Immediate Annuities and Gift Planning - Part Two

Ten Commercial Immediate Annuity Applications in Gift Planning: A Case Study Approach

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Summary

Following Part I of Immediate Annuities and Gift Planning, 10 case studies are presented below to illustrate how immediate annuities can provide solutions in unique charitable planning scenarios.

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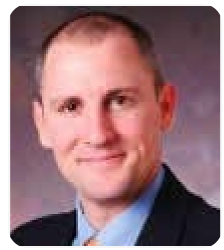

Case #1 - Donor Wants to Provide Income for Young Nieces in Estate.

Often, a decedent may wish to provide a fixed income for heirs, and then for any residuum to go to multiple charities. A lump sum may not be practical because perhaps the person is a spendthrift or the decedent does not want to burden the person with money management. To accomplish this objective, charitable planners suggest using a charitable gift annuity. This can become quite complicated as the number of heirs increase, the number of charities involved, and whether or not they offer gift annuities and then state regulation.

Immediate Annuity Solution #1:

- The executor or personal representative can receive bids from an insurance company to solve for:
  - What is the premium required to guarantee specified benefit for each heir?
  - The contracts may be owned by the annuitants and would not allow any withdrawals (no immediate annuities can be surrendered) so the heir would not have access to any principal.
  - After the immediate annuities are purchased, the remaining amount can be distributed in cash to the specified charities.
  - This simple solution does not require multiple gift annuities assuming the charities could even offer them nor gift administration for what might be 30-40 years.

Case #2 - CFO Worried About Large Gift Annuity.

Charity receives a donor request for a $3 million gift annuity funded with appreciated stock, but the charity only has $1 million in unrestricted assets. The CFO is concerned that this annuity would represent a concentrated risk. In addition, the donor is concerned that the charity may not be financially stable enough to guarantee the payments. The CFO will meet the Finance and Investment Committee, but plans to recommend declining the annuity.

Immediate Annuity Solution #2:

- The charity can reinsure the gift annuity with either a retail or group immediate annuity product.[i]
- The insurance company will generally require 60-70 percent of the donation as the premium, but then will take over all payments and allow the charity to shift the investment and longevity risk to the insurance

company.

- The donor is more comfortable because there is a multi-billion dollar life insurance company backing the gift as well as the charity should the insurance company default.
- No immediate annuity has defaulted in the history of our country, but the past may not be representative of the future, of course.
- The charity then can place the other 30-40 percent into its endowment today, so that it can grow to life expectancy.
- Remember that the American Council on Gift Annuity Rate Methodology assumes a 50 percent future value residuum. So this reinsurance technique provides a known amount at a known point in time versus an unknown amount at an unknown period of time.

The CFO or others might wish to add a term certain or refund option on the immediate annuity to protect against premature death. Two favorable private letter rulings have been issued which would allow a premium refund – that is, a refund of the original premium paid, less all payments made. They are PLR 200847014 and PLR 200852037. While the premium refund option is possible, it is rarely mathematically advisable to pay the increased premium, unless there is a high probability of early death. If that is the case, the charity likely should not reinsure. Note that as long as the charity is not required to reinsure, there are no adverse tax implications to the donor relative to the deduction or the income taxation of the payments.

Case #3 - Charity Buys Land Under Bargain Sale with 20-Year Installment Note.

An environmental charity purchased a large tract of wetlands for $2 million. The fair market value was $4 million, but the donor, a passionate environmentalist, needed a current income tax deduction, and wanted to spread out the remaining gain over 20 years. Five years into the note, the market had fallen precipitously and then rebounded. The original $2 million segregated in the endowment had fallen to $1.25 million. The charity also did not have excess unrestricted funds should the market drop any further, so they wanted to lock in a guaranteed rate to limit any downside risk. The donor also had some life changes and wanted to cash out immediately, but his present value calculations show that he should be paid $1.4 million.

Immediate Annuity Solution #3:

The CFO explored purchasing an immediate fixed-term annuity for the remaining 15 years. The premium was $1.3 million or $50,000 more than was available. The donor initially required $1.4 million, but the CFO explained that they could purchase the same guaranteed stream of income from an insurance company for $1.3 million. The donor agreed to this amount and the charity added $50,000 to complete the purchase. If the donor would not have budged, the charity could have purchased the guaranteed annuity for the 15-year term and protected any future market losses.

Case Study #4 - Donor/Charity Wants to See CGA Gift Portion Used Immediately.

An elderly donor is exploring a $500,000 donation for a charitable gift annuity, but she does not want to have to die to see the money put to its intended charitable purpose. She has challenged the charity to come up with a solution as she wants one fund of $100,000 to be used for scholarships and another fund for unrestricted purposes.

Immediate Annuity Solution #4:

The charity proposed reinsuring the gift, which would cost $300,000, and then they would establish two $100,000 funds for her intended purposes. She had the joy of seeing the gifts used while she was alive (she joined the Scholarship Committee) and still received the $35,000/year in annual income that she needed. The charity was particularly happy to have the $100,000 unrestricted fund because they were able to get a 50 percent match from another funder for all unrestricted contributions and the gift annuity would have been specifically excluded from that program.

Case Study #5 - Donor Concerned About Making Large Major Gift – Simple Estate Planning.

A donor wanted to make a large capital contribution to his university, but was concerned about living too long or surviving through another market crash. He had primarily invested in real estate and stocks during his life but at 76, he was looking to simplify his investments. He told the major gifts officer, "I would like to make a $1 million donation to the school, but my investments are so volatile, that I could see myself regretting it later if the market drops. Plus, my wife is much younger than me and I am concerned about her managing these assets when I'm gone." The major gifts officer encouraged to the donor to see a financial advisor. The advisor quickly discovered that the donor was concerned about his family's lifestyle and maintaining their standard of living. He was so concerned, that even with a $6 million estate, he had artificially reduced his income out of fear of an equity market downturn.

Immediate Annuity Solution #5:

The advisor determined that the family needed to have $120,000/year to meet their current lifestyle needs and then another $80,000/year of discretionary money. Of the $200,000/year that was needed, they were only receiving $30,000 in Social Security as guaranteed income. The advisor recommended purchasing an inflation-adjusted immediate annuity to generate the other $170,000. The annuity premium was $1.5 million. Now, the family's financial "nut" was covered and he finally felt comfortable enough to make the $1 million donation using appreciated real estate. His advisor invested most of the remainder in a diversified equity portfolio since the immediate annuity represented the fixed income allocation. At the end of the plan, he said, "I can finally sleep at night knowing that no matter what happens to me, my wife won't have to worry about who the next Lehman Brothers might be when she is in an assisted living center. I feel like I can finally start living my life."

Case Study #6 - CRAT Trustee Concerned About Senior Olympics Half-Marathon Winning Income Beneficiary.

A charity was serving as trustee for a charitable remainder annuity trust that was set up in 2006. The 76-year-old income beneficiary was winning half-marathons and in unbelievable shape. She recently asked what would happen if the trust ran out of money before she died and did not like the answer. The 6.5% trust was funded with $700,000 and now had $510,000 after the market decline and $45,000/year payouts.

Immediate Annuity Solution #6:

The trustee reviewed the various PLRs related to charitable remainder annuity trusts owning commercial annuities. PLR 9009047 held that an annuity owned by a charitable remainder trust would not be treated as an annuity contract for purposes of 72(u) because the charity was determined to be a non-natural person that held the remainder interest. The IRS also issued Private Letter Ruling (PLR) 201126007 in which it ruled that a charitable remainder annuity trust can include a provision allowing the trustee to purchase an annuity contract to make the annual annuity payment to the trust's income beneficiary. So, the trustee used 50 percent of the assets to partially insure the income stream which generated about $30,000/year. The remaining 50 percent was invested in a diversified equity portfolio for some growth and for the remaining $15,000/year that was required.

Case Study #7 - Charity Has a NY Donor Wanting a CGA, but Does Not Have NY Permit.

A New York resident had heard about charitable gift annuities and asked if a Virginia community foundation could offer a 7 percent rate that the ACGA suggested. The Virginia community foundation had a gift annuity program, but was not registered in New York and had no plans to do so. The donor wanted to contribute $100,000 in cash.

Immediate Annuity Solution #7:

The charity suggested a gift annuity look-alike solution. The planned giving officer suggested that the donor contact his financial advisor and ask how much it would take to provide $7,000/year. The advisor said it would take a premium of $68,000. The donor purchased the annuity to get the intended guaranteed income of $7,000, and then made an outright cash donation of the remaining $32,000. The charity acknowledged the cash donation, but didn't have to issue or administer a gift annuity since the donor purchased the commercial annuity directly.[ii]

Case Study #8 - Dissolving Charity Has a Defined Benefit Pension Obligation to Two Employees.

A charity seeks to wind down, but carries defined benefit pension liabilities for two long-term employees. Both employees wish to retire, but they are concerned about the safety of their vested retirement income benefit.

Immediate Annuity Solution #8:

The accountant suggests a terminal funding annuity which is an immediate annuity used to insure defined benefit plans. The contract would then release the pension liability so that the charity could dissolve the corporation.

Case Study #9 - Charitable Childless IRA Donor with Required Minimum Distributions.

A 73-year-old widow wanted to make a donation for a charitable gift annuity. She was childless and concerned about outliving her income. Her only asset, however, was a $650,000 IRA invested mainly in money market mutual funds. Each year, she was required to take minimum distributions of approximately $25,000.

Immediate Annuity Solution #9:

The gift planning officer suggested that the donor might want to consider a qualified immediate annuity that would generate approximately $25,000 and then make the charity the IRA beneficiary. After a thorough review, the financial advisor agreed this could work well and that she would need about $300,000 in premium to purchase that payout. Some part of her required minimum distributions were now covered by the annuity payout to her and she was comfortable investing the remaining portion in a diversified growth portfolio (Note: If only part of the defined contribution money is used to purchase an annuity, the remaining funds must meet RMD without an offset for annuity payments - 26 CFR 1.401(a)(9)-8) This growth would help provide an inflation-hedge, but also could grow for the eventual charitable bequest.

Case Study #10 - Donor Creates Quasi-Endowment During Life with Bequest to Follow.

A wealthy donor is approached by a major gift officer to fund a business school Center for Entrepreneurship. The school has asked for a quasi-endowment annual gift of $250,000 as long as the donor lives and then a $5 million gift at death for the naming rights. The donor wants to give a one-time gift of $2 million that could be drawn down by $250,000/year during his life. The university is not comfortable with this arrangement unless they can count on the donor to fund any deficiencies in the future. The endowment office said that they are comfortable managing the $2 million as a permanent fund to generate $100,000/year. So the donor would have to add $150,000 in an on-going basis and then $3 million through his estate. The donor did not like this proposal.

Immediate Annuity Solution #10:

The business officer suggested exploring an immediate annuity for the donor's lifetime. The $2 million closely-held stock donation would provide the required premium for the $250,000/year annuity. The donor then will fund the remaining $5 million estate gift, with adjustments for inflation, with his IRA and 401(k) assets.

Summary

These 10 charitable case studies illustrate both the creativity and flexibility of immediate annuities. Fixed immediate annuities fit quite well in cases where the charity has an obligation to pay – pension plan, gift annuity, trustee of charitable remainder trust or an installment sale. And commercial immediate annuities may also fit in direct and indirect situations where a donor is not comfortable making a large donation by providing: stable income to cover lifestyle; income to meet qualified plan required minimum distributions; additional security for a large gift annuity; a simplified inheritance solution; lower current donations for lifetime charitable goals. This boring, guaranteed income product which transfers the investment and longevity risk away from the donor, when combined with a diversified equity portfolio, can provide just the right solution for unique gift planning conundrums.

Endnotes

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[i] See Clontz, B. and Behan, D., 2005. "Optimizing Charitable Gift Annuity Risk Management Part II: Reinsurance Revisited." The Journal of Gift Planning, June 2005.

Clontz, B., 2007, "Charitable Gift Annuity Reinsurance: The Top Ten Most Frequently Asked Questions." Planned Giving Design Center   http://www.pgdc.com/pgdc/charitable-gift-annuity-reinsurance-top-ten-fre...

[ii] For a detailed explanation of this and nine other planning options, see Clontz, B., 2009, "Charitable Gift Annuity Reinsurance Part II: The Top 10 Creative Solutions for Turbulent Times." Planned Giving Design Center   www.pgdc.com/pgdc/charitable-gift-annuity-reinsurance-part-ii-top-10-cre...

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