Choosing Wisely: How the IRS Discount Rate Affects Gift Annuity Calculations
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A donor establishing a charitable gift annuity has the option of using the IRS discount for the month in which the contribution is made or for either of the two preceding months. Should the donor always select the discount rate that will produce the largest charitable deduction? Not necessarily. Making the right choice entails understanding a few details about the role played by the discount rate.

The basic impact

The general rule is the higher the discount rate, the higher the deduction available for a gift annuity, *all other factors being the same*. Thus, in a low-discount-rate environment such as the one gift planners have experienced during the last several years (and can expect to continue experiencing for at least the next year or two), gift annuity deductions will remain quite low compared with what they were over a decade ago.

Indeed, prior to December 2001, the discount rate had never been below 5.0%. By contrast, the last time the rate was above 4.0% was autumn of 2008, with nothing above 3.0% being available since summer of 2010 and nothing above a mere 2.0% available since autumn of 2011.

The "age overlay"

It turns out, however, that the discount rate's impact on the deduction varies quite a bit, once an additional factor – annuitant age – is taken into account. Consider the deductions in the following table, which assume in every case a contribution of assets worth $10,000, the gift annuity rate currently suggested by the American Council on Gift Annuities (ACGA) for each given age, and payments made at the end of each quarter:

Age of Annuitant	Discount Rate = 1%	Discount Rate = 2%	Discount Rate = 3%	Discount Rate = 4%	Discount Rate = 5%	Discount Rate = 6%
60	$1,653	$2,582	$3,357	$4,006	$4,556	$5,025
65	$2,507	$3,231	$3,849	$4,377	$4,833	$5,229
70	$3,354	$3,901	$4,377	$4,794	$5,159	$5,483
75	$4,016	$4,426	$4,791	$5,116	$5,407	$5,669
80	$4,607	$4,908	$5,181	$5,429	$5,655	$5,861
85	$5,377	$5,582	$5,772	$5,947	$6,109	$6,259
90	$6,108	$6,243	$6,370	$6,488	$6,599	$6,703

As is evident, the younger the annuitant, the greater the impact of the discount rate. This is because the charity is presumed to have earned that rate of return for a longer time. The discount rate does not have much effect on the deduction for a 90-year-old because the funds are presumed to be invested over the 90 year-old's life expectancy only, which is just a few years.

Drawing on the figures in the table above, here is how the difference between the deduction associated with a 1.0% discount rate and the deduction associated with a 6.0% discount rate varies depending on the age of the annuitant:

Age of Annuitant	**Difference in Deduction**
60	$3,372
65	$2,722
70	$2,129
75	$1,653
80	$1,254
85	$882
90	$595

A corollary is that the higher the discount rate, the less the annuitant's age affects the deduction. Drawing once again on the figures in the first of the tables above, here is how the deduction for a 60-year-old will differ from the deduction for a 90-year-old depending on the discount rate:

Discount Rate	**Difference in Deduction**
1%	$4,455
2%	$3,661
3%	$3,013
4%	$2,482
5%	$2,043
6%	$1,678

In short, the significance of the very low discount rates currently in effect is compounded in the case of younger annuitants. Moreover, regardless of annuitant age, the choice of discount rate will have more influence on the charitable deduction when the available discount rates are lower. For example, if the discount rates for the month of the gift and the two immediately preceding months are 1.2%, 1.4%, and 1.0%, respectively, the choice will have greater consequences than if those rates were, respectively, 3.2%, 3.4%, and 3.0%.

The flip side of the deduction

Except in a handful of fairly rare instances, such as those in which ordinary income assets or “unrelated use” items of tangible personal property are contributed for a gift annuity, the deduction will be simply the contribution amount minus the present value of the annuity. This means that the lower the deduction, the higher the present value of the annuity and, consequently, the larger the amount of each annuity payment that will be taxed favorably.

Let’s look at the situation of an 80-year old donor who establishes a gift annuity for his own benefit with a cash gift of $10,000. If the discount rate used in making the tax calculations is 1.0%, his deduction is $4,606.70, meaning the present value of the annuity payments is $5,393.30. When this $5,393.30 is returned to him in the form of annuity payments over his 9.4-year life expectancy (as determined by IRS tables), $143.48 of each full quarterly payment he receives during this period will be tax free.

If instead a discount rate of 1.6% were used, the deduction would increase by $184.40 to $4,791.10, with the present value of the annuity decreasing by the same amount to $5,208.90. Consequently, the tax-free portion of each full quarterly payment over the same 9.4-year period would decline to $138.55.

Especially in the case of a donor who does not itemize deductions, the lowest possible discount rate should be selected, as this will maximize the tax-free portion of each payment. Note: This will be the case even if the annuitant is someone other than the donor.

If the donor does itemize deductions, however, it will usually be advantageous to select the highest available discount rate because the future value of larger up-front tax savings will normally exceed the future value of larger after-tax cash flow.

Similarly, if a donor contributes appreciated property, it is more likely to be advantageous to select the highest possible discount rate. Choosing the lowest available rate, in addition to generating a smaller deduction, produces more taxable capital gain when appreciated property is contributed and the donor is an initial annuitant. Although the after-tax cash flow will still be higher in this case than if the donor chose the highest available rate, the differential will be less than if cash were contributed. The tax savings from the larger deduction that come with choosing the highest available discount rate will be more likely to outweigh the slightly increased after-tax cash flow from choosing the lowest available discount rate.

Suppose that a donor, age 72, contributes stock having a fair market value of $100,000 and a cost basis of $20,000, and receives quarterly payments based on the annuity rate suggested by the ACGA. Her tax rate with respect to ordinary income is 28 percent and capital gain is taxed to her at a 15-percent rate. The table below shows that the donor’s annual after-tax cash flow varies only a little compared to the deduction as the IRS discount rate is varied.

Discount Rate	Deduction	Annual Payment	Total Gain Taxable	Portion of Annual Payment Taxable as Gain*	Portion of Annual Payment That Is Tax Free*	Annual After-tax Cash Flow*
1%	$35,658.00	$5,400.00	$51,473.60	$3,551.04	$887.76	$4,598.20
2%	$40,595.00	$5,400.00	$47,524.00	$3,278.89	$819.71	$4,543.78
3%	$44,929.00	$5,400.00	$44,056.80	$3,036.96	$759.24	$4,495.40

*During 14.5 years of life expectancy per IRS tables

Note that the latest version of *Planned Giving Manager*, released on February 4, allows you to compare side-by-side the benefits of a gift annuity under all three available IRS discount rates. Open Basic Gift Illustrations, choose the Summary of Benefits chart, then open Gift Date – IRS Discount Rate and click “Yes” to “Compare gift annuity benefits on Summary of Benefits under all 3 available rates.”

Observations regarding deferred annuities

When the discount rate is low, a gift annuity may not be able meet the requirement of Section 514(c)(5) of the Internal Revenue Code that the present value of the annuity be less than 90% of the value of the assets contributed. While this can sometimes be a problem when gift annuity payments begin immediately, it is more likely to be an issue with deferred annuities.

This is because the ACGA recommends adjusting deferred annuity rates upward by 3.25% for ever year of deferral. Meanwhile, the IRS discount rate has been languishing near 1% for the last 9 months. This means that the ACGA recommends increasing deferred annuity rates significantly faster than the IRS discounts the value of those rates. When the annuitants are in their early 50s or younger at the time of the gift, the combination of the IRS discount rate and the likelihood of the annuitants dying during the deferral period discounts the value of the annuity at less than 3.25%/year for at least the first few years of deferral. Unless the deferral period is long enough for mortality to become an important influence on valuing the annuity, the present value of the deferred annuity actually increases as the annuity rate rises with each additional year of deferral.

The result is that particularly with younger annuitants of deferred annuities, the choice of discount rate may spell doom for the annuity vis-à-vis the aforementioned Section 514(c)(5) test unless the annuity rate is decreased to something lower than that suggested by the ACGA. One is most likely to see this in the case of commuted payment deferred annuities such as the so-called “college annuity” that usually have very young annuitants.

Conclusion

Unlike with charitable remainder trusts and certain other planned giving arrangements, where the discount rate to choose is clearly the one that produces the highest charitable deduction, with gift annuities the deduction is just one facet to consider. Sometimes these additional facets will make the case for using the highest available discount rate even stronger. In other cases, however, low will be the way to go. Furthermore, occasionally – in order to balance the effect of different considerations – a donor might opt to use a discount rate that is neither the highest nor the lowest, assuming that the month of the gift and the two prior months each feature distinct rates. Above all, you will do your gift annuity donors a service by making them aware of these trade-offs and giving them the opportunity to weigh their options so that they can choose the IRS discount rate that works best for them.