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Putting the “Gift” Back in Gift Annuities

While the final results are not in yet, based on preliminary data and initial surveys, charitable giving was down in 2009. This is not much of a surprise considering the economic turmoil of the past year. This makes the second year in a row that donations have decreased, which is a historically rare event. Many donors may not have the financial ability to make the sizeable donations they have in the past. These individuals may, however, now be good candidates for planned giving techniques that generate income to the donor such as gift annuities, pooled income funds and charitable remainder trusts. This article briefly describes gift annuities and the idea of gift annuity reinsurance as a way for charitable organizations to mitigate their risk and accelerate the financial benefits to their organization.

A gift annuity is a contractual agreement between a charitable organization and a donor. The donor makes a charitable contribution to the charity, and in return for their donation, the organization promises to pay the donor a certain amount of money (at least annually) for the remainder of their life. The amount the charity pays is based on the donor’s age, the amount of the donation and an annuity rate which is typically the current rate provided by the American Council on Gift Annuities. Sounds pretty simple, the donor receives a lifetime income stream and a charitable deduction for a portion of their contribution, and the charity has use of the funds contributed. An issue that arises with gift annuities is that the charity takes on a certain amount of risk when they enter into a gift annuity agreement. Since the charity is required to make payments for life, should the donor exceed life expectancy, there is a risk that the charity will end up paying out more than they took in – taking the “gift” out of the gift annuity.

In order to reduce or eliminate this risk, charities often look at reinsuring their gift annuity obligations (gift annuities must comply with State regulations so they need to check to see if the State where they are located has any specific reserve requirements). Reinsuring a gift annuity obligation may be done by having the charity use a portion

of the donated funds to acquire a commercial immediate annuity product from a life insurance company with the measuring life being the donor’s life. Gift annuity rates are generally lower than the rates offered by commercial annuity products, which means

that the amount needed to generate the required income to the donor will require a lump sum premium that is lower than the amount of the charitable gift. For example, let’s say a charity received \$100,000 from a donor under a gift annuity arrangement and the charity was required to make annual payments of \$5,000 for the remainder of the donor’s life. The charity then acquires a commercial immediate lifetime annuity that pays them the same \$5,000 per year. For the purpose of our example, let’s say they could acquire this annuity for \$85,000. The charity has now fully reinsured their obligation. They have shifted the mortality risk to the insurance company. They can now take the remaining \$15,000 and use this money as needed and not worry that the donor will live beyond their life expectancy.

Charitable gift annuities are regulated by the States (only Wyoming, Michigan, Ohio and Delaware are silent on CGAs). Many States require that the charitable organization segregate funds as a reserve for their liabilities under their outstanding CGA agreements. For example, Florida Statute 627.481 states that “every such domestic corporation or such domestic or foreign trust shall have and maintain admitted assets at least equal to the sum of the reserves on its outstanding annuity agreements, and a surplus of 10 percent of such reserves. In determining the reserves of any such corporation or trust, a deduction shall be made for all or any portion of an annuity risk which is

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reinsured by a life insurance company authorized to do business in this state.”

Charities that promote gift annuities will often have numerous contractual obligations to donors. These

charities may wish to analyze their current exposure to mortality risks associated with their gift annuity obligations and whether or not reinsuring these obligations is a viable alternative.

Smallegan v. Kooistra and the Importance of Professional Advisor Collaboration

The concept of using a charitable remainder trust along with a wealth replacement trust funded with life insurance is a very common estate planning solution for the charitably inclined. A charitably inclined, high net worth individual makes a contribution to a charitable remainder trust (typically highly appreciated assets) that pays them an income for life with the remainder passing to a favorite charity upon death. The individual uses the income stream from the CRT, along with the additional cash flow from the charitable deduction, and purchases a life insurance policy on their life. The death proceeds replace the value of the gift made to charity. The goal is to make a substantial charitable donation while not reducing the inheritance received by heirs. The strategy, while simple in concept, requires the collaboration of various professionals including legal, tax and financial advisors. A 2007 court case emphasizes the importance of this collaboration. In *Smallegan v. Kooistra* (2007 WL 840123, Mich. Ct. App., March 20, 2007), the clients approached their attorney to develop an estate plan. The attorney referred the client to a financial advisory firm and together they recommended a concept combining a charitable remainder unitrust and a wealth replacement trust (i.e. life insurance trust) as part of

the client’s overall estate plan. The CRUT would remove appreciated stock from the client’s estate. Ms. Smallegan would receive the trust’s earnings during her life which she would use to acquire a life insurance policy to replace the value of the stock donated to charity. The attorney prepared the CRUT documents and three days prior to executing the CRUT, Ms. Smallegan was denied life insurance coverage. The financial representatives, however, informed Ms. Smallegan that they could find another life insurance company to issue coverage on her life. The CRUT documents were then executed and, as you can guess, no other life insurance companies would issue life insurance on Ms. Smallegan and she passed away. Ms. Smallegan’s heirs decided to file a suit against the attorney who was involved in the planning. The good news is that the court found in favor of the attorney regarding malpractice and the decision held up on appeal. There is a strong indication that the financial advisory firm did not get off so easy (possibly settling out of court). The bad news, in addition to the client’s estate planning needs not being met, is that the attorney lost valuable time and incurred unnecessary expenses defending himself against malpractice charges.

Charitable IRA Rollover Not Extended for 2010

Starting in 2007 and extending through 2009, the IRS permitted donors to make charitable gifts directly from their IRA without withdrawing the IRA funds first and then donating them to charity. The donor had to be 70 ½ years or older and the contribution was limited to \$100,000; however, this was very favorable tax treatment and there was hope that it would be extended into 2010 and beyond. Without the charitable IRA rollover, if a client wishes to use their IRA funds to make a charitable donation they will have to take a distribution, recognize the income as taxable income, then make a charitable contribution. The donor may not be able to deduct the entire contribution due to certain limitations placed on deductions for charitable contributions, making IRAs for some donors a rather poor source for funding charitable donations. This particular tax break was not extended for 2010.

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