



Flexible Deferred Gift Annuities – Choices for the Baby Boomers

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How many of us “Baby Boomers” actually know when we’re going to retire? At this point, in our 50s and 60s, we’re likely reaching high points in our careers, in terms of earnings and fulfillment; or we have started completely new careers at midlife and have no intention of slowing down anytime soon. We’re healthier and more active than our parents were at this age, and, with ever-increasing life expectancies, it’s reasonable to envision not only living into our 70s and 80s, but also, living well and remaining vibrant. Sure, we’ll have Social Security (it won’t run out that soon, right?), but it won’t be enough to sustain our lifestyles, and we’ve watched the values of our retirement funds gyrate like roller-coaster rides over the past 10 years. Besides, we are the Boomers, the generation that kept refusing to grow up – we’ve finally learned to trust people over 30, but we’re nowhere near being “old enough to retire!”

And so, like us, many planned giving donors face similar uncertainties, especially those who establish charitable gift annuities. If donors in their 50s and 60s are thinking about establishing deferred charitable gift annuities that won’t begin payments until their late 60s or 70s, why not encourage them instead to consider flexible deferred gift annuities? That way they can choose, at some point in the future, when they would like payments to begin. The best part is that the payout rate increases for each year deferred – as with Social Security, there is an incentive to delay payments as long as possible. This strategy allows the donor to derive the greatest benefits possible from a life income gift arrangement – provide support to the charity now, receive the income tax deduction now, enjoy the certainty of income in the future, and get rewarded for waiting. It’s an amazing gift arrangement – perfect for the Boomers.

Deferred charitable gift annuities are certainly nothing new – they’ve been around almost as long as “regular” (immediate-payment) gift annuities. According to IRS rules, they must meet the minimum 10% estimated charitable remainder requirement to qualify for the income tax deduction and the special tax treatment – meaning that the payments are a combination of ordinary income and tax-free / capital gain distributions, typically over the life expectancies of the annuitants.

They can make payments to one or two named persons for their lifetimes but they don't start making payments until more than one full year after the date of funding. That's the key distinction between regular gift annuities and deferred gift annuities. The payout rate is based primarily on the annuitants' ages at the date of first payment, but the rate is increased by the number of years that the payments are deferred.

We've seen scores of donors use deferred charitable gift annuities to supplement anticipated retirement income. Unlike a charitable remainder trust, the deferred charitable gift annuity can be structured to begin payments at a precise point in the future; moreover, the relatively low entry point of any type of gift annuity makes this gift arrangement available and popular with the vast numbers of donors who are not in the storied "one percent" – most organizations who offer gift annuities allow minimum funding levels of anywhere from \$10,000 to \$25,000. Those amounts are attractive and viable even for donors we consider upper middle class, which opens up life income gift programs to an extremely large prospective audience. We even see many donors establish multiple gift annuities over the course of several years, which is possible because of the low minimum requirements. In aggregate, these laddered gift annuities can provide a substantial boost to retirement income in later years. And remember, you can't add appreciated securities to your IRA, but you can use them to create a gift annuity to supplement your income in retirement years.

Generally speaking, when a gift vehicle works really well in the realm of planned giving, inevitably, someone will come up with a variation of the gift concept that pushes the boundaries of the envelope (of course only some of those times is the concept a permissible and constructive variation on the theme!). The flexible deferred charitable gift annuity was first recognized by the IRS in 1997 by means of a Private Letter Ruling, and two subsequent rulings have reaffirmed its acceptance. We should point out, however, that a favorable PLR is not "binding law" – each ruling clearly states that the letter is "directed only to the organization that requested it" and that the letter "may not be used or cited by others as precedent." While PG Calc cannot render legal advice, the reality is that thousands of charities have issued flexible deferred gift annuities in the wake of those rulings.

Over the past 17 years, the flexible deferred gift annuity has become increasingly popular among the different types of gift annuities. While regular gift annuities still make up the majority of all gift annuity arrangements, the number of flexible annuities as a proportion of deferred gift annuities is growing quickly. According to the 2013 survey by the American Council on Gift Annuities, 31%

of the organizations participating in the survey offered the flexible version – up from 21% in 2009 and 10% in 2004. And the trend is expected to continue, due in large part to the considerations highlighted above¹.

So how exactly does the flexible deferred gift annuity work? PG Calc's Planned Giving Manager (PGM) includes the vehicle as one of the choices in the Gift Options section, which is easily accessed on the main front screen. Having chosen the type, the gift planner then needs to specify the first possible payment starting date, the first year of possible starting payments, and the last year of possible starting payments. PGM uses the annuitants' dates of birth to determine the appropriate payout rate for a regular gift annuity. Then, PGM recalculates the payout rate for each possible starting year, to recognize the higher ages of the annuitants at those later times, and also, to recognize the numbers of years the charity will have the money to invest without making any payments.

In reality, behind the scenes, PGM actually calculates the values for distinct deferred charitable gift annuities for each possible starting year. Then, according to the IRS rulings, the application selects the highest possible investment in contract out of all of the possible investment in contract values. This will be the official investment in contract value for the entire flexible annuity arrangement. [Remember that the investment in contract is the present value of the future stream of annuity payments – it's basically the cost of the annuity to the charity, and is usually the complement of the income tax charitable deduction, which represents the present value of the future benefit to the charity.] Because the methodology uses the highest possible investment in contract value for all of the possible starting payment years, the corresponding income tax charitable deduction is the lowest possible deduction for all of the possible starting payment years.

This means there is usually a compromise in the amount of charitable deduction for the donor who establishes a flexible gift annuity vis-a-vis the donor establishing a conventional deferred gift annuity. If the donor knows exactly what year he would like to begin receiving payments, he likely could get a higher deduction with a simple deferred gift annuity than if he includes that year as one of many possible years in a flexible deferred gift annuity; but the tradeoff is the flexibility, the ability to have choices, and the difference in the potential deduction amounts may not even be significant.

The details of this are provided in PG Calc's Charitable Gift Annuities: The Complete Resource Manual (aka the "Gift Annuity Manual") – an invaluable resource representing the remarkable work of Frank Minton, Bill Zook, and Edie Matulka. Indeed, there is an entire chapter (18) devoted

to flexible deferred gift annuities and another variation known as step gift annuities².

So what do the numbers for a flexible deferred gift annuity actually look like? Here's a typical Summary of Benefits chart produced by PGM:

Summary of Benefits					
<i>Flexible Gift Annuity</i>					
ASSUMPTIONS:					
Annuitant				[7/1/1954]	60
Date of Gift				8/9/2014	
First Payment Start Date in Range				3/31/2024	
Last Payment Start Date in Range				3/31/2033	
Cash Donated				\$10,000.00	
Payment Schedule				quarterly	
BENEFITS:					
Charitable Deduction					\$4,425.70
Schedule for Elective Payment Start Dates (annuity rates from ACGA2012 table)					
Electiv Start Date	Age at Start Date	Annuity Rate	Tax-free Portion	Ordinary Income	Total Annuity
3/31/2024	70	6.9%	\$350.52	\$339.48	\$690.00
3/31/2025	71	7.4%	\$367.04	\$372.96	\$740.00
3/31/2026	72	7.8%	\$384.54	\$395.46	\$780.00
3/31/2027	73	8.2%	\$404.26	\$415.74	\$820.00
3/31/2028	74	8.7%	\$425.43	\$444.57	\$870.00
3/31/2029	75	9.2%	\$449.88	\$470.12	\$920.00
3/31/2030	76	9.8%	\$472.36	\$507.64	\$980.00
3/31/2031	77	10.5%	\$501.90	\$548.10	\$1,050.00
3/31/2032	78	11.2%	\$530.88	\$589.12	\$1,120.00
3/31/2033	79	11.9%	\$562.87	\$627.13	\$1,190.00
The entire annuity will become ordinary income after the life expectancy of the annuitant.					
Basic Gift Illustrations Prepared by: PG Calc				IRS Discount Rate is 2.2%	
These calculations are for illustration purposes only and should not be considered legal, accounting, or other professional advice. Your actual benefits may vary depending on several factors, including the timing of your gift.					

Calculating the numbers is the first part; the second part is preparing the documents. The flexible gift annuity is actually a deferred gift annuity with an additional clause added to the gift annuity agreement. Here is the suggested wording in PGM and the Gift Annuity Manual:

“To elect irrevocably the commencement date of payments hereunder, which shall be the last day of (month) and which shall not be earlier than (month),(date),(year), nor later than (month),(date),(year), the Donor during his life shall deliver written notice to Charity no later than ninety (90) days prior to the desired commencement date. If no election is made, annuity payments will commence on (month), (date), and (year).”

The special clause makes it clear that the donor can elect when to start taking payments at some point in the future, but it also establishes some parameters about giving notice to the charity within a certain timeframe.

The list of possible payment commencement dates and corresponding payment amounts would appear as a schedule at the end of the gift annuity agreement. Here is a sample:

Gift Annuity Agreement Between (donor name) and (charity name)	
<i>Schedule B</i>	
Annual Annuity Based on Year in which Payments Commence	
If payment commence on this date,	this will be the annual annuity amount:
3/31/2024	\$690
3/31/2025	\$740
3/31/2026	\$780
3/31/2027	\$820
(etc.)	

All of this is included in the documents produced by PGM – when the gift planner models the numbers for the flexible deferred gift annuity, and chooses the gift annuity agreement in the Narratives section of Presentation Selection, the application includes both the special clause and the separate schedule.

Clearly the flexible deferred gift annuity makes sense for a lot of donors who want the ability to choose the starting payment date at some point in the future. And the rationale isn't limited just to the typical case of the donor wanting to supplement retirement income – the donor might want to establish one because of the uncertainty of other sources of income in the future – perhaps there is income from a trust, which is expected to end at some point, but that timing is currently unknown. Or maybe the donor doesn't know if she will need the income in the future, but wants to allow for the possibility - in a recent PG Calc Webinar, Frank Minton suggested the use of this vehicle as a “just in case gift.” Should the donor decide later that she doesn't need the income, and she is confident that she will not need it at any point, she can assign the interest to the charity and receive an additional income tax deduction for the lesser of the undistributed investment in contract and the present value of the annuity as of the date of the assignment³.

What happens if the donor (annuitant) passes away prior to receiving any payments from the charity? The charity simply keeps the funding amount, as well as all cumulative earnings from the investments, and the donor's estate may be eligible to take an additional charitable tax deduction⁴.

One of the usual roadblocks to a charity deciding to offer flexible deferred gift annuities is the appearance of extremely high payout rates in the later possible payment starting years. The business / finance areas may resist the prospect of making future payments at rates that seem unreasonable. At first glance, this reaction makes sense – in our example above, the payout rate for year 2033 is 11.9% when the payment amount is compared to the original funding amount. On closer inspection, however, the payout rate is a much lower percentage when expressed as a proportion of the future value of the funding principal; if the original funding amount of \$10,000 grows by 4% annually, the compounded value of the principal will be \$14,889 in 2033. Given that the payment is already set at \$1,190 per year, that amount actually translates into a relative payout rate of approximately 8%. Development professionals who are challenged to defend the logic of offering this newer type of gift annuity may need to demonstrate this type of analysis in order to get everyone on board with the concept.

In the final analysis, flexible deferred gift annuities likely will make sense for many organizations, but for others, they may simply appear too risky. There is always a chance that the average annual investment returns will be minimal (or even negative) over a particular period of years, and that could spell disaster for a program that is not large enough to sustain a number of under-water annuity arrangements. Likewise, at the individual donor level, the flexible deferred gift annuity will

make sense for many, but not for all. In some cases the donor will know fairly precisely when the need for supplemental retirement income will arise in the future. It doesn't make sense to accept compromise on the charitable deduction when a higher deduction can be achieved with a simple deferred gift annuity. There may also be concern that the annuitant – whether the donor or another person – will not be as capable of making important financial decisions in the later years of life.

For the charities that decide to offer them, and for the donors who choose to establish them, flexible deferred gift annuities will provide the ultimate combination of benefits available through a life income gift arrangement. Donors in their peak earning years get the deduction now, and the charities receive the funds now. Years will pass before any payments are possible, allowing the charity to invest the principal for the for long-term r return. The annuitants can enjoy the luxury of postponing some of their retirement income, and there is an incentive for waiting longer to start the payments. It's almost like the proverbial having one's cake and eating it too – but, of course, it makes perfect sense for the Baby Boom generation. We have always insisted on doing things differently, and the world continues to change as a result of our impact. Now that we're gradually transitioning into the retirement years, it's only natural for us to demand changes to those areas of life as well. And while it may be true that 60 is the new 40, even we will – eventually – become old(er).

¹ <http://www.acga-web.org/resources-top/surveys-reports-conference-papers-and-brochures>

² <http://www.pgcalc.com/education/charitable-gift-annuities-manual.htm>

³ Charitable Gift Annuities: The Complete Resource Manual, Revised September 2013, chapter 20: Special Situations, p. 14. Note that if the annuitant has not already done so, she should select the starting date for the payments before making the assignment.

⁴ Every estate situation is unique, and the determination of any additional charitable deduction should be made by a qualified tax advisor.