Five of the Top Ten Lessons Learned from the Front Lines of Client Services

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The world of planned giving is complex and fascinating. It is squarely at the intersection of philanthropy and estate planning, but it also overlaps with the areas of law, taxation, investments, and human behavior. There are so many nuances and specialty areas of knowledge that the gift planning professional can easily become overwhelmed and lose sight of the core issues. We at PG Calc hesitate to say, "we've seen it all," but in some ways, we have!

We produce software for gift planning and gift administration, and we provide a wide array of services ranging from consulting to web services. We thought it might be helpful to pause for a moment and share what we've identified as the top 10 lessons (this is the first installment of 5) in planned giving that we have learned over the 37 years of our company's existence. These are not necessarily in order of importance or relevance, and, of course, they represent only a tiny portion of the knowledge required for any modern-day gift planner.

1. Is it a gift, or is it an investment? Umm…yes.

In some ways this is the simplest and most important point of all, but it frequently gets lost in the flurry of calculations, brochures, and projections. If we are dealing with any kind of split interest gift arrangement – charitable gift annuities (CGAs), charitable remainder trusts (CRTs), charitable lead trusts (CLTs) – they are all vehicles by which the donor wishes to make a substantial gift to charity, but also wishes to provide some type of financial benefit to herself and/or to other persons. When a 72-year-old donor establishes a $25,000 CGA in March of 2022, she gets a payout rate of 4.9% and a

charitable income tax deduction of $11,523.75. The deduction is only for a portion of the funding principal, because there is also a *financial benefit to the donor* of receiving the annuity for the rest of her life.

2. Never forget about the value of the non-charitable benefit.

In the example above, the donor's tax deduction is $11,523.75, because according to IRS-mandated methodology, the value of the *financial benefit of the annuity payments* to the donor is $13,476.25. Notice that the 2 numbers add up to the total funding principal of $25,000! With CGAs, the IRS requires the calculation *for the value of the personal benefit* to be computed first; the remaining amount is the value of the estimated charitable benefit. It's simple subtraction. Other split interest gifts use slightly different methods (per the IRS), but the concept is the same. The charitable benefit (the deduction) plus the value of the non-charitable benefit (the value of the annuity or income stream) equals the total funding amount.

3. CGAs (almost) always lose money – really!

If the donor establishes a CGA with $25,000, does that mean the charity receives the $25,000 when she passes? Most likely not. That $25,000 is used to make payments to the donor for the rest of her life. At $1,225 per year, after a little over 20 years, the CGA would run dry – there would be nothing left. But there is another side to the equation. The money does not sit in a savings account, but rather, it is invested in a prudent manner for total return. We've published articles in recent years illustrating how, with simplified mainstream investment portfolios – even with overly conservative postures – it is reasonable to expect a long-term average annual return of 7-8%. That rate of return can be significantly greater than the annual payout percentage to the annuitant or beneficiary.

If the gift annuity principal is earning more than it is paying, the principal amount will go up. In the real world, however, there are reasons why it's not so simple. Many CGAs have payout rates higher than 4.9%, and some restrictive investment policies limiting the portfolio's exposure to equities. Typically, the principal remaining after the donor/annuitant passes will be somewhere between 60-90%. If the residuum comes out in that range, it is considered a successful gift annuity.

4. The IRS discount rate isn't really that important (for the most part).

A fair amount of attention is paid to the IRS discount rate (the "7520 rate" or "charitable mid-term rate"). Here is a quick reminder of what it is and how it works. The discount rate is published monthly, between the 15th and 20th of the month, and it applies to gifts

in the following month. It equals 120% of the annual mid-term rate, rounded to the nearest 0.2%. The annual mid-term rate is the annualized average yield of U.S. Treasury instruments over the past 30 days with remaining maturities of 3-9 years.

The IRS requires use of the discount rate in calculating the charitable deductions for the majority of split-interest gifts. It serves as an assumed rate of investment return. Why does that matter? In the example we've been using, the $25,000 is theoretically invested for the long run. The residuum (remainder of the principal) will depend on the combination of the payout rate to the annuitant and the presumed investment rate of return. With the present discount rate of 2%, the 4.9% payout rate would significantly exceed the investment return ($1,225 vs. $500).

That would cause a significant erosion of principal, which is why the charitable deduction is a relatively modest $11,523.75. If the discount rate were 5%, however, the underlying principal would earn $1,250, and the principal balance would increase year after year (assuming there were no direct fees or expenses involved). With a discount rate of 5%, the deduction would rise to $14,140.25. Certainly, that is a significant increase, but in reality, the discount rate changes only slightly from month to month, or even year-to-year. Further, since the deduction represents the present value of a future sum, while the nominal residuum would be higher than $25,000, the charity would wait many years to receive it.

The point is this: gift planners shouldn't encourage potential donors to delay making split interest gifts because of the possibility of incremental discount rate changes. There are always exceptional cases, but, in general, it doesn't make sense to "play" the IRS discount rate.

5. **The donor does NOT escape all his capital gains with a life income gift; it's in his best interest to supply a cost basis for a life income gift.**

We hear this frequently: the donor doesn't understand why he should provide a cost basis for the appreciated property he is contributing to establish a life income gift (for simplicity, we'll assume the property is marketable securities). Some donors are quite insistent that since they are "making a gift to charity," nobody needs to know how much they paid for the stock. This is where it's critical to remind them that they are making a gift, but it is a *partial gift.* Going back to our examples above, the gift annuity funded with $25,000 of highly appreciated stock is partly a gift and partly a financial arrangement to benefit a person. We need to explain to donors that the cost basis is unnecessary only in cases of outright gifts.

With a life income gift, the IRS requires a *portion* of the donor's capital gain to be distributed to the donor through the payments (assuming the donor is the annuitant or beneficiary). PG Calc's gift calculations and projections help to illustrate that only a *portion* of the total capital gain is distributed, but to calculate the *correct* portion of the capital gain, there needs to be a specific number for the cost basis. If the donor absolutely cannot find a cost basis or steadfastly refuses to provide one, the gift planner should assume a zero-cost basis. The results will be dramatic – the total capital gain will be assumed to be the entire value of the stock, which means the amount of reportable capital gains will be exaggerated. But it would be unwise to assume any number other than zero. Doing so would risk *underestimating* the capital gains, which would mean *underpaying the tax on those reportable gains*. The donor could face serious consequences from taking that position, and the gift planner should steer clear of the situation.