 10 years older than when they established their first deferred gift annuity, they will receive a payout rate that is markedly lower than the first time around.* It’s simply a reflection of dramatic changes in the financial sector – the prevailing interest rates are nowhere near the levels they were 10 years ago. It’s the same phenomenon that has occurred with home mortgage rates – those rates have dropped so much in recent years that the U.S. has experienced unprecedented levels of refinancing over a short period of time. These have been truly historic changes with wide-reaching consequences.

This situation likely makes it harder to promote subsequent deferred gift annuities from existing donors. Are there alternative solutions? Should you consider offering a higher payout rate to match the previous gift arrangement? No – even if you’re free of any state regulations that would prohibit adjusting the payout rate upward - that is not a good idea. *The maximum payout rates suggested by the ACGA are based on the premise that the charity, on average, should receive a residuum equal to 50% of the original funding amount. They also reflect reasonable rates of future investment performance based on a balanced model portfolio.* Your organization shouldn’t have to reduce the value of its ultimate benefit to “sell” a 2nd gift annuity. We recommend explaining that the payout rates are reflective of the current interest rate environment; that the rates have gone down dramatically in the same way that

interest rates on CDs and bonds have gone down. The current rates are appropriate for this point in time.

The deferred gift annuity established in 2015 is very different from the one established in 2005 because the world is very different. No one knows exactly how or when interest rates will change. But it will certainly be interesting to see where we go from here.

We always enjoy receiving feedback on our published materials. Please feel free to contact us if you have any comments or questions about this article. You may call us toll-free at 1-888-474-2252 or write to us at support@pgcalc.com.

To see the full gift illustrations from *Planned Giving Manager* referenced in this article, please click on the links below:

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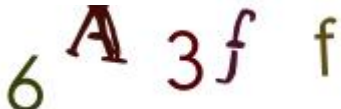
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