

### Does A Charitable Gift Annuity Make Tax Sense For You?

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William Baldwin, Forbes Staff

At a gathering in May at the New York City Harvard Club, alumni with distinguished careers in law and finance rose to extol the virtues of "planned giving." That refers, among other things, to schemes in which you transfer assets to your alma mater while taking back a lifetime income.

When you do this, the testimonial givers said, you support a great institution. Also, you can get a 5% payout—"pretty good these days."

The audience of aging plutocrats warmed to the pitch, appealing as it did at once to their sense of noblesse oblige and their thirst for income.

It turns out that there are a few subtleties here, among them that a 5% yield on a lifetime-only asset is in no way comparable to the 2% yield on a Treasury bond or a stock portfolio. And yet these retirement income schemes do make sense for a lot of people. They are a lovely tax dodge.

### Consider yourself a prime candidate for investing with your college if:

- you are in a high tax bracket,
- you'd like to consume a certain chunk of your principal rather than leave it all to ungrateful heirs,
- you were going to make a gift or bequest to this institution anyway,
- your health is terrific and
- you have appreciated assets in a taxable account that you'd like to unload.

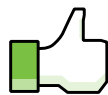
Your college probably offers a complex menu of semi-philanthropic investment deals. Two of the most popular are charitable remainder trusts and charitable gift annuities.

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*"Instead, let me be your investment advisor and get you eleven-per-cent return, year in and year out, regardless of market conditions."*

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A remainder trust has you transferring assets and getting in return a regular payout from those assets. Typically this payout is set as an annual percentage (like 5%) of the trust's value. Your dollar payouts fluctuate, but if the trust delivers average returns above 5% these payouts will grow. At your death the charity pockets the principal.

A gift annuity is an annuity you buy from a charity. You hand over a lump sum and get in return a fixed monthly or quarterly payment for life.

You can fund either investment with appreciated securities and postpone capital gain tax on the appreciation. With either arrangement you get an immediate tax deduction for the charitable element of your contract, notwithstanding that the charity has to wait for its share. With either, your heirs wind up with nothing.

Let's consider two hypothetical examples involving a contribution of Apple shares worth \$100,000 that you bought years ago for \$25,000.

**Case I:** You and your spouse are both 60, and you opt for a charitable remainder trust with a 5% payout continuing as long as at least one of you is alive. The college sells the Apple shares right away and invests the \$100,000 in a stock index fund.

Suppose you both live to 80. The result is that you are giving away a pile of assets and then taking back 5% of those assets 20 times. Does that mean you have recaptured the entire gift? No. In the arithmetic of compounding, 20 times 5% equals not 100% but 64%. In this case setting up the trust would be the economic equivalent of clawing back 64% of the money involved and donating only 36%.

Of course, you might live to 80, or to 99, or to 61. The value of what is being given away depends on actuarial tables as well as the compounding effect. For a pair of 60-year-olds taking out 5% over two lives, the tax-deductible gift, it turns out, comes to 27% of the assets.

Donors could get that deduction, of course, just by writing a check. What's powerful about the charitable remainder trust is that it can be funded with appreciated assets that you want to dispose of. Perhaps they are too risky for you or aren't yielding any income.

"The ability to diversify without getting hit with an immediate capital gain tax is the driver," explains Christopher Carlson, an estate and trust lawyer in Wellesley, Mass.

"You have 100 cents on the dollar working for you inside the trust."

How your payouts get taxed depends on how the \$100,000 is reinvested. If it goes into a stock index fund, you will have, at the start, \$2,000 or so of dividend income and \$3,000 of long-term gain. The capital gain portion continues until the whole \$75,000 of Apple appreciation is accounted for.

The combination of tax deferral and diversification may make this deal attractive to you. But don't be swayed by the 5% payout rate. It has nothing to do with the yield on stocks or bonds. After all, if you want to spend 5% of your portfolio every year you don't need a helping hand. You could keep the assets in your name and leave the balance to charity in your will.

**Case II:** You are 70 and use the Apple shares to fund a charitable gift annuity covering only your own life. Harvard will give you \$6,200 a year in return for \$100,000 of cash or securities. Some institutions (like Stanford) pay less. Some (notably Pomona College) pay more.

These annuity payments are a fixed-income asset. They don't keep up with inflation, but they are highly secure, since they are typically backed by an endowment

**VALUING ANNUITIES CONSERVATIVELY, THE IRS CALCULATES THAT A \$6,200 ANNUAL PAYOUT, PAID QUARTERLY AND BEGINNING AT AGE 70, IS WORTH 12.4 TIMES \$6,200, OR ROUGHLY \$77,000.**

BENEFIT PLANS	AGE	HARVARD PAYOUT	IRS VALUE FACTOR <sup>1</sup>	IRS LIFE EXPECTANCY (YEARS) <sup>2</sup>
ONE LIFE	60	4.9%	17.7	24.2
	70	6.2	12.4	16.0
	80	8.0	7.6	9.5
TWO LIVES <sup>3</sup>	60	4.0	21.7	29.7
	70	5.5	15.9	20.6
	80	7.5	10.3	12.8

<sup>1</sup>MULTIPLY THIS BY ANNUAL PAYMENT TO GET PRESENT VALUE OF ANNUITY. FIGURES ASSUME MARKET INTEREST RATE IN EFFECT FOR MAY. <sup>2</sup>DIVIDE ANNUITY PURCHASE PRICE BY THIS TO GET ANNUAL "RETURN OF CAPITAL" PORTION. <sup>3</sup>ANNUITY

many times larger than the annuity liabilities. As a Harvard money manager smugly notes, her institution's credit rating is higher than that of the U.S. government.

Here's how the numbers work out at Pomona, like Harvard a triple-A credit. Its payouts are so generous that half of the annuities it sells are to nonalumni.

The tax code mandates that the college retain a back end worth at least 10% of the deal. So, for \$100,000 of stock, Pomona can give you an annuity ostensibly worth no more than \$90,000. We say "ostensibly" because the IRS is too kind. It undervalues the annuity.

Pomona hews close to the line. In May it was paying just over \$600 a month, an annuity the IRS valued at \$90,000.

The IRS interprets the deal this way: You are using 10% of your Apple shares to make a \$10,000

donation to Pomona. You use the rest of the Apple shares to buy a \$90,000 annuity. On the latter bunch of shares you have a \$67,500 capital gain (\$90,000 minus 90% of \$25,000).

You report your capital gain over your life expectancy. IRS Publication 939 says that, for a 70-year-old, this expectancy is 16 years. Over the same 16-year stretch you will recover, as a tax-free return of capital, the \$22,500 cost of the shares used to purchase the annuity.

Any other cash you get out of Pomona is ordinary income, as it would be with a commercial annuity. After 16 years your entire paycheck is taxable.

**Economics?** Very good. That \$600-plus payout slightly exceeds what you could get from New York Life, the leading commercial vendor of fixed annuities (and one of a few with a credit rating in Pomona's

league). If safety is important to you, an annuity from Pomona is a very attractive deal even if you harbor no charitable impulses.

The tax treatment is sweet: You get a \$10,000 tax deduction you don't really deserve. That's because the IRS tables used to calculate the value of the annuity wrongly assume that annuity buyers are average Americans.

*If safety is important to you, an annuity from Pomona is a very attractive deal even if you harbor no charitable impulses.*

What's wrong with that assumption? Jane Austen put her finger on it (*Sense and Sensibility*, 1811): "People always live forever when there is an annuity to be paid them." Annuity buyers are aberrantly healthy.

Two other nice things about the deduction are that you can claim it all in the first year and that the \$7,500 of Apple appreciation built into it is never taxed.

Harvard annuities, being less lucrative, need a philanthropic motive to make sense. But even there you are giving away very little, particularly if you are in a high tax bracket and were thinking of selling the Apple shares in order to buy a commercial annuity.

If you die young after buying a collegiate annuity, it's not an insurance company that gets a windfall. It's an institution you admire.

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*"Your pot o' gold is doing nothing for you sitting at the end of the rainbow. At the very least, you should put it in a no-risk interest-bearing account."*

# As Interest Rates Fall Further, Younger Donors May Not Qualify for the *Pomona Plan's* Regular Rate Schedule...

**A** hallmark of the *Pomona Plan* is that we offer higher gift annuity rates than most charities.

In the current low interest rate environment, however, we are forced to reduce our rates for younger donors—typically those in their 60s and early to mid-70s. This is due to the impact of the IRS Discount Rate used to calculate the charitable deduction for an annuity. In order for a charitable annuity to qualify legally as being *charitable*, the deduction must equal at least 10% of the face value of the gift.

Over the past year, the IRS Discount Rate has continued to fall in a series of steps, dropping to historic lows at or near 1.0%; currently, the rate is 1.2% for October. This

means that individuals as young as age 73 and couples with one member age 79 or younger may not qualify for our regular rates.

If you have been considering an annuity with the *Pomona Plan*, you may want to check on how this might affect your rates this fall so that we can help you qualify for the highest rate possible. Because we are allowed to use the IRS Discount Rate for either the current month or either of the two preceding months, a gift before the end of December would still be eligible for at least the 1.2% rate.

**Give us a call at (800) 761-9899 and one of our staff will be glad to assist you with a gift illustration.**

## FROM THE DIRECTOR:

### *The Pomona Plan Garner's Attention from Forbes Magazine*

Harvard has sometimes been referred to as the Pomona College of the East. It is a reputation well-deserved. They are, after all, a pretty good school and do compare favorably with Pomona. (Both of us also happen to rank in the top ten on *Forbes'* 2012 list of "America's Top Colleges.")

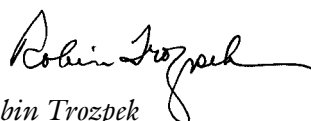
Perhaps, then, it is not surprising to find *Forbes'* investments commentator William Baldwin writing about Pomona and Harvard in the same magazine article, as he did this past June in the annual "Investment Guide" issue. Commenting on life-income opportunities available through "planned giving," Baldwin highlights charitable remainder trusts and charitable gift annuities at both institutions. In this case, both institutions offer the opportunity to support a wonderful institution through a life income gift backed up by triple-A credit worthiness.

In this current issue of *Flash! News from the Pomona Plan*, we have reprinted in its entirety William Baldwin's June 25 article titled, "Does a Charitable Gift Annuity Make Tax Sense For You?" In it, Baldwin succinctly writes of gift

annuities, "Economics? Very good." While we agree, we like even more his comment, "If you die young after buying a collegiate annuity, it's not an insurance company that gets a windfall. It's an institution you admire." This brings home the critical importance of the gift component of the charitable annuity. While we do believe that a gift annuity can represent a wise financial choice for the donor, the real investment is in the public good represented by the support for private higher education in America. The annuity works for you now as part of your financial plan, and it lets you make a future gift that will better society for succeeding generations.

If you'd like to consider a gift that will allow you to do well while doing good, please give us a call. We would be delighted to help you achieve your combined charitable and financial objectives.

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