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De-Mystifying Gift Liability Reports

PART II

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Note: This article is a continuation of our discussion of liability reporting issues. This part covers compliance with regulated states, the effect of minimizing your reserve account, liabilities for deferred annuities, and more.

Q: With which regulated states must an organization file for a permit? With which state laws regarding reporting and investment should a charity comply?

A: These are policy questions that should be addressed by the organization's legal and financial leadership; it may also be a good idea to involve the appropriate sub-committee of the Board (audit, finance/investment). The planned giving office will likely be asked to provide information for these policy discussions. Several steps should be taken:

Charities should first check the laws of the state in which they are incorporated, as well as those where the charity has satellite or related operations. The prevailing tendency is to comply with the charity's "home state" regulations.

Next, the planned giving office should be asked in which states it markets and solicits gift annuities, remembering that a testimonial advertisement in a constituency publication may well be interpreted as marketing and/or solicitation. This data on the states in which gift annuities are marketed and solicited should be augmented with state-specific data about what constitutes a regulated gift (solicited in the state versus donor residing there versus beneficiary moves there, etc).

All of this research should be distilled so that the decision-makers can understand the scope of the potential regulatory environment. Outside specialized advice, such as from the planned giving office's legal advisor, may also be warranted. The analysis that will be undertaken, particularly for regulations promulgated by states other than the charity's home state is essentially one of cost versus benefits of compliance.

On the cost side, compliance with many states' procedures can require:

- Initial and annual registration and fees;
- State-specific gift annuity contract language, which will not be uniform from state to state, requiring complex and ministerial gift documentation procedures;
- Annual filings that may be in different formats;
- Restrictions on how a subset or all of the charity's gift annuities can be invested;
- Limitation on the assets that can be accepted to fund gift annuities.

On the benefit side, the charity may avoid being penalized by a state regulating agency for issuing annuities under its purview but not following the associated regulations.

For comprehensive information on state annuity regulation, visit the following Web sites: www.plannedgivingservices.com/giftannuities/, www.pgresources.com/.

Q: Why aim for the lowest reserve? How does this affect investment?

A: Generally, states that require reserve filings also regulate how the computed reserve amount can be invested. These investment regulations may not dovetail with the organization's investment approach for its other planned gift and endowment assets; usually, state regulations are more conservative than charities' investment policies.

Therefore, if the reserve account is kept at the minimum required by law, and invested accordingly, the so-called excess account — assets in the annuity pool over the reserve mount — can be invested as the charity's investment policy directs. Often, the excess and reserve accounts are considered jointly in the investment approach so that the stock/bond mix for the entire pool approximates the policy investment portfolio. The “excess" account should not be confused with a "surplus" required by a regulated state; the latter is considered part of the reserve account.

In 2001, some movement was seen in the regulated approach to gift annuity reserve investments. One of the important regulating states, New York, adopted the Prudent Investor standard for gift annuity reserves, replacing its previous approach (primarily fixed income). As this approach is adopted, the need for differing investment policies for the reserve and excess accounts disappears.

Q: Why does the liability of a deferred gift annuity increase each year during the deferral period?

A: If interest and mortality assumptions are held steady, a deferred gift annuity’s liability will increase each year until payments begin. During this time no payments are made, mortality probabilities are applied, and the principal is assumed to grow, resulting in an increased principal when payments commence. The payout percentage is based on this increased principal, which also explains why deferred gift annuities offer high payout percentages. As the years until payments commence

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decrease, the likelihood that an annuitant will survive to receive each payment increases while the amount of interest earned on the principal prior to making payments decreases.

Q: Are state and FASB liability reports similar to the liability calculation done when a charitable deduction is computed?

A: Yes, the calculation is basically the same although the details of the IRS-mandated approach differ from those of state annuity regulators. The IRS is not involved in ongoing liability reports for the gift.

Q: What is an RCV?

A: An RCV, which many California charities may be familiar with, stands for a "reasonably commensurate value." The RCV, originally implemented by California but utilized by several states, was intended to inform the donor of the commercial value of the gift annuity. The RCV is 115 percent of the net present value, or reserve, and is required to be stated in the annuity contract. Acceptable values for the RCV vary by state; an RCV is not the same as a reserve amount and is not recomputed each year.

Conclusion

Liability reporting involves several steps, which differ based on the purposes for which the report is being prepared. The starting point is an understanding of the organization's policies, the accounting requirements and the state regulations that apply. From this, the organization's controller, investment, and gift-planning offices can together create procedures for computing liabilities and completing reports. Documenting procedures will be helpful, both for auditor review and to ensure that the processes do not have to be "re-learned" anew each year.

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