Planned Giving with Gift Annuities

New laws have restored confidence in gift annuities. Here's what you need to know before starting your own gift annuity program.

BY DONALD F. BEHAN

Serious concerns surfaced last year when a lawsuit in Texas challenged nonprofits' use of gift annuities for fundraising. The lawsuit alleged that gift annuities violated both antitrust and securities laws. Some nonprofits were worried enough to stop soliciting gift annuities.

We're pleased to report that Congress has responded overwhelmingly in favor of nonprofits. Unanimously, legislators have passed two bills that affirm the importance and suitability of charitable annuities for philanthropy. (For more on these new laws, see "Gift Annuity Decision Resounds through Nonprofit World" on page 00.) These bills reaffirm the position that philanthropy is the primary purpose of charitable annuities. Nonprofits can now have renewed confidence in using gift annuities as a fundraising tool.

What Are Gift Annuities?

Gift annuities are a planned giving opportunity that all large nonprofits should consider.[1] With gift annuities, donors receive a charitable deduction and lifetime income while providing major gifts to the nonprofit.

Donors are often more generous when they enhance their own financial security in conjunction with a charitable gift. Donors who give a few hundred dollars a year may donate many thousands in the form of a gift annuity.

Typical annuity rates provide the nonprofit with about 30% of the total donation. The donor receives a similar charitable deduction.

You can use gift annuities to realize a previously untapped source of donations, but first you need to consider some critical issues. Before offering gift annuities, you should calculate how much money you can raise and review the issues in this article.

Case Study: A private university added gift annuities to its planned giving alternatives. Alumni publicized the benefits of gift annuities to the college and its donors. The result: a significant increase in cash donations through the planned giving program. In three years, gift annuities have become the university's number-one planned giving alternative.

What Types of Annuities Exist?

To establish a gift annuity, a donor contributes funds or assets to a nonprofit organization and, in return, receives a promise of income for life. This income amount depends on the donor's age and the annuity type. Amounts also vary as interest rates move up and down.

The basic (or straight-life) annuity is a series of similarly-sized payments, paid at regular intervals for the rest of the donor's life. There are, of course, many variations of the basic annuity. You should be aware of two other common annuity types:

1. Term-certain annuities. This type of annuity specifies a number of years (the "certain period") during which payments continue even after the donor dies. After the certain period, payments continue only if the donor is alive.

A term-certain annuity helps protect the nonprofit from misunderstanding by heirs. If the donor dies soon after

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Nonprofit World • Volume 14, Number 2 March/April 1996
Published by the Society for Nonprofit Organizations
6314 Odana Road, Suite 1, Madison, WI 53719 • (800) 424-7367

GLOSSARY

Actuary: Person who computes insurance risks.

Amortization: The systematic write-off of the cost of an intangible asset to expense.

Annuity: A specified income payable for a fixed period.

Assets: Probable future economic benefits obtained by a particular entity as a result of past transactions.

Callable bond: A bond that gives the issuer the right to call (buy back) the bond before its maturity date. A company might exercise this call right if outstanding bonds bear interest at a much higher rate than the company would have to pay if it issued new but similar bonds.

Cash-flow requirements: The amount of cash you need to receive over a given period to meet your financial obligations.

Equity (or net assets): The residual interest in the assets of an entity that remains after deducting its liabilities.

Equity investment. Investment in stocks.

Fair market value: The price that would be paid for an item in the normal course of business.

Generally Accepted Accounting Principles (GAAP): Standard methods which organizations must follow in presenting their financial information. For nonprofits, these standards are set by the Financial Accounting Standards Board (FASB).

Gift annuity: A gift a donor makes to a charity in return for an agreement to pay the donor an annual fixed income for life.

Liabilities: Probable future sacrifices of economic benefits of a particular entity as a result of past transactions.

Multiple-life (or joint-life) annuity: annuity with more than one beneficiary.

Planned giving: Arrangement in which a donor sets aside money or property for a charity's future use.

Portfolio: All the investment holdings of an individual or institution.

Reinsurance: The purchase of an annuity on the life of a donor by a charitable organization.

Retained margin: The percentage of the annuity donation received by the nonprofit organization. This margin is typically about 30%.

Straight-life annuity: a basic annuity in which a donor receives periodic income for life in return for a donation to a nonprofit.

Term-certain annuity: annuity which includes a number of years (the "certain period") during which payments don't depend on the donor's survival.

the start of a basic annuity, heirs may feel that the arrangement was unfair. But with a term-certain annuity, payments continue for the stated term, even if the donor dies right after the annuity starts. In return for this added benefit, annuity payments are lower and pricing is more complex than for straight-life annuities.

Case Study: An elderly woman donated $200,000 to her church in exchange for a gift annuity. One of her potential heirs (the donor is still alive) has challenged the transaction and has brought a lawsuit seeking treble damages. At this writing the suit is still in litigation.

2. Multiple-life annuities. A multiple-life or joint-life annuity is an annuity with more than one beneficiary. A common example is an annuity set up by a married couple, with payments continuing as long as either survives.

With this type of annuity, there's no limit to the number of donors. Pricing can be complex, and the margin retained by your organization can be small. To be sure your margin is large enough, you should have an actuary calculate the retained margin for complex joint-life annuities.

How Do Donors Benefit?

Donors benefit by receiving a tax deduction for the amount of their "donation." This donation is the amount in excess of the annuity's value, computed in accordance with IRS Section 7520(a)(1).

In addition, donors can exclude part of future payments from their taxable income. This excludable portion is determined at the time the annuity is issued. IRS Section 1.1011-2(c) explains how to do so.

The value of any annuity is an estimate, involving projection of interest rates and survival probability. Because donors select from interest rates in effect during a two month period, there can be a lag in recognizing market changes. This lag benefits donors if they make the gift when interest rates are decreasing.

How Are Gift Annuities Regulated?

If your organization has a certain amount of reserves (over $50,000 for example; the amount varies by state), you must apply for permission to accept

CREATIVE FUNDRAISING IDEAS

Going Once, Going Twice—Sold!

Create one-of-a-kind auction items by having celebrities autograph objects of interest. The International Association of Culinary Professionals netted $2,500 when they auctioned off an apron signed by 25 eminent chefs, including Julia Child. For more tips on conducting a fundraising auction, see *The Fundraising Auction Guide* (William R. Lynn Company, 3627 Marigny St., New Orleans, Louisiana 70122; phone 800-249-5559; fax 504-943-6872).

Personalize Your Appeals

Add a personal touch to your fundraising letters. A special computer system will sign appeal and thank-you letters automatically in wet ink. Signature Systems by E.S.P. Systems runs as a peripheral off your computer. Contact E.S.P. Systems, 704 Interstate Business Park, Fredericksburg, Virginia 22405 (phone 800-345-7446, fax 703-371-4090). For more creative fundraising ideas, see the *National Directory of Service and Product Providers*, beginning on page 35 of this issue.

Give Consumers New Ways to Give

A new form of cause-related marketing, called CareCash (CC), gives consumers a creative way to support a charity. When they buy certain products, they receive a $5 certificate in or on the package. They mail in the certificate, and the marketer donates the agreed-upon amount to the participating charity. For more information, contact Bozell Promotional & Relationship Marketing in New York (212-727-5870).

gift annuities. In most states, you should apply to the state agency that regulates insurance laws.

Approval will depend on the adequacy of your reserves and assets. This amount also varies by state. In New York, for example, a nonprofit must hold assets of $100,000 or 110% of the annuity reserves, whichever is greater.

After receiving authority to accept annuities, you must report annually to the insurance regulators. They will specify the form your report should take. It's important to note that this report may differ from what the IRS requires. It may also differ from the form required by Generally Accepted Accounting Principles (GAAP). Thus, you may need to prepare three sets of actuarial and investment calculations to fulfill all regulations.

Such regulations protect both donors and nonprofits. Without regulation, annuity pricing might fall to people without the necessary skills or information.

Case Study: Personnel at a large hospital saw that their annuity fund was nearing their state's size threshold for obtaining authority to write gift annuities. They submitted an application for authority, which they expected to be approved routinely. State regulators reviewed the relationship between the annuities and corresponding gifts, and discovered a problem. The hospital had continued to use a five-year-old table of annuity rates as interest rates declined in the market. Instead of an expected margin of 30%, the recently issued annuities had no margin at all, even before expenses. The state regulators required the hospital to install controls to assure proper annuity rates in the future. Once the hospital did so, it received authority to write annuities. But the annuities that had been issued on the basis of an outdated table had already lost money. The hospital never recovered that loss.

Most states also regulate the annuity amount in relation to the gift. This regulation assures that a specified portion of the gift will benefit the nonprofit. A typical requirement is that the nonprofit must expect to receive one-half of the initial gift when the donor dies. The actual amount will be more or less depending on how long the donor lives. Of course, if the donor survives longer than expected, there will be less money left for the charity at the time of death.

How Can You Recognize & Control Risk?

To assure a successful gift annuity program, you must include a process to control risk. Keep your eye on three types of risk:

1. Investment Risk. Investments backing gift annuities should provide a

An out-of-date table can produce a serious error in the annuity's price.

reliable stream of long-term cash flows, matched to your organization's payment obligations. High-quality corporate bonds may be suitable. They carry some risks, however, even if expected cash flows are matched. These risks include:

- the risk of default
- the risk that callable bonds may be prepaid at a time of low interest rates.

Treasury securities, which are backed by the federal government and are not callable, eliminate these risks. However, they provide lower yield.

Establishing an investment portfolio to match investment yield against annuity payments is complex. To do so, you will need to simulate investment values and cash flow under a variety of interest scenarios. You will likely need sophisticated investment managers and actuaries to help you do so.[2]

You must include a process to control risk.

2. Mortality Risk. Unless your organization has many gift annuities (at least several hundred), you will see a series of apparent losses on your annuities. It takes a great many contracts in the portfolio before the number of deaths smoothes out and becomes relatively predictable. With a small portfolio, there will be no deaths in most years. The financial results will show a loss in the years with no deaths.

It is important that you explain this pattern to your board and top management. They must be able to take a long-term view and put such "losses" in perspective.

3. Pricing Risk. Pricing risks arise when personnel do not fully understand the basis for pricing. Annuity values shoot up and down as interest rates change. An out-of-date table can produce a serious error in the annuity's price.

Be sure to refer pricing of complex arrangements to a qualified actuary. It's usually better not to issue complex annuities unless the gift is substantial, because of the administrative costs involved.

Reinsurance: How to Reduce Risk & Complexity (for a Price)

One way you can lessen risk and simplify administration is to "reinsure" your donor's annuity. You can do so by purchasing your own annuity on your donor's life. This annuity will take care of the payments your organization has agreed to make. Reinsurance has both advantages and disadvantages:

Advantages of Reinsurance:

1. You can transfer investment risk and mortality risk to the insurance company.
2. Reinsurance relieves you of an investment management burden that you may not be equipped to handle.
3. The insurance company's portfolio management skills may produce higher investment yield than you could realize on your own.
4. If the annuity you purchase is covered by a state guaranty fund, this fund provides additional financial protection.[3]

5. Insurance companies have well-developed systems to administer annuity payments and comply with state and federal regulations. They can probably handle these duties more easily than you can.

Disadvantages of Reinsurance:

1. It can be costly. The insurance company will include an expected profit margin in its price.
2. You must be careful to choose a financially strong insurance company. If the company can't meet its obligations, your organization has ultimate responsibility.

Even if you decide not to rely on reinsurance, you may still use reinsurance to transfer the mortality risk on very large annuities.

Case Study: A 90-year-old woman gave a service organization $400,000 in exchange for an annuity. The organization's actuary simulated future experience under the annuity. She found that the annuity would produce a loss of $45,000 each year the donor survived. The chief financial officer thought this risk was too great. The organization sought reinsurance of the annuity, and, after some effort, found a carrier willing to reinsure an annuity on such an elderly person. The organization's personnel feel the $17,000 cost of the reinsurance was worth it. It allowed them to release the surplus funds held in relation to the annuity. It relieved them of administrative effort and expense. And it reduced their risk.

Gift Annuity Pros, Cons, and Tips

Before entering the gift annuity field, consider the following benefits, disadvantages, and advice:

Pros of Gift Annuities:

- Gift annuities can provide an immediate benefit to your organization and to your donor.
- Because donors receive both immediate and long- term benefits, they usually give more than they do with other planned-giving alternatives.[4]
- Gifts may be extremely large.

Cons of Gift Annuities:

- A gift annuity program requires long-term administrative responsibilities. These obligations continue for the donors' lifetime.
- The annuity portfolio usually requires regulatory compliance. You will need to hire an attorney and actuary to file the application for authority.
- You will need systems to pay benefits, manage your portfolio, and follow tax reporting requirements. You will need the help of tax professionals.

Tips to Remember:

- The American Council on Gift Annuities (formerly the Committee on Gift Annuities), based in Dallas, Texas, is sponsored by over 1,000 nonprofit organizations to exchange information about gift annuities. The Council publishes advisory annuity rates that have been accepted by regulators in many states. The Council has also been active in informing its members about regulatory issues.[5]
- Several companies sell software that can help you manage a gift annuity program. (See "Planned Giving Software Resources.") Such software is useful, but you should supplement it with tax advice on complex issues. The importance of good tax advice in managing a gift annuity program cannot be overstated.
- To establish a gift annuity program, you need to make a large time commitment. Experience shows that large nonprofits can justify this effort, because it will result in many previously untapped donations.■

Footnotes

[1] To determine if planned giving is a good fundraising strategy for your organization, see *Are You Sitting on a Gold Mine* (see "Selected References.")

[2] For information on choosing an investment manager, see Byrd in "Selected References."

[3] Most states have such guaranty funds. These funds protect policyholders in case of insurance company insolvency. Coverage varies from state to state.

[4] For a comparison of gift annuities with other forms of planned giving, see "Why Planned Giving?" (See "Selected References.")

[5] For more information, contact the American Council on Gift Annuities, 2401 Cedar Springs Road, Dallas, Texas 75201-1427 (214-720-4774).

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These publications are available through the Society for Nonprofit Organizations' Resource Center. For ordering information, see the Society's *Resource Center Catalog*, included in this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).

Planned Giving Software Resources

ParaGon planned giving software, Blackbaud, 4401 Belle Oaks Drive, Charleston, South Carolina 29405-8530 (phone 800-443-9441, Ext. 307 or 803-740-5400; fax 803-740-5410).

Planned Giving Manager (PGM) software, PG Calc Incorporated, 129 Mount Auburn Street, Cambridge, Massachusetts 02138 (phone 617-497-4970; fax 617-497-4974).