BY RUSSELL A. WILLIS III, J.D., LL.M.

Ask the Expert

Got a question itching for an answer? Technical troubleshooting, marketing roadblocks, practical advice—any topic's fair game. Email success@plannedgiving.com and we'll get one of our experts on the job!

Q *I'm the director of development at a small private school, and I've been approached by an alumnus who wants to fund a gift annuity at $1 million. The existing pool of annuity contracts at our school is quite small, and they range from $10K to $25K. This one contract alone would comprise well over half our total commitment to gift annuities. The prospective donor is only 65 and in excellent health. What are the risks of taking on this commitment and how might we mitigate them?*

A The risk, of course, is that the annuitant will outlive his "table" life expectancy, exhausting the reserves set aside to fund his annuity, depleting the reserves set aside for other annuitants in the pool, and possibly requiring the school to dip into its general assets to support the contract.

To put some numbers to this, the ACGA recommended maximum annuity rate for an individual aged 65, as of July 01, 2020, is 4.2 percent. If you use the maximum recommended rate, you will be paying out $42,000 per year for probably 20-something years. The present value of your commitment to this contract would be almost $700,000.

Short of declining the gift altogether, and setting a formal policy to decline gift annuities in excess of some stated dollar amount, you might begin by offering a lower annuity payout. This will increase the amount allowable as an income tax deduction in the year the annuity is funded, and it will reduce somewhat the portion of each payment that is treated as ordinary income.

But the problem here is much larger than that. You simply cannot allow your risks to be so heavily concentrated in one or a few contracts. You will want to find a way to "reinsure" the risk.

How this is typically accomplished is by using a portion of the proceeds of the gift to purchase a commercial, single-premium annuity contract paying exactly the same amounts, at the same intervals, over the donor's life as the school is required to pay out under the gift annuity contract. This arrangement would completely remove the risk to the school (assuming the commercial provider remains solvent).

Because the tax code requires that the present value of the residuum to the issuing charity be at least ten pct. of the amount contributed to fund the annuity, whereas the issuer of a commercial annuity will set the present value of the residuum to zero, the amount required to purchase the annuity will be considerably less than the amount your donor has contributed.

For ease of illustration, let's say roughly the $700,000 present value of the annuity payout. The effect would be to immediately free up the remaining $300,000 or so for the school to place in its endowment fund. There are at least two letter rulings approving an arrangement under which the issuing charity negotiated a premium refund with the commercial provider, to hedge against the possibility that the annuitant might die early.

Alternatively, you might consider pooling your risks with a national issuer of gift annuities, of which there are several, by arranging for your donor to contribute instead to that entity, which will handle the annuity payout and then remit the residuum to the school at the donor's death, net of a modest management fee.

Under either scenario, your donor will likely be reassured by the fact that the annuity payout is backed by an entity that has a much larger risk pool. •

Russell A. Willis III, J.D., LL.M. is a tax lawyer, a freelance writer, and a consultant to other lawyers—an advisor to the advisors—on issues arising in connection with wealth transfers generally, and with a particular emphasis on charitable gift planning. www.plannedgiftdesign.com