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Underwater Gift Annuities: Don't Go Down with the Ship!

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We frequently hear about so-called "underwater gift annuities" from our clients. We're talking about those charitable gift annuities (CGAs) that were established many years ago – by donors with the best of intentions – but for which, over the years, the annuity payments have used up all the gift principal. The annuitant (who is frequently the donor) has probably lived well past his or her original life expectancy, but the sponsoring charity is still obligated to continue making annuity payments for as long as the annuitant is still alive. In case there is any question, there is absolutely zero chance of the charity ever receiving any residuum from that gift. And rest assured, this is not an unusual occurrence. We hear this same sad story again and again.

How did this happen? How did we end up in these unpleasant circumstances? And more specifically, what is to be done now? How does the sponsoring charity manage the situation going forward? And does the charity have any options at this point?

Let's review the basic facts about a charitable gift annuity before we go any further. The donor contributes cash or property, typically appreciated marketable securities that have been held for over one year. The gift occurs when the cash or securities are received by the sponsoring charity. There are a couple of variations on that, but for discussion purposes, the date received is the official date of the gift. If the funding consists of marketable securities, the official gift value is based on the average trading price of the security on the actual date of gift – just like any charitable gift of marketable securities.

Once the gift date and gift value are determined, the charity writes a gift annuity agreement in which the charity promises to pay one or two annuitants a specific dollar amount for as long as they are living. If there is money left from the gift after both annuitants have passed, that money is called the "residuum" (or "charitable remainder"), and it is distributed to the sponsoring charity. It is presumed that, in general, the gift annuity arrangement will result in a gradual erosion of principal over time because the investment earnings of the principal will be less than the total amount paid out each year.

Having said that, in most cases, there is SOMETHING left in the end. Typically, the charity will receive some amount of residuum at the end of the life of a gift annuity. The American Council on Gift Annuities (ACGA) recommends gift annuity payout rates based on a goal of achieving a 50% residuum for charitable gift annuities. Many charities, in fact, achieve a much higher proportion of the original principal, on average. A gift annuity program that results in an average residuum of 80% or 90% is considered to be a very successful program.

Which brings us back to our original question: how did this gift annuity go underwater? There is a fair amount of discussion in the planned giving community these days about why gift annuities run out of money. The conversation ultimately seems to break down into two areas – one is that the annuitants are living much longer than originally expected, and the other is that the investment results were insufficient to maintain healthy balances in the investment pools.

Why are annuitants living much longer than originally expected? When a gift annuity arrangement is executed, the necessary calculations produce results that include the amount of the charitable tax deduction and the breakdown of how the annuity payments will be taxed over the years of life expectancy. It may seem that when a gift annuity is signed the annuitants are guaranteed to live longer than expected.

The life expectancy for the tax reporting side of a gift annuity is determined by an older IRS mortality table (currently the 2010CM mortality table), which is likely to predict a shorter life expectancy than the life expectancy determined by a newer mortality table. Annuitants are also living longer than originally expected because the general attributes of the donor population tend to amplify the original bias. Mortality tables created and used by the federal government are based on U.S. Census data, which ostensibly represents the total population of the country at the time of each census. Any group of planned giving donors is likely to live longer than the population, as a whole, because they are typically wealthier than the average person. They have higher levels of education, better access to quality healthcare, and resources to maintain healthier lifestyles – a whole list of attributes that are correlated with longer lifespans. This means that annuitants, from the very beginning, are likely to outlive their life expectancies contained in the original gift annuity calculations.

If we venture so far as to say that the typical (average) annuitant of a charitable gift annuity lives three years longer than the original estimate of their life expectancy, what does that really mean in terms of payments over time? What if we say the difference is five years? Or seven years? Every situation is unique, of course, but should we be concerned if we are seeing five to seven years of additional lifespan on the typical annuitant of a gift annuity?

For every additional year lived by the annuitant of a gift annuity, there are more payments made than originally projected, but is that enough to sink the typical (average) gift annuity? If the original gift (the money) were stashed under the proverbial mattress, the sponsoring charity might, indeed, run out of gift money on an annuity that runs for 10 or 15 years longer than expected.

Let's say a gift annuity was established in 2010 by a 65-year-old donor. The funding amount is $100,000 (nice round numbers!) and the payout rate is 5.5%. That translates into $5,500 per year. The remaining life expectancy for a 65-year-old at that time was approximately 20 years. If you multiply the annual payment amount times the number of years, you get $110,000. How can that be? How can a gift annuity that was established with $100,000 pay out $110,000 over 20 years and still be a qualified charitable gift annuity (meaning that, among other things, the estimated charitable remainder is at least 10% of the original principal funding amount)?

As the late, great Paul Harvey used to say, let us now hear the rest of the story: The $100,000 is NOT stashed under the proverbial mattress. Rather, the money is placed in an investment account with the presumption that the money will accumulate investment earnings over time. In our example above, the payments on a $100,000 gift would total $110,000 over the expected remaining lifespan of 20 years. On the investment side of the equation, using a very simplified spreadsheet, we could estimate that the $100,000 was invested in conventional marketable securities with a 5% net investment return over the long run. [A net investment return assumption of 5% is, in fact, on the conservative side. We've published many articles explaining how a conventional fiduciary portfolio should be able to produce an average return of 5% or more over the long run.]

The net results at the end of 20 years are that the $100,000 earns 5% each year and distributes 5.5% each year. The principal does indeed decline over the 20 years as there is a small amount of principal erosion from each year to the next. However, that does not mean the gift annuity goes underwater. The estimated remaining principal at the end of the 20 years would be $83,467! Wow! That's more than 83% of the original funding principal amount. That's downright amazing!

What if the annuitant lives 10 years longer than originally projected? Using the same calculation method above, the estimated remaining principal after 30 years would be $66,781! Still amazing! That is a residuum of 66% of the original funding amount, which is still far more than the magic 50% goal!

Let's get really courageous and say that, in a few cases, the annuitant will live 20 years longer than originally expected. Will we get into trouble with this gift annuity? No, because the remaining principal, if the annuitant lives 20 years beyond the original life expectancy, still comes out at $39,600. That's right. There is still almost 40% of the original principal amount sitting in the investment account for this gift annuity. And just for fun, if the annuitant lived 25 years beyond the original life expectancy the remaining principal would be $20,150! The residuum is still slightly above 20% even when the annuitant lives 25 years longer than originally projected.

When we look at the total equation, it's hard to understand how gift annuities ever go underwater – assuming we are paying according to the recommended (or otherwise reasonable) payout rates and the money is invested in a prudent and responsible manner. It's not that complicated. At least in theory.

In the real world there are always exceptions, such as the occurrence of a particularly bad year for investments. Our previous articles have shown that, if the investment manager maintains a long-term approach and avoids knee-jerk reactions to real-world events, it is still possible to have a long-term average investment return north of 5%. However, if a disproportionately large addition to the gift annuity pool were to be made on the eve of a precipitous fall in the stock market, the value of the entire pool might be dragged down as a result. According to that unfortunate truism, once the market value goes down, it is difficult to bring it back up.

There are other reasons for exceptions, and we can't rule out human error. A gift annuity might be issued, for example, with an incorrect payout rate that is too high for the age of the annuitant. If the error is caught right away, it would probably be possible to work with the donor to start over – especially if payments have not already been made. But if a few years have passed before the error is discovered there's really no way to go back in time. We should note, however, that the standard gift annuity agreement includes a provision that allows the charity to amend the agreement if an incorrect date of birth was used in error.

Whatever the argument is for why a gift annuity shouldn't go underwater, and whatever the exceptions are that explain why they sometimes DO go underwater, the reality is that it happens. This naturally begs the question, what can the sponsoring charity do once it *has* happened? There are, in fact, a number of possible courses of action. The easiest choice is to do nothing. When a gift annuity has exhausted all of the principal associated with the gift arrangement, the charity has NO choice about what to do in regard to the payment obligation. A charitable gift annuity is a contract and a legal obligation of the charity. The charity HAS to keep making payments, regardless of whether or not the principal has been exhausted. So where does the charity get the money to make the payments?

When gift annuities are invested together as one aggregate pool of assets, which is typically the case, the rising tide lifts all boats, and the falling tide lowers all boats. If a particular gift annuity goes underwater, the money for the ongoing payments comes from the investment pool as a whole. That means the gift annuity in question is actually taking money away from every other gift annuity in the pool to make the payments. It is "robbing Peter to pay Paul," as they say. Is that a problem? Is it wrong that every other annuity in the pool is giving up value to make the payments on the underwater annuity?

There are, in fact, different opinions in this situation. Some charities say it all goes together eventually as financial resources for the organization, so, in the long run, it doesn't matter if the underlying principal for other gift annuities help to make payments for the underwater gift annuity. Some charities, however, want to keep the other gift annuities intact; this is especially important when at least some of the gift annuities have special purposes and designations. In those cases, the charities can transfer money from general funds to replenish the money used to make payments for the underwater gift annuity. Each time a payment is made for the underwater gift annuity, the money is replaced by money from the general funds. It is like a checking account that keeps getting overdrawn, and then the money is added to bring the balance back up to zero.

As we previously asserted, the charity cannot simply stop making payments for a gift annuity just because the underlying principal has been exhausted. But it is possible to have a conversation with the annuitant to see if they might consider relinquishing their remaining life income interest in the gift annuity. In some cases, the annuitant can take a charitable deduction for the gift of the annuity. The charitable deduction would be the total tax-free portion of the future annuity payments that *have not yet been paid to the annuitant.*

However, if the annuitant has lived beyond their original life expectancy, and all the tax-free income has been paid out, the annuitant cannot take a charitable deduction for relinquishing their remaining life income interest. It should be noted that while these annuitants cannot take a tax deduction, they are still making a charitable gift of the remaining life interest.

Another possible option for the sponsoring charity of an underwater gift annuity is to negotiate a cash settlement with the annuitant. The charity can agree to pay the annuitant an agreed-upon sum in exchange for the annuitant irrevocably relinquishing the remaining life income interest in the annuity. There is nothing illegal or wrong about this choice of action – it relieves the charity of the obligation for all future payments and removes the computed liability from the charity's financial reports. That is indeed a gift to the charity. The annuitant should be aware, however, that some or even all of the cash payout will be reported as taxable income.

One other possible option for the sponsoring charity of an underwater gift annuity is to purchase some kind of insurance annuity to provide the stream of payments due to the annuitant for the rest of his or her life. This would require a one-time cash outlay by the charity, but it shifts the burden of the annuity payments to a third party. It would be best – and it might be required – to include the annuitant in the decision process. The annuitant need not be concerned if the quarterly payment comes from an insurance company instead of the charity, as long as the check arrives on time and for the right amount.

In summary, we face the reality that even though charitable gift annuities should not go underwater, they sometimes DO go underwater. If a significant number of gift annuities are going underwater for a particular charity, there is a broader problem that requires careful review and analysis. Annuitants' longer lifespans are not significant enough to cause the depletion of original gift principal in case after case. Simply put, the fact that people are living longer than originally expected is not the reason for a gift annuity program to devolve into disaster.

If the occasional gift annuity goes underwater, the sponsoring charity should address the situation directly. Someone should ask the annuitant if they would consider relinquishing their life interest, thereby making an additional gift to the organization. If they are not interested in that possibility, someone should ask them if they would accept a cashout for an amount that both parties consider fair and reasonable. It's best for the charity to get out of that annuity obligation at the earliest possible opportunity, because the negative value detracts from the overall value of the gift annuity program. Quite simply, it's a drag on the gift annuity program as a whole, both figuratively and literally. Sometimes the best course of action is to recognize a loss and move on.