Why is the discount rate so low? (And does it really matter?)

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Gift planning professionals devote much of their time to creating attractive gift arrangements that offer significant benefits, both to the donors who provide the funding, and to the charitable organizations named in the gifts. Life income gifts, in particular, provide the donors with charitable deductions, income for life and / or a period of years, and the satisfaction of knowing they have supported a charitable organization in whose mission they believe. The amount of income resulting from a life income gift arrangement is fairly straightforward and depends on the amount of funding principal, the range of possible payout rates allowed by the IRS, the level of income appropriate for the underlying investments, and (for gift annuities) the ages of the beneficiaries.

The charitable deduction, on the other hand, is based on the estimated value of the charitable benefit, discounted to present value. The deduction amount is calculated based on the funding amount, payout rate, and term length of the gift plan, and the IRS discount rate. Of those four components, the IRS discount rate has varied tremendously over the years, and recently, has been stuck at stubbornly low levels. The low discount rate has resulted in most donors receiving much lower charitable deductions, all other things being equal, than the deductions they would have received several years ago when the discount rate was much higher. So what does this mean for the donor? Just how significant are those differences in the deduction amounts? And are they enough to suppress levels of charitable giving?

Historical Perspective

Until March of 1989, the IRS discount rate was fixed at 10%. At that point it began to float, and the first monthly rate was 11.2%. Since then we have seen periods of relatively high rates as well as periods of relatively low rates. However, the overall trend has been one of decline. The highest rate ever was 11.6% in May of 1989; the lowest rate ever was 1.0%, seen 3 times in 2012 and once in 2013. Let's take a look at some sample gift calculations to understand the implications of such a dramatic change in the discount rate.

For a 72-year-old contributing $10,000 to establish a 5.4% charitable gift annuity with an IRS discount rate of 11.6%, the charitable deduction would be $6,712.90. In contrast, with an IRS discount rate of 1.0% and all other assumptions remaining constant, the charitable deduction would be $3,565.80, a little more than half of the deduction computed using 11.6%. Just for a reality check, if we use the highest discount rate currently available – 2.0% in April of 2015 – the charitable deduction would be $4,059.50.

So we can see that the charitable income tax deduction can vary significantly with the IRS discount rate. But charitable gift annuity and charitable remainder annuity trust deductions are much more affected by changes to the IRS discount rate than are charitable remainder unitrusts. Charitable deductions for gifts to pooled income funds, by the way, are affected by changes to the IRS discount rate only in certain cases. Deductions on gifts to PIFs with at least 3 taxable years of experience are based on the highest income rate of return for the PIF for the last 3 calendar years; deductions for gifts to new PIFs, however, are calculated using a unique rate specified by the IRS, which is very much affected by changes in the IRS discount rate[1].

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[1] The IRS mandates the valuation rate for a fund with less than three taxable years of experience, a so-called "young" fund. The valuation rate for young funds equals the highest of the average monthly discount rates over the previous three calendar years, minus 1.0% and rounded to the nearest 0.2%. Source: PG Calc.

PG Calc has produced a couple of useful articles over the years regarding the influence of the discount rate on charitable deductions and suggestions for gift planning during periods of low interest rates. Although the articles were written in the past, the contents are timeless and well worth the read.

- The General Theory of Discount Rate Relativity
- Gift Planning when the IRS Discount Rate is at an All-time Low

About the Discount Rate

We know we don't have any control over the discount rate, but still we wonder, why is it so low, and why has it been stuck at such low levels for so long? To answer those questions, we need to understand how the rate is determined. The IRS discount rate is based on the average interest rate of United States Treasury obligations (notes and bonds) with a maturity of 3 to 9 years; this average interest rate is increased by 20%, and then rounded to the nearest 2/10 of one percent. The underlying interest rates are referred to as "mid-term Treasury rates." Short-term interest rates, in comparison, are considered to be the rates on Treasury obligations (notes, bonds, and bills) of less than 3 years.

Short-term interest rates, by the way, are the only interest rates directly controlled by the Federal Reserve System – the Fed sets the rates at which banks borrow short-term money, and that sets the rates on short-term obligations in the financial marketplace in general. Long-term interest rates, in contrast, are usually considered to be the rates on obligations that extend more than 9 years; the current interest rate on a Treasury bond with a 10-year maturity is a frequently-quoted example of long-term interest rates. The rates on long-term obligations are controlled to a much greater degree by the current investment environment; these rates are essentially subject to the basic demand for capital in the economy, both nationally and internationally.

It's a Brave New World

Mid-term interest rates, in general, are affected by both short-term and long-term rates, and all interest rates have been at historically low levels for many years now. In the past, when interest rates were low, the common perception was that it was a temporary phenomenon due to a slower period in the economic cycle. The demand for capital was diminished because of the economic slowdown, but interest rates would rise as the economy picked up speed. In recent years, however, interest rates have remained low even when the economy has been strong. We can't attempt to explain in this article why the dynamics have changed – it's a complex issue about which there are many opinions. But we can say that the world economy has changed dramatically over the past 30 – 40 years, and the transformation has had a permanent effect on the demand for capital. Just as the demand for labor has shifted with increasing automation and the disappearance of geographic boundaries, the demand for capital is played out on a global stage and is tempered by better use of technological innovation. Companies still increase output in part by building larger plants and hiring more workers, but they are also able to reap the rewards of newer equipment and more efficient processes. They like to call it "smart growth." It's great for the bottom line, but it results to some extent in higher unemployment and lower interest rates.

So if the IRS discount rate is based on underlying interest rates that are stuck at historically low levels, and might not be changing anytime soon, what does this mean for life income gifts? Has the level of giving been affected by the declining discount rate? Are current prospective donors sitting on the sidelines because the deductions they could earn are too low? It's really not possible to answer these questions fully, as there are too many competing variables that make statistical analysis impossible. The current strength of the stock markets, for example, will certainly have some effect on the level of charitable giving, and the stock indices do not necessarily change in concert with the IRS discount rates. But we can look at certain data and make some general observations.

Some Actual Data

There is not much data available on levels of giving in the area of life income gifts – the most noteworthy information is probably the statistics based on self-reporting of gift annuities in the form of the American Council on Gift Annuities survey, and the summary data released by the IRS on tax returns filed for charitable remainder trusts. There is, however, some valuable information available on charitable giving in general, by way of the Giving USA Foundation annual reports. In a cursory review of the data over the past 10 or 15 years, we see that as the discount rate increased from one year to the next, the total amount of charitable giving by individuals in the U.S. increased in certain years, but not in other years;

likewise, as the discount rate declined from one year to the next, the total amount of charitable giving decreased in some cases, but not in others.

Let's look at the specific numbers for a couple of recent years: the average IRS discount rate increased from 1.25% in 2012 to 1.60% in 2013, and the amount of charitable giving by individuals increased by 4.2% (as measured by inflation-adjusted dollars). That, of course, would seem logical. From 2011 to 2012, however, the average IRS discount rate fell from 2.33% to 1.25%, and yet, the total amount of charitable giving by individuals increased by 8.0%.[2] Why would charitable giving increase when the discount rate – and in turn, the charitable income tax deductions – were falling? The transition from 2011 to 2012 is not unique – we see the same pattern occurring over different years as we look back to 1989, when the rate began floating.

Concluding Thoughts

Clearly the level of charitable giving by individuals in the U.S. is not determined solely by the current IRS discount rate or the recent direction in which it has been trending. The decisions by individuals to make charitable gifts are influenced by a number of factors, including their devotion to a particular charity's mission, as well as their current sense of economic well-being. The level of comfort regarding their financial assets will be greatly affected by the current values of their homes and the values of other significant assets, such as investment portfolios and retirement accounts. The income tax deduction is an important component in the decisions made regarding charitable gifts, but it is only one piece of the puzzle. These periods of low interest rates, low IRS discount rates, and relatively low charitable deductions compel us to focus on other aspects of the gift-making process – long-term support of the charity's mission, the importance of leaving a legacy, and providing a significant stream of income during the retirement years. In the long run, both the donors and the charitable organizations will achieve greater levels of success and satisfaction than if the focus were placed disproportionately on the charitable deduction.

[2] Source: The Annual Report on Philanthropy for the Year 2013, Giving USA