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Pooled Income Funds Revisited

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Today's Topics

- Basic Trust Concepts
- Pooled Income Funds (PIFs), generally
- Valuation
- Taxes
- Investments
- PIFs versus Gift Annuities

Basic Trust Concepts

- Separate legal entity
- Often a separate tax entity
- Sometimes a separate tax-exempt entity (CRT or Foundation)
- Trust can be revocable or irrevocable

Basic Trust Concepts

Parties to the Trust

- Grantor/Settlor/Trustor (creator) – creates the trust
- Trustee – Legal title, manages the trust
- Beneficiaries – has the benefit or use of trust assets and income

Basic Trust Concepts

Two types of Beneficiaries

- Income or lifetime beneficiaries
- Remainder beneficiaries

This creates a "Split-Interest" Trust

Pooled Income Fund Background & History

Prior to Tax Reform Act of 1969

- Unlimited charitable contribution deduction
- 1965 Treasury Report to Congress
- Focus on Private Foundations
- Simple form of charitable remainder trust
  - allowed invasion of principal in emergency
- Often charity received little, if any benefits
- Purpose of TRA 69 was to enhance benefits for charity
- Result was rather complicated set of new rules

Background & History

Effect of TRA 69

- Divide charitable organizations into two basic categories:
  - Public charities - 509 (a) (1), (2), (3)
  - Private Foundations - 509(a)

Background & History

Imposed a number of restrictions on Private Foundations & Charitable Trusts

Those that apply to PIFs are:

- Self-Dealing
- Taxable Expenditures
- Retaining Excess Business Holdings
- Jeopardizing Investments

Background & History

- Gifts of partial interests are generally not deductible
- However, there are specific exceptions for qualified interests

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Background & History

Establish 3 precise ways to have a qualified charitable trust:

- Charitable Remainder Unitrust (CRUT)
- Charitable Remainder Annuity Trust (CRAT)
- Pooled Income Fund (Trust)

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Pooled Income Funds Split-Interest Trusts

- Income Interest
- Remainder Interest
- Valuation of the interests
  - Number of income beneficiaries
  - Ages of income beneficiaries
  - Rate of Return/Payout
- Determining the charitable contribution deduction

Pooled Income Funds – IRREVOCABLE – Section 642(c)(5)

Is a type of split-interest TRUST

- Initially, slow to gain recognition and use - SEC
- Permits POOLING of smaller gifts into ONE TRUST
  - save expenses - economies of scale

Pooled Income Funds

- DONOR transfers PROPERTY to the Fund
  - Cash
  - Stocks, Bonds and other Securities
  - Real Estate
  - Other property (tangible personal property)
- CHARITY gets <u>IRREVOCABLE</u> REMAINDER interest
- DONOR (or OTHER BENEFICIARY) gets INCOME interest

Pooled Income Funds

- PIF MUST COMMINGLE all property transferred to it
  - other assets of charity - separate accounting
- PIF can NOT ACCEPT or INVEST in securities which are exempt from income tax
- Donor (or other income beneficiary) obtains UNITS, similar to mutual fund

Pooled Income Funds

- ALL INCOME MUST be paid out annually
  - 65-day rule
  - amount will fluctuate
- All income is taxed as ORDINARY income

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Pooled Income Funds

- DONOR or other INCOME BENEFICIARY can NOT act as trustee of the PIF
- Pooled Income Fund must be MAINTAINED by the charity
  - Agents
  - Independent Trustee

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Pooled Income Funds

- Appropriate size of PIF gifts

- PIF transfer can be made during life or by Will

Tax Consequences for Donor

Income Tax

- Charitable deduction (30/50/5 year)
- No capital gains tax on transfers of appreciated assets
- PIF takes over donor's basis and holding period
- All income taxed at ordinary rates

Tax Consequences for Donor

Gift Tax

- Charitable deduction - no limitation
- If donor (and/or spouse) is the only income beneficiary - no gift tax
- If someone other than donor or donor’s spouse is an income beneficiary - possible gift and gift tax
- Power to revoke successor benefit by will

Tax Consequences for Donor

Estate Tax

- Value of gift included in Donor's estate
- If donor (and/or spouse) is the only income beneficiary - full charitable deduction
- If Husband and Wife, charitable deduction and marital deduction
- If successor income beneficiary other than donor or spouse charitable deduction based on the value of the interest and beneficiary's age at the time of donor's death

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Tax Consequences for the Trust

- Takes donor's basis and holding period
- Generally, no income tax
  - all ordinary income must be paid out to income beneficiaries, and they pay the income tax
  - "set-aside" deduction for long-term capital gain charitable organization
- However, Trust WILL pay tax on <u>short term</u> gains, and Unrelated Business Taxable Income (UBTI)

Investments

- Can NOT invest in securities that produce tax-exempt income
- No capital gains are ever distributed, so realized gains from investments produce no benefit to beneficiaries
- Income paid to beneficiaries is not measured by a percentage of the value of trust principal, so capital growth does not directly benefit the income beneficiaries

Investments – What does the Income Beneficiary Want?

- We find that most charities seek the highest rate of return possible
- Primary investment objective - highest yield consistent with preservation of principal

Rates of Return

- Rate of return for the donor/income beneficiary
- Rate of return for the PIF
- Highest Average Annual Rate of Return for the PIF
  - three year rule
  - variable assumption for new PIFs, 1.8% for 2012 (deemed rate of return)

WHY HAVE A POOLED INCOME FUND?
- Donor Perspective

- Easy
- Quick
- Inexpensive
- Avoid capital gains taxes
- Relatively high yield
- Substantially increase income for life
- Income tax deduction
- Reduce probate expenses (avoid probate)
- Reduce estate taxes
- Can get involved with planned giving without a large contribution
- Can reinvest income to produce greater income in later years
- Stepping stone to larger planned gifts
- Donor becomes more deeply involved with the organization
- Provide greater support to favorite charity

WHY HAVE A POOLED INCOME FUND?
- Charity's Perspective

- Easy
- Quick
- Inexpensive
- Can obtain planned gifts from a far greater number of donors because of the size of the gifts
- Gets greater number of prospects involved with your development program
- Donor becomes more deeply involved with your organization
- Income beneficiary (other than donor) becomes involved with your organization
- Cultivates individuals for continuing contributions to PIF
- Cultivates individuals for larger individual planning with unitrusts, etc.
- Cultivates individuals for larger outright gifts
- Gives donor/income beneficiary more income, therefore a greater capacity to make outright gifts

Gift Annuities vs. Pooled Income Funds

- Regulation
- Restrictions on Investments
- Taxation of Donors/Beneficiaries

Regulation of Gift Annuities

- Virtually every state regulates Gift Annuities in some form
- There is not much consistency between states, so an organization may need to comply with different rules in many states

California Regulation of Gift Annuities

- Regulated by Department of Insurance
- One-time filing fee of $3,180, $117 annual renewal, and $60 for each new gift
- Detailed annual report
- Segregated Reserve Fund

Reserve Fund

Must hold a segregated Reserve Fund in trust

- Reserve Fund must be calculated using the Annuity 2000 Mortality Table, and
- a 4.5% discount rate

Reserve Fund - Example

- Joint Annuity - Male age 65, Female age 65
- Gift of $18,000
- Annuity equal to $756 per annum, paid in quarterly installments
- Segregated Reserve Fund equals $15,239

*** Annuity based on the American Council of Gift Annuities (ACGA) rate of 4.2% for 2012

Investment limitations on Reserve Fund

- At least 50% of the Reserve Fund must be in investment specified in California Insurance Code

- At most, 50% can be invested in other investments, which are also limited

Investment limitations on Reserve Fund

- Obligations of the U.S., Canada, Puerto Rico, or any province or subdivision
- Obligations of any county, municipality, or school district in any state, province or political subdivision
- Bonds of any permanent California road division
- Bonds of any California county water district
- Loans guaranteed by the U.S.
- Notes or bonds secured by mortgage guarantee
- Certain trust bonds or notes
- Certain farm loan bonds
- Bonds under the "Home Owner's Loan Act of 1933"
- Registered warrants of California

Reserve Fund – Other Investments Allowed

- Again, no more than 50% of the Reserve Fund can be invested in other investments
- Other investments may include equity or bond mutual funds, or securities listed on the NYSE, AMEX, or NASDAQ

Reinsurance as an alternative

- May reduce the required Reserve Fund
- Commercial single-premium annuity
- Paying this single-premium tends eliminate a large portion of the gift

Gift Annuities – Income Tax

- Charitable deduction to the extent the property transferred exceeds value of the annuity received
- The AGI limitations described previously apply
- Annuity payments have three components:
  - An ordinary income portion,
  - A capital gain portion, and
  - a tax-free return of investment portion

Gift Annuities – Income Tax

- If appreciated property is transferred, the bargain sale rules trigger capital gain
- In most cases, the gain may be reported ratably over the life expectancy of the annuitant

Gift Annuities – Income Tax

- Income is reported on Form 1099-R
- Organization completes the 1099-R and provides copies to the donor and taxing authorities
- By comparison, Pooled Income Fund income is reported on a Form K-1

Gift Annuity - Example

Joint Annuity - Male age 65, Female age 65

- Transfer of $18,000 of IBM Stock, basis equals $2,000
- Annuity equal to $756 per annum, paid in quarterly installments
- The $756 represents: $144 ord inc, $544 cap gain, and $68 tax-free
- Charitable Deduction equals $2,752

Pooled Income Fund - Example

- Joint Interest - Male age 65, Female age 65
- Transfer of $18,000 of IBM Stock, basis equals $2,000
- Annual Income equal to $990 per annum, paid in quarterly installments
- The entire $990 represents ord inc
- Charitable Deduction equals $3,554

*** Assumes a 5.5% yield by PIF

Gift Annuities vs. Pooled Income Funds

	Gift Ann	PIF
Payment	$ 756	$ 990
Deduction	$2,752	$3,554
Tax Benefit	$1,101	$1,421
Advantage in Taxation	$ 109	$ 0
Net	$1,966	$2,411

**** Assumes: (1) effective combined federal and California tax rate of 40% , and (2) 5.5% yield by PIF

Gift Annuities vs. Pooled Income Funds

Amount that passes to charity

- Gift Annuities – ACGA rates are designed and published with the objective of getting 50% of initial gift values to the charity
- Pooled Income Funds – We commonly see remainder interests equal to 100% or more of initial gift values to charity

**** Actual investment performance varies from case to case, which impacts the percentage passing to charity