



Pity the Poor Pooled Income Fund

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These days, the struggling Pooled Income Fund is like the Rodney Dangerfield of life income gifts – ***it just can't get any respect!*** Prospective donors interested in establishing split-interest charitable gift arrangements that provide income for life typically consider either the Charitable Gift Annuity or the Charitable Remainder Trust. The former offers low entry points, consistent payment amounts, and simple tax reporting, while the latter offers considerably more options to donors who are prepared to make significantly larger gift amounts. Pooled Income Funds, on the other hand, pay very little current income to the beneficiaries and involve complicated and lengthy tax reporting. As a result, they attract few if any new participants. As the size of the PIFs decrease, the work and expenses associated with these funds push many organizations to question if they should even continue to maintain their PIFs. But what options do they have? The gift arrangements mandate income to the beneficiaries for the rest of their lives. Is closing out a Pooled Income Fund the only logical solution? Is it the best choice of action for every organization? Are there other considerations?

The Pooled Income Fund as we know it has been around for decades. In fact, in the 70s and 80s, the PIF was the gift vehicle of choice for donors interested in life income gift arrangements. Thousands of non-profit organizations established PIFs during these years, and in some cases, charities established multiple PIFs, varying the investment objectives to appeal to different groups of donors. The high-interest-rate environment of the 70s and 80s was perfect for the Pooled Income Fund. PIFs are limited to ***paying only the net earned income to the beneficiaries***, but interest rates during some of these years pushed well into double-digits. This resulted in PIFs paying substantial levels of income to the participants.

The 90s brought about very different conditions. Interest rates began a downward spiral that has continued into recent years. Over time, the income levels in Pooled Income Funds followed that course and the resulting payments to beneficiaries became much lower. In contrast, **Charitable Gift Annuities (CGAs) become increasingly popular** over the same time period. By design, they are not limited to paying only the net earned income to beneficiaries (annuitants), but rather, they make payments from both income and principal, at a specific and fixed dollar amount determined upon funding.

The basic premise of a CGA is that the payments will involve a consistent erosion of principal over time, because the payments almost always exceed the amount of true income. Indeed, the American Council on Gift Annuities (ACGA) recommends payout rates for gift annuities based on the objective of the **charity receiving only 50% of the original funding amount as its residuum**. This means the other 50% of the original principal has been used to make payments to the annuitants. Under these conditions, Pooled Income Funds have not been able to compete fairly with CGAs for the past two decades. As the donors have gradually passed away, the PIFs have declined in size. And because the operation of PIFs requires a certain level of fixed expense – fees for Trustees, fees for tax accountants, etc. – the perceived value of having PIFs has been declining as well.

While the sponsoring charity cannot simply close a languishing Pooled Income Fund as long as the participants (beneficiaries) are still alive, there are other possible solutions. One is to offer the participants the opportunity to relinquish their remaining life income interests in the PIF, in exchange for a charitable income tax deduction. The charity or Trustee simply needs to compute the present value of each participant's future income from the PIF. This can be done in PG Calc's Planned Giving Manager (PGM) by using the Non-charitable Interest Actuarials (NIA) chart in Program 1 : Basic Gift Illustrations. The user merely needs the current value of the participants' units in the PIF, their dates of birth, and the 3-year high PIF Rate of Return computed in accordance with IRS methodology. The **Value of Life Interest in the NIA chart is the value of the benefit that the donor is permanently** relinquishing, and this is the amount of the charitable income tax deduction. The only necessary documentation is a letter of understanding or a simple one-page document stating that the donor is irrevocably giving up all future income from the PIF¹.

Some PIF donors will not be interested in giving up their income from the PIF in exchange for a charitable tax deduction, as they may not itemize their tax returns, or they may consider the

income essential to their well-being. However, they **may be interested in cashing out their interest in the PIF**. This can be done by running the same calculation as described above, only in this case, instead of executing a document to substantiate the deductions for a charitable gift, the donor needs to put in writing that he is giving up his or her income interest in exchange for a cash amount. The cash amount would be for the Life Interest Value in the chart mentioned above. Please keep in mind that the cash settlement would require some type of year-end tax reporting, the details of which should be provided by a professional tax advisor.

Another possibility for the charity maintaining a struggling Pooled Income Fund is the conversion of the Pooled Income Fund participation into a Charitable Gift Annuity. This involves yet again the computing of the Value of Life Interest in the Non-charitable Interest Actuarials chart in PGM as described above. At first blush, the idea of switching from a PIF participation to a CGA may be very attractive to a donor, since the payout rates are typically so much higher with the latter. **But there is a possibility that the gift annuity may provide even lower payments than the PIF participation.** This is because the CGA is created not with the total value of the PIF units, but rather, with the value of the life interest. The PIF participation for a particular donor, for example, may be worth \$40,000, but the life interest portion may be worth only \$10,000 or \$20,000. Keep in mind that the value of the life interest is highly dependent on the age of the participant. Upon further analysis, the PIF paying 3% on the \$40,000 participation will be more attractive than a \$10,000 CGA paying 6%. The specific details of this “conversion” are provided in PG Calc’s CGA Manual, which has just been updated².

Before getting too far along with plans to get rid of that Pooled Income Fund, charities may be well advised to take another look at that gift vehicle. While it’s true that long-time donors may be dissatisfied with a current income stream of 3%, that may not be an impediment to certain prospective donors. For a donor who is significantly younger than the charity’s minimum age for a CGA, the PIF offers an opportunity for the charitable deduction now and the flow of income over 30 years or more. Pooled Income Funds usually have a combination of stocks and bonds in their investment portfolios, meaning the principal value increases over time. **The 3% “yield” right now likely will be based on a much higher principal value 20 years from now**, so the income rate of return expressed as a percentage of original funding amount will be significantly higher than 3%. In addition, if bond interest rates go up from today’s levels, which is predicted by most economists and investors, the net income payments from PIFs will increase for that reason as well.

There is another relatively unknown benefit of establishing a PIF participation instead of a gift annuity, which has to do with gifts of appreciated property. With a gift annuity, the contribution of stock held long term that has appreciated significantly over the years results in the distribution and taxation of a **portion of the capital gains over the life expectancy of the donor(s)**³.

The donor does not completely wash his or her hands of the appreciation in the stock; the IRS eventually will tax a portion of the gains. With a Pooled Income Fund, however, the gift of appreciated stock relieves the donor completely of any tax on that capital gain. The donor gets a charitable income tax deduction for the portion of the value of the stock that is projected to benefit the charity, and the Pooled Income Fund absorbs all potential liability for the tax on the gains realized from the stock. Of course, there will be no tax on the PIF if the stock was held long-term by the donor. The PIF only pays tax on the gains if the donor held the stock for less than a year prior to making the contribution. And gifts under those conditions should not be accepted as gifts to Pooled Income Funds.

Regardless of the type of funding property, one of the strongest arguments for continuing to maintain a Pooled Income Fund is the very large income tax deduction that donors can get right now for establishing a participation. Because the official income rates of return have been so low in recent years, the estimated benefit to the PIF beneficiary is projected to be relatively low, while the estimated benefit to the charitable remainderman is projected to be relatively high. **This means that the charitable income tax deductions under current conditions are significantly higher than in the past.** Remember that the total benefit to a donor for establishing a life income gift arrangement is a combination of the initial income tax deduction and the value of the stream of payments over time.

When a prospective donor is seriously considering either making a gift to a Pooled Income Fund or establishing a Charitable Gift Annuity, gift planning professionals should look carefully at the combined benefits for one versus the other. The **large deduction up front and the modest but steadily-increasing payment stream of the PIF may actually be more beneficial** than a modest income tax deduction up front and somewhat higher income payments over time from a gift annuity.

And what about the eventual benefit to the charity? Does the relatively large charitable deduction for a Pooled Income Fund gift, compared to the deduction for establishing a CGA, reflect what happens in reality? Indeed, this is an area not to be overlooked when the charity is evaluating its

Pooled Income Fund. While there is no statistical data on the long-term results of a gift annuity compared to a contribution to a PIF, ***there is anecdotal evidence that gifts to Pooled Income Funds result in significantly larger residua (charitable remainders) than gift annuities funded by the same dollar amounts.*** As mentioned above, the premise of a CGA is that there will be significant reduction in principal over the years, and a residuum of 70% or 80% is considered a very successful gift annuity for the charity. With a Pooled Income Fund, however, the original principal is never invaded, and charities frequently report that the typical residuum is well over the original amount of contribution. In many cases, we hear about principal values that have doubled over the remaining lifetimes of the donors. So, while the Pooled Income Fund may have considerable operating costs, the eventual benefits from the terminating participations may more than offset those costs.

In summary, there is no one-size-fits-all for the long-struggling Pooled Income Fund. In some cases, it will make sense for the charity to work toward the closing of the fund, either through voluntary terminations, cash settlements, or conversions to gift annuities. In other cases, however, the PIF may deserve a second look. ***Life income gift arrangements were never intended to provide significant levels of income to the donors.*** Rather, they were intended to benefit the organization, while providing a modest amount of income as a token of appreciation and to keep the donors more connected with the sponsoring charities. Donors considering life income gifts should be given all of the relevant numbers and facts, so that they can make the best decisions for their own circumstances.

We hope this article has been helpful. Please keep watch for a webinar in 2015 that covers areas of concern pertaining to Pooled Income Funds.

As always, we invite you to contact us if you have any questions. You may reach ***PG Calc's Client Services*** by telephone at 1-888-474-2252 or by email at support@pgcalc.com.

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¹ If the surrendered interest is greater than \$5,000, the donor will need to obtain a qualified appraisal to substantiate the amount of the charitable deduction.

² Here is a link to information regarding the CGA Manual on PG Calc's website:
<https://www.pgcalc.com/education/charitable-gift-annuities-manual.htm>

³ The distribution of the reportable portion of the capital gains on a gift of stock requires that the donor is either the first annuitant or the only annuitant.