Single Premium Immediate Annuities (SPIAs) Help Make a Charitable Gift Annuity Work Even Better

SPIAs can help charitable gift annuities work better for both the charity and the donor.

A charitable gift annuity is a promise that a charity makes to a donor to pay a set income for life. In exchange, the donor agrees to give something to the charity—usually cash (though it could be stock, land, or anything else of value). For example, Matt, age 67, gives $100,000 to his favorite charity and the charity promises to pay him $517 a month. The income is fixed when Matt makes the gift and continues for as long as Matt lives. Most states let charities make promises like this with varying degrees of regulation and oversight.

THOUGH THE CHARITY'S OBLIGATION IS FIXED, THE RISKS IT ASSUMES ARE NOT

Most charities decide how much to pay under a charitable gift annuity based on rates set by the American Council on Gift Annuities (ACGA). Its tables say, for example, a charity should pay a 67-year old an annual income equal to 6.2% of the gift. A couple, one age 67 and the other 65, should be paid 5.7%. Charities use this approach to help encourage people to give to the charitable causes they want to support—not just those that provide the highest income. It's one of those rare times when antitrust considerations don't apply.

The ACGA rates—though making it easier to know what to pay a particular donor—can also create risks for the charity. The ACGA rates use assumptions that generally result in the charity using only about half of the gift to pay the promised income. The other half is the charitable gift—money the charity can use for its charitable purposes.

- Every donor is female.
- Every donor is 2 years younger than her (or his) actual age.
- The charity will earn a 5.25% net investment return on investments.
- The charity's investments are allocated using a distinct model and each asset class will have a certain rate of return.
- The charity does not get its gift until the end of the donor's life.

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These assumptions, though wonderfully conservative and thus more likely to benefit the charity than the donor (which is, after all, the purpose of a charitable gift), also carry some risks—primarily to the charity.

- If a donor lives too long, the charity may have to start using more than 50% to keep the promise it made to pay a lifetime income. That is, it must start “eating into” the 50% that it expected to be left after paying the lifetime income.
- It faces the same risk if its investments don’t earn the assumed 5.25% after expenses.
- If it experiences both poorly performing investments and a donor who lives too long, that combination of risks might exhaust the entire gift—the charity might be forced to use both the half earmarked for the income and the half earmarked for the gift. If the situation is even more dire, it might then have to start using other assets to make its promised payments. Not only does it not get a gift, the gift starts costing more.

Fortunately, the charity does have a way to lessen those risks.

STRATEGY: SECURELIVING℠ INCOME PROVIDER AND SECURELIVING℠ INCOME PROVIDER NY SPIA WITH PAYMENTS FOR LIFE

A SecureLiving Income Provider Single Premium Immediate Annuity can help the charity shift those risks away from itself.

No matter how long the donor lives, the charity will have the income it needs to honor its contracts to the donor and it will not have to manage any investments to produce that income.

Let’s see how this might work.

Matt gives his favorite charity $100,000. The charity promises to pay him $517 a month (based on the ACGA rate) for as long as he lives. Part of each payment is income tax-free to Matt for 18.4 years. After that, the entire payment is taxable, just like a commercial annuity.

The charity uses part of Matt’s gift to buy a SPIA. The premium for the SPIA is “reverse calculated” by asking, “How much do I have to pay to buy a guaranteed monthly income of $517 that will last as long as Matt is alive?” That number, when we wrote this bulletin (6/6/07), was $73,340. Since annuity rates often change weekly, it may be different when you read this.

THE GIFT THE CHARITY GETS IS NOT NECESSARILY THE GIFT THAT MATT DEDUCTS

The “real” gift to Matt’s charity is the $26,660 difference between Matt’s gift ($100,000) and what the charity pays for the SPIA ($73,340). That is cash in the pocket for the charity—not some future gift the charity will get 20 or so years from now when Matt dies. Note that some states may require that the charity keep part of Matt’s gift in a reserve account. Some let charities use the SPIA to satisfy any reserve requirements the state imposes.

Because Matt has given $100,000 to charity, Congress lets him take a charitable income tax deduction. Of course, he can’t deduct the full $100,000. As the famous philosopher/cartoon character J. Wellington Wimpy said to Popeye, “I’ll gladly pay you Tuesday for a hamburger today.” Money you get in the future is not worth the same as money you get today. Matt’s gift, for <u>tax</u> purposes, is the $100,000 minus the value of all that future income he’ll get. Congress knows both exactly how long Matt will live (and the charity will pay income) and exactly what the inflation rate will be during those many years. The IRS is therefore able to calculate with precision the value today of the hamburger (with apologies to Wimpy) the charity will get at Matt's death. It is, says the IRS, $39,414. That is what Matt can deduct on his 2007 federal income tax return. The other $60,586 is what the IRS says Matt's lifetime income is worth.

If his gift is cash, he can't deduct more than 50% of his adjusted gross income this year. If the $39,414 is more than that, he can carry the rest over into any of the next five taxable years. And, as with all things tax, the rules can be immensely more complicated—which is why the donor must talk with his or her own tax advisor.

Are you wondering about those numbers? Aren't the charitable gift annuity rates supposed to get the charity 50% of the gifted amount? If the charity buys a SPIA and gets only $26,660, are the insurance company's calculations of how much it will cost to provide $517 a month income that far off? Are the IRS' calculations that wrong?

Asked another way, why does it cost $73,340 to buy the SPIA to provide Matt with $517 a month for life when the IRS says the value of that income stream is only $60,586?

Remember Wimpy. Matt is getting an income tax deduction today for a charitable gift the charity technically doesn't get until some tomorrow. The better question might be, would Wimpy (i.e., the charity) rather have $26,600 today without the longevity and investment risk? Or the possibility of that $50,000 tomorrow—but with both the longevity and investment risk?

Note also that if Matt used the entire $100,000 to buy a SPIA, his income would be $705 a month for life—not $517. However, he would not satisfy his charitable wishes. Nor would he get a $39,414 income tax deduction.

Finally, it's important to understand the charity's promise is unsecured. There's no specific asset backing the charity's promise. Even the SPIA it buys doesn't guarantee that Matt will get his income. (It may guarantee that, based on the insurance company's solvency, the charity will get <u>its</u> money, but that does not guarantee that Matt will get <u>his</u>.) In fact, if the charity were to file for bankruptcy protection, Matt would be in no better position than any other unsecured creditor. That's one reason it's important that customers deal with well-established, well-run charities.

In summary, a SPIA can make a charitable gift annuity more attractive to both the charity and the donor. The charity is able to shift both investment risk and longevity risk to the insurance company. The donor knows the charity may be able to use part of his gift now instead of having to wait until many years in the future. And the donor knows that even though the SPIA doesn't guarantee his income, it does help put the charity in a better position to be able to make those payments.

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