THE POOLED INCOME FUND AT 45 – CONSIDER THE POSSIBILITIES!

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I. INTRODUCTION

Earlier this year, PG Calc published an article in our eRate monthly newsletter titled "Pity the Poor Pooled Income Fund." In that piece, we provided a brief overview of the history of the Pooled Income Fund (PIF), and explained what has happened to this venerable vehicle over past 20 years as interest rates have dropped lower and lower. With Charitable Gift Annuities (CGAs) typically paying much higher rates of return, donors nowadays have lost interest in making contributions to PIFs. As existing participants pass away, there is a natural rate of attrition, leaving existing Pooled Income Funds with fewer and fewer participants. The once-mighty PIF has been rendered to be, for many organizations, an anachronism, a virtual relic; often the sponsoring charity is simply waiting for the last few participants to die so that it can be closed down, shuttered up, and shipped off to the archives of history.

But that is only one side of the story. With our recent history of persistently low interest rates, the charitable deductions for contributions to PIFs have become historically high, especially in the case of new Pooled Income Funds. *Wait - what's that you say? New Pooled Income Funds?* Yes – brand spanking new Pooled Income Funds! In some cases, the deduction for gifts to a new PIF represents 80% to 90% of the funding principal amounts. *Now may be the perfect time for your organization to create a new PIF. Or even multiple PIFs!* If you think that's just crazy talk, please stay with us as we walk through a comprehensive review of the pros and cons of Pooled Income Funds – both existing PIFs and newly-established ones. The combination of high deductions and long-term growth of principal – which translates eventually into higher rates of payments – can in many cases make the PIF an attractive life income gift vehicle once again.

That is not to say that all PIFs should be relaunched, or that every organization should have a Pooled Income Fund. There are certain attributes that have a powerful effect on the viability of maintaining a PIF. The number of participants, the total value of the assets, the magnitude of fees and expenses, and the level of understanding and commitment by the organization as a whole, will greatly influence whether or not the organization should sponsor this gift vehicle. In some cases, the best solution indeed will be to close down an existing PIF and / or not start a new one. In this webinar, we want to give you a better understanding of how Pooled Income Funds work, and provide some tools for analyzing the true value of having one. We want to give you the tools to consider all of the possibilities for Pooled Income Funds, so that you can make a better-informed decision for your organization.

II. HISTORY

The Pooled Income Fund as we know it was created by the Tax Reform Act of 1969 and is governed by IRS Section 642(c)(5). The main provisions are that the contributions from individual donors are pooled together for investment purposes. The donor receives a charitable income tax deduction for a portion of the value of the contribution, which is the estimated value of the eventual benefit to the charitable organization, discounted to present value. Like any life income gift arrangement, the value of the benefit to the charity is greatly influenced by the age of the donor – the older the donor, the lower the remaining life expectancy, hence the greater potential value of the benefit to the charity. Based on the amount of the contribution, the donor receives a computed number of units in the Fund, which are used to determine how much of the overall income each participant is paid. Much like a mutual fund, new donors can contribute at any time, and based on their assigned units, they receive a prorated amount of income for their first partial period in the PIF.

The income distributed in a Pooled Income Fund is the net income after all expenses, and it is typically derived from a combination of dividends on stocks, interest on bonds, and in some cases, rents and / or royalties. It's important to note that the definition of income for the PIF is the traditional concept of accounting income – it does not include any realized capital gains or any increase in the market values of its investments. This is a huge distinction. It essentially limits the amount of income paid currently to the participants, but it allows for accumulation and reinvestment of realized capital gains. As the value of the PIF investment portfolio grows, that leads to increasing levels of income for the participants and ultimately, higher remainder values for the charities.

III. The Existing Pooled Income Fund – On Its Last Legs?

Many organizations have Pooled Income Funds that were established in the 1980s, or even in the 1970's. When these PIFs were established, the prevailing interest rates on bonds were quite high – this was a period of time in the U.S. during which the rates on medium term bonds were well into double digits. This allowed the managers of Pooled Income Funds to invest in a combination of stocks and bonds, which resulted in a still-impressive rate of income, but also enabled the long-term preservation and growth in principal. It was not unusual for PIFs to pay out 10 or 12 percent during those decades.

When interest rates began to decline in the latter half of the 80s, and as they continued their downward spiral over the next two decades, the resulting payout rates for PIFs declined as well. In the new millennium, it has become commonplace for PIF payout rates to fall below 3%. Compare that against Charitable Gift Annuities – overall, the payout rates on CGAs have declined as well over the past 20 years, but at least in terms of nominal numbers, the rates are markedly higher than those for PIFs. While the existing Pooled Income Fund might pay 3%, the standard ACGA recommended rate for a 70-year-old is 5.1%. And of course, CGA rates are based on the age of the annuitant at the time of creation, so older annuitants receive higher payout rates.

It's important to remember, however, that Pooled Income Funds and Charitable Gift Annuities are technically referred to as split interest gifts. For life income gift arrangements in general, there is a charitable interest and a non-charitable interest. The payout to the beneficiary is the non-charitable portion, but the remainder left for the charity – the residuum – is the other side of the coin. We all know that payout rates need to be attractive to new prospective donors, but we should also take a look at what happens after the beneficiaries die. This is difficult information to gather, because there is generally a dearth of statistics available on planned gifts. There are no government tables showing how much is typically left for the charity from either a CGA or a PIF participation.

PG Calc provides planned gift administration services for a large number of charitable organizations s. In randomized and blind searches through the data we maintain, we find that the average residuum for gift annuities is approximately 70%. That actually seems reasonable, given that the premise of a CGA is that payments will be made from both the original principal of the gift and from the income earned on that principal amount. The ACGA sets recommended payout rates with a goal of achieving at least a 50% residuum on average. Despite abnormal years in the stock markets (like 2008), the long-term average returns for major U.S. stock indices are in the range of 7 to 10%. If a typical gift annuity investment pool is 50% in stocks, the average annual return would be around 4% (the annual returns from bonds would typically be zero or close to zero for these types of portfolios). If the average annual return is around 4%, and the gift annuity pool pays out approximately 6% on average each year, it's clear that there would be some measurable invasion of principal consistently over time.

When we run randomized and blind searches for the average residua on Pooled Income Fund gifts, however, we come up with very different results. We found after a number of searches that the typical residuum on a PIF gift is around 140% of the original principal. *That's right*. The original PIF gift amounts increased by around 40% over the long run. Because the Pooled Income Fund distributes only the actual earned income, net of all expenses, the original principal (from donors' gifts) is never invaded for payments to the participants. All of that principal remains intact. If there is any measurable portion of the portfolio invested in quality stocks or stock funds, the values of those holdings will typically increase over time. And to make the pot even richer, any long-term capital gains realized from the sales of investments in the portfolio (or received from holdings in mutual funds) will be added to principal of the Fund and reinvested. So there is continual accumulation and reinvestment in new assets, to enable the long term growth in the value of the investment portfolio. This is a dramatically different model from the CGA over the long run. The basic design of a CGA program is to sustain a significant degree of principle erosion over time, while the design of a Pooled Income Fund is to allow and encourage the original principal to grow.

So why aren't charities at least considering a certain level of promotion for their Pooled Income Funds? Wouldn't it be worthwhile to try to find at least a modest number of new donors who are willing to accept the lower rates of income in exchange for better (larger) eventual gifts to the charity? Especially considering that the charitable income tax deductions are at historically high proportions of the principal funding amounts (which we'll cover a bit later)? The answer is unclear and likely varies from one charity to the next. We know that the Pooled Income Fund has to compete with higher nominal payout rates offered by Charitable Gift Annuities, but as PIFs across the board have dwindled in terms of market values and numbers of participants, the effort and costs of running them has contributed to their further demise.

Let's take a look at what's actually involved in maintaining an existing Pooled Income Fund, and the potential costs of those efforts. First and foremost, the PIF is a trust – it is governed by trust laws, each PIF has its own tax identification number, and the Trustee for each PIF has to file at least one federal income tax return each year. Sometimes additional returns are due at the federal level, and in some cases, the Trustee is also required to file tax returns for the state in which the PIF is located. The costs of preparing tax returns is not insignificant – depending on other aspects of the business relationship, it's probably fair to estimate on a very rough basis that each tax return will cost the Trustee around $1,000. If there are 2 federal returns and 2 state returns, that's $4,000 per annum regardless of the size of the Fund. If the assets are in the neighborhood of $500,000 or more, that $4,000 is less than one percent of the total value. If the PIF is worth significantly less than $500,000, it's obvious that the cost of the tax returns could become prohibitive.

On top of the costs of the required tax reporting, the assets of the Pooled Income Fund require ongoing management. The assets of a Charitable Gift Annuity program also require active management, but the PIF assets are a little more difficult because of the more obvious tension between principal and income – with a CGA program, payments are made from both principal and income, whereas with a PIF, the income is clearly for the benefit of the donors / participants, and the principal is solely for the benefit of the charitable remainder entity. An asset manager who understand the difference and who follows the prudent investor standards will need to exert more effort in an attempt to strike an appropriate balance between the two interests. It's classic trust management and it tends to be more expensive than a simple total-return posture that is adequate for the CGA program.

In addition to the tax reporting and asset management costs, a Pooled Income Fund requires administration by a person or group who understands the unique characteristics of the vehicle. CGA payments can be scheduled ahead of time, because the exact payment amount for each annuitant is already established from the point of the original creation of the gift arrangement. With a Pooled Income Fund, however, the income is variable – the Trustee needs an administrator who knows how to analyze the income and other transaction activity in the investment portfolio in order to determine how much net income is available for distribution to the participants each period (usually a calendar quarter). This determination can only be made after the close of the period, which means payment amounts are computed during the first or second week of the new quarter. Because of the greater complexity of determining and issuing PIF payments, the administration costs are usually higher than those for comparable Gift Annuity Funds.

Unlike the fees for tax preparation, which tend to be at flat rates, the fees for asset management and administration services are usually based on either the total value of the assets, or the total number of participants, or some combination thereof. Traditionally, investment management has hovered around 1% of the total value of the assets, whereas the fees for administration services vary widely. Some financial services providers agree to provide administration for an additional percentage of the total asset value, and other vendors will simply asses fees on a per unit basis (number of participants, number of checks issued, number of K-1s produced, etc.).

Of course, as in all things related to money, the larger the size of the business, the smaller the level of fees. While the typical costs for investment management and administration services "off the shelf" would probably each be around 1% of the total market value, especially if they were delivered separately, service providers are frequently willing to provide services at much lower rates if the asset value is above a certain threshold, like $1 million or $5 million or even $10 million. On top of that, if the sponsoring charities have significant endowment and / or pension fund balances managed under the same umbrella arrangement, the costs for handling the planned giving program can be surprisingly low – like 50 basis points (half of a percent) or less based on the value of the assets.

Putting aside any significant discounting opportunities – which likely are unavailable for the majority of Pooled Income Fund situations – the combination of the three areas of carrying costs for Pooled Income Funds can be overwhelming for many sponsoring charities. For the larger organizations, they have advantages not only of bundled and discounted pricing for services, but also, they have the ability to absorb any or all of the expenses out of pocket

In the cases of smaller organizations who have larger PIF asset values, the costs can be paid out of the investment portfolio and not cause too much damage – for example, on an $800,000 Pooled Income Fund, the combined asset management and administration cost might be 1 ½% of the total value each year – which would be $12,000 – but the costs of the tax returns at most would only be another $4,000. The total carrying costs of $16,000 would not be insignificant – a total of 2% on the portfolio value – but with good investment management, positive investment returns would still be possible in the long run.

The Pooled Income Funds that are at a clear disadvantage are the ones whose costs cannot be subsidized by the sponsoring charities and whose values are below the threshold of being self-sustaining – which is probably somewhere in the neighborhood of $500,000. For these PIFs, the carrying costs will create continual erosion of principal that cannot be recovered even in the long run.

It is this last group of PIFs – those with smaller asset values and whose costs cannot be covered out-of-pocket – that find themselves in trouble these days. A $200,000 Pooled Income Fund with $4,000 each year in tax return fees and $4,000 each year in asset management and administration fees likely will be in continual state of bleeding value. As the portfolio value sinks lower and lower, the sponsoring charity throws up its hands and looks for ways to get rid of the problem.

This brings us to a handful of possible solutions for the languishing vehicle. Perhaps the easiest choice – and most lucrative for the charity - is to close out the Fund by convincing the participants to relinquish their income interests permanently and irrevocably. This solution works especially well if the participants are all donors themselves – they have a historical interest in the well-being of the charitable organization and will be more likely to give up the modest stream of income than a participant who has no direct connection to the charity.

The practice of relinquishing interests in life income gifts is becoming more common in general; many donors realize after 15 or 20 years that they don’t really need the income anymore, and that waiting until March to receive a Form K-1 (for PIFs and Charitable Remainder Trusts) is more aggravation than it’s worth. They’d rather give up the income interest, receive an additional charitable deduction, and complete the charitable gift now while they are still alive. Surrendering the income interest in a PIF actually can be a better deal than surrendering the interest in a CGA, all other things being equal. With the CGA, many planned giving professionals opine that there is only a charitable deduction if the annuitant has NOT outlived their original life expectancy. With the relinquishment of a PIF participation, there is *always* a charitable deduction, because it’s based on the value of the participant’s income interest, and there is *always remaining value in the participant’s income interest.*

The additional charitable income tax deduction for the voluntary surrender of a PIF participation is relatively straightforward to compute – it’s very similar to the calculation of the charitable income tax deduction when a new PIF contribution is made. The computation is based on the current value of the participant’s units in the fund, the date of birth of the participant, the date of surrender, and the highest “Pooled Income Fund Rate of Return” for the past 3 calendar years. The remainder factors in the IRS tables are used just as they are in the computation for the new gift, only in this case, the deduction is for the opposite of the estimated value of the benefit for the charity; this time, it’s for the estimated value of the remaining lifetime of income payments for the PIF participant. The PIF will be entitled to take their charitable income tax deduction for the calendar year in which the surrender occurs. There is little documentation required, generally just a one-page form which documents the participant giving up the income interest permanently and irrevocably.

While the easiest and most lucrative method to close a dying PIF is having the participants relinquish their income interests, the sponsoring charity may not be able to convince all of the participants to take such action. An alternative is to offer participants a cash payment for surrendering their interests. The method of calculating the value of the interest is the same as with a voluntary surrender. Instead of taking a charitable income tax deduction, however, the PIF participant receives a check for the value of his or her income interest. The documentation would still be the same as for the voluntary surrender – the participant needs to document that the income interest is forever given up. But the charity needs to go a step further and issue some kind of tax reporting form at the end of the calendar year, indicating that the PIF participant received the one-time payment. PG Calc cannot dispense tax advice, but general indications are that some variation of a Form 1099 is required, and the recipient may be taxed on the whole amount as ordinary income.

There is another possible solution for the languishing Pooled Income Fund on its last legs – the "conversion" of each PIF participation into a Charitable Gift Annuity. This involves the same computation of the participant's income interest as explained above, but in this instance, that value is used as the funding amount for a Charitable Gift Annuity for the same individual. The logic is beautiful – get everyone out of that annoying dinosaur Pooled Income Fund by promising to pay them a specific amount every quarter. This way, the charity no longer has the carrying costs of the PIF, and the donor / beneficiary receives a Form 1099R at the end of January. The problem with this solution is that the resulting gift annuity typically doesn't pay as much as the Pooled Income Fund did. The CGA is not being established using the entire value of the person's PIF units, but rather, it is being established using the value of the remaining income interest. It's like trying to earn income on income itself – the payout rate may be higher, but the underlying value on which the payout is based is significantly less. Still, it may work in some situations, and is worth considering as a last resort.

IV. THE EXISTING POOLED INCOME FUND – POSSIBLY WORTH RESURRECTING?

Closing down a languishing Pooled Income Fund that appears to have no reasonable hope for future success is clearly the easiest solution to the "PIF problem," and this seems to be the most popular choice for charitable organizations these days. Even charities that don't take direct action to shut down their PIFs are essentially doing the same thing by allowing their Funds to die a slow and silent death. While we recognize that in some cases, it makes sense to put the PIF out of its misery, by doing this webinar, we hope to show you other potential ways to deal with the "PIF problem." We want you to know all of the possibilities and make the decision that best fits your situation.

If you ask any gift planner why the Pooled Income Fund is no longer a viable choice for life income gift arrangements, he or she will typically reply that donors aren't interested in PIFs because they don't pay enough income compared to CGAs. There is certainly truth in this response, but if the organization realizes the potential superior results of a Pooled Income Fund in the long run – residuum values well above original funding amounts as opposed to residuum values for CGAs well below original gift amounts – perhaps at least part of the problem is that Pooled Income Funds are not being presented in the appropriate ways. As we said earlier, the income from a Pooled Income Fund is only the net earned income in the portfolio, as opposed to the payout from a Gift Annuity, which pays no heed to how much the investments are actually earning behind the scenes. What if we looked at the PIF income as a percentage of the original principal amount instead of measuring it as a percent of the current market value?

Let's think about that. CGAs are structured according to payout rates based on the original principal fund amounts; the payout amounts never change, and the payout rate is always quoted as that original percentage. The underlying market values of CGAs actually change over time, but we never look at that dynamic – we just keep referring to it as a 5% payout, or whatever it is. In the investment arena there is a concept known as effective payout rate, which basically means quoting a payment or return based on the original principal amount rather than on the current principal value. If we take a Pooled Income Fund gift that pays income to the participant at the rate of 3% each calendar year, but the value of the Fund grows steadily over time, that effective payout rate actually goes up.

Using an amount for which the initial math is simple, if the gift is for $10,000, the income paid out in the first year will be $300, and the principal value increases by 4%. So in year 2, the principal value is at $10,400. We assume that the income is still produced at the same rate relative to the current market value – 3% - because we simply buy more units of the same investments that have producing the 3% income rate of return – so the income paid out on this gift in year 2 will be $312. If we express that income as a percent of the original funding amount, the effective payout rate goes up to 3.12%. That doesn't seem like much difference, but if you extrapolate over 5 or 10 or 20 years, the resulting effective payout rates become noticeably higher. Here are some actual numbers: after 5 years, the effective payout rate goes to 3.5%; after 10 years, it becomes 4.4%; after 15, it goes to 5.4%, after 20, it goes to 6.6%. And in cases involving relatively younger donors, after 25 years, the effective payout rate is at 8.0%. That's right, ladies and gentlemen, the effective payout rate on a Pooled Income Fund participation after 25 years is 8%! If a donor contributes to a Pooled Income Fund at the age of 60, and is alive after 25 years, they would be receiving an effective payout rate of 8%. For a newly established CGA, the 85-year-old donor would only start receiving payments at the rate of 7.8%, and would not have received any of the income for the previous 24 years.

This is an example of how effective a Pooled Income Fund participation can be for relatively younger donors – those in their 50s and 60s. Sending income payments back to the charity to be used as additional contributions to the PIF will accelerate the growth in the value of the units, and the resulting effective payout rates, to even more dramatic numbers. We believe this is a story that has not been communicated effectively to the legions of potential PIF donors. If donors were made aware of the possibility of contributing cash and / or securities to the Pooled Income Fund, and if they understood the combined benefit of the charitable income tax deduction and eventual effective payout rates, we think more people would be interested in knowing about this vehicle.

Speaking of contributing securities, there is a special distinction for the Pooled Income Fund that is unique among the life income gift choices. With CGAs and CRTs, when a donor contributes a highly-appreciate long term asset (like stock) to the charity or trust, the donor escapes taxation on only a portion of the long-term capital gains. With a CGA, the "reportable capital gain" will be computed at the creation of the gift arrangement, and as long as the donor is the annuitant (or first annuitant) the reportable gain will be distributed ratably over the donor's life expectancy. With a CRT, the trust realizes the long-term gains, and as a tax-exempt entity, the trust pays no tax on the gains. When the periodic payments are made to the beneficiary, however, a portion of each payment is typically categorized and reported as capital gains – the very capital gains realized inside the trust when the funding asset was sold. The amount cannot be computed in advance for future years – it is determined one year at a time, in conjunction with the preparation of the trust's tax returns. So with CGAs and CRTs, the donor almost always ends up paying taxes on portions of the long-term gains in the assets donated.

With a Pooled Income Fund, in contrast, the donor who contributes an appreciated long-term asset (such as stock) never pays tax on any of the long-term capital gains. The PIF manager sells the contributed stock, and the capital gains are realized inside the Pooled Income Fund, which is a tax-exempt account; but unlike the CGA and CRT, none of the capital gains are ever distributed back to the donor, and therefore, the donor is never taxed on those gains. This is due to the basic structure of a Pooled Income Fund – the income paid to participants is only the net income earned after expenses. Realized capital gains are on the principal side of the ledger sheet and are never distributed to the PIF participants. This means that donors can truly walk away from taxation on all long-term gains in assets that are contributed to a PIF.

The other aspect of existing Pooled Income Funds that we need to discuss is the availability of historically high charitable income tax deductions for new contributions. The deductions are abnormally high right now because the official "Pooled Income Fund Rate of Return" for recent years has been so low. For every PIF, for each calendar year, the IRS requires a specific computation to determine the "rate of return," which is, in reality, simply an adjusted income yield calculation. Basically, the average market value is computed for the year, and the total income is divided by the average market value to determine the "return" (yield). There are some slight adjustments to compensate for the time value of money relevant to when the beneficiary payments were made, but in general, the "return" calculation is really just an income yield calculation.

When the charitable deduction is calculated for a new gift to an existing Pooled Income Fund, the proportion of the funding principal that is considered to be the value of the remainder to the charity is based on the highest "PIF Rate of Return" for the past 3 calendar years. The PIF Rate of Return is used by the IRS to determine how much income the donor will receive in the future for his or her gift; the total principal funding amount minus the value of the future income equals the charitable benefit for deduction purposes. Because the rates of income are so low, there is relatively little projected income for the PIF participant, which means that the IRS considers a large portion of the funding principal to be for the benefit of the charity.

Let's compare the charitable deduction calculation right now for a $10,000 gift made by a single 70-year-old donor. The ACGA recommended payout rate would be 5.1% and if payments are quarterly, the charitable income tax deduction is approximately $4,002. With a new contribution to an existing PIF whose 3-year-high rate of return is only 2.5%, however, the deduction would be $7,158. That's a huge difference!

There is an investing concept known as *Return (or Yield) Based on Cost of Plan* which takes into account the true cost of an investment. With life income gifts, the true cost of the plan includes any tax savings obtained from the charitable income tax deduction. With the CGA, the true cost of the gift plan for an individual at the 28% tax bracket is $8,880: the deduction amount of $4,002 results in a tax savings of $1,120, meaning that the net out-of-pocket cost is $10,000 - $1,120 = $8,880. For the PIF gift, the true cost of the gift plan for the same donor is $7,996: the deduction of $7,158 results in a tax savings of $2,004, bringing the net out-of-pocket cost to

$10,000 - $2,004 = $7,996. The nearly $900 difference in cost between the CGA and PIF for this donor would be even greater if he or she were in a higher tax bracket, such as 35% or 39.6%.

When we compare the returns (or yields) based on cost of plan for the CGA and the PIF gift, the numbers are quite compelling for the PIF gift. For the Charitable Gift Annuity funded with $10,000 in cash by a 70 year-old donor in the 28% tax bracket, the return based on cost of plan is 7.4% during the donor's life expectancy; this is due to the large amount of *tax-free income* ($377 out of $510 annually) that is paid out during those 16 years. If the donor lives longer than the original life expectancy, the return based on cost goes down to 5.7% thereafter. For the PIF, the income *amount* is increasing from year to year, and the true cost of the plan is always $7,996, so after 15 years, the return based on cost is already up to 6.8%, and after 20 years, *the return based on cost is up to 8.2%*. These numbers show that once again, the payout rate for the PIF is actually much higher than the rate commonly quoted when we look more carefully at the actual numbers and use a more appropriate way of measuring them.

We have reviewed various ways of looking at an existing Pooled Income Fund and seen potential value from various perspectives. The decision by a sponsoring charity on whether or not to resurrect / relaunch a languishing PIF is unique to every situation. In some situations, the true rate of income on a PIF may be better than it appears at first blush when using either an effective rate of return calculation or a return based on cost of plan calculation. Convincing potential donors to make new contributions to a PIF will depend in part on the extent to which they understand and appreciate the more thoughtful ways of measuring the return. It will also depend in part on the importance of the relatively high charitable deductions and the ability to escape any future taxation on long-term appreciation on stocks and certain other types of property.

V. Establishing a New Pooled Income Fund

As we mentioned at the beginning of this discussion, now may actually be the best time to start a new Pooled Income Fund. While that may not make sense to the many people who have watched existing PIFs sinking into oblivion, the current environment offers some unique benefits for new PIFs. The biggest news out there for Pooled Income Funds is the availability of historically high charitable income tax deductions for PIF gifts right now. This is especially pronounced on new PIFs.

The IRS requires that for additional gifts to existing PIFs, the calculations for the charitable deductions need to be based on the highest of the PIF rates of return for the last 3 calendar years. For a new PIF, however, there are no previous years' rates of return; instead, the IRS dictates a specific number to be used instead. For gifts made to new PIFs in 2015, the assumed rate of return as dictated by the IRS is 1.2%. That is a very low rate to use and results in a very high deduction.

For our $10,000 gift from a 70-year-old donor, the charitable income tax deduction to a "new" PIF in 2015 is $8,470. That means the donor is able to deduct about 85% percent of the total funding amount. The tax savings from that deduction, for the donor in the 28% bracket, would be $2,371, resulting in a true cost of gift of $7,629. If we measure the yield on the cost of the gift plan, we get a rate of return after 15 years of 7.1% and a rate of return after 20 years of 8.6%. Those are great rates of return for any type of investment, but they are amazing rates of return for a split interest gift arrangement that also provides a significant benefit to the charity after the death of the donor.

Is it reasonable to assume that donors will participate in a Pooled Income Fund for 15 or 20 years? Or even longer? That depends on how the PIF is presented and marketed to the charity's donor constituency. If the emphasis is on a gift vehicle that provides a relatively high rate of return immediately, the PIF obviously isn't the right vehicle. Donors who are in their 70s or older likely won't be interested in a gift vehicle that takes so many years to reach full potential. But after all, in planned giving, we see a fair number of donors in their 50s and 60s, who would like to establish a life income gift, and who are told they are simply too young. Instead of turning this group away, or insisting they establish a deferred gift annuity, why not offer them a participation in a Pooled Income Fund? Their charitable deduction will be higher than that for a Charitable Gift Annuity, and if they contribute their income payments as additional contributions to the PIF for a certain number of years, their eventual "return" may equal or exceed that for a CGA. Shouldn't we at least be offering a choice to the donors? To use that wonderful contradiction in terms, "there are some definite possibilities here!"

So if an organization decides to consider establishing a new Pooled Income Fund, what exactly is involved? The first question should be the same first question as when a donor decides to establish a Charitable Remainder Trust: "Who is going to serve as Trustee?" As mentioned earlier, the Pooled Income Fund is actually a type of Charitable Trust, and for a trust to be created, there has to be a Trustee. The Trustee of a PIF can be the sponsoring charity itself, or it can be an attorney, a trust company, a bank, or a financial institution - any person or entity who is qualified to take responsibility for the ongoing operation of the PIF and who is legally allowed to serve in that capacity. There can even be co-trustees, such as the sponsoring charity and a bank.

Like with any trust, the party establishing the PIF needs to work with a competent attorney, preferably someone who is familiar with the establishment of charitable trusts. The attorney will draft the governing trust document, and the IRS makes a sample version available to the public. The attorney also needs to produce the different variations of the individual gift agreement documents which will be used by donors to make contributions. The IRS provides samples for these documents as well (see Appendix). This legal process generally will require a few hours of billable time by a qualified attorney. The cost will be modest, but should be anticipated as part of the startup process.

Corollaries to that initial and critical question regarding who will serve as Trustee are two other questions that must be addressed before establishing a Pooled Income Fund: "Who is going to manage the assets?" and "Who is going to serve as administrator?" These aspects may be handled by one service provider, or they may be handled by separate parties. The asset manager needs to understand the specialized investment process for Pooled Income Funds – determining how much emphasis is to be placed on creating current income and how much emphasis will be placed on long-term growth of principal value. This investment objective needs to be communicated clearly to the donor constituency.

The importance of the role of the administrator cannot be overstated. The party who assumes responsibility for issuing the checks and complying with tax reporting requirements affects the overall success of the PIF every bit as much as the other parties involved. Payments and tax forms must be accurate and timely, which depends on the quality of the ongoing administration – maintaining error-free records, processing new gifts, handling terminations, analyzing net income activity, providing periodic reports, and so on.

All of these aspects combined make for a significant amount of work, for which the overall expense may seem hard to justify. We are in no way dismissing the considerable level of work and expense required by Pooled Income Funds, but keep in mind that CGAs can be complicated and expensive to handle as well. The basic components of issuing the annuities, making payments, and sending Form 1099Rs are all fairly routine work, but anyone who has worked with the registration and annual reporting requirements in one or more highly-regulating states can vouch for the additional costs involved with some CGA programs. Between the annual reporting fees by certain states and the costs of putting all of the information together each year, not to mention the rounds of discussions and reports for auditors on the liability estimates, a gift annuity program can be much more complicated and expensive to handle than would appear at first blush.

As we have said earlier, we want gift planners and charitable organizations in general to be aware of the possible benefits from starting or re-starting a Pooled Income Fund, and we want our clients to have a better understanding of the relative costs that go along with PIFs. But we don’t want to overstate the benefits of PIFs. The last thing the planned giving community needs is a sudden influx of people looking for Pooled Income Funds who have no real charitable intent. In recent months we have seen a dramatic increase in the number of inquiries about Pooled Income Funds. Some have been from charitable organizations, but others have been from those in the for-profit sector who have discovered the startup PIF as the next greatest-thing-ever. There are companies and individuals who are looking to leverage the abnormally large charitable deductions for new PIFs into investment schemes that are clearly not in line with the split interest charitable gift arrangements envisioned under the federal tax rules.

VI. Conclusion

In summary, we hope this paper has helped to provide information about the range of possibilities for Pooled Income Funds that exist in today’s environment. The historically low IRS discount rate results in unusually high charitable income tax deductions for contributions to Pooled Income Funds – especially those to new PIFs. In addition, the way we have been looking at the payout rates on Pooled Income Funds has not truly recognized the real rate of return. If we express the return based on the original funding amount, known as the effective rate of return – and this is how we measure the return on CGAs - the “payout rate” is actually much higher, especially over the long run, as the principal value and resulting income continually increase. We can also measure the return on PIFs using a return based on cost method, which makes the payout rate even higher than the effective rate.

The effort and related expense of starting and maintaining a Pooled Income Funds are significant and cannot be overlooked. The PIF is a Trust, which requires someone or some entity to serve as Trustee; there also needs to be an asset manager and a professional administrator. The requirement of computing net income each period (quarter) and the complex nature of the tax reporting responsibilities make the PIF a more difficult and expensive vehicle to run than a Charitable Gift Annuity program. But CGAs are governed by a complex patchwork of state regulations, and the cumbersome requirements by certain highly-regulated states render the costs of a CGA program much higher than appears at the surface. Further, the size of the PIF and the ability of the sponsoring organization to absorb some or all of the expenses will make a huge difference to the degree of success the PIF is able to enjoy.

Clearly not every organization should have a Pooled Income Fund, and some existing PIFs should be closed down. It is possible for the sponsoring charity to close a PIF without waiting for the last of the participants to pass away. For an existing PIF, however, we feel strongly that the organization should look carefully at the potential benefits and costs with a full range of tools necessary to analyze all of the costs – both obvious and hidden - of PIFs and CGAs. The Pooled Income Fund has particular strengths for relatively younger donors – high deductions that are valuable during the final working years – and future income, which is so important for the retirement years. We want our clients to understand the range of possibilities for the Pooled Income Fund and we hope that each organization makes its decision on PIFs based on a true understanding of the costs and benefits.

Appendix

Sample pooled income fund declaration of trust and sample 1-life and 2-life pooled income fund instruments of transfer from Revenue Procedure 88-53.

SECTION 1. PURPOSE.

This revenue procedure makes available a sample form of declaration of trust and instruments of transfer that meet the requirements for a pooled income fund as described in section 642(c)(5) of the Internal Revenue Code.

SEC. 2. BACKGROUND

The Internal Revenue Service receives and responds to many requests for rulings dealing with the qualification of trusts as pooled income funds and the availability of deductions for contributions made to such trusts. In many of these requests, the trust instruments and charitable objectives are very similar. Consequently, in order to provide a service to taxpayers and to save the time and expense involved in requesting and processing a ruling on a proposed pooled income fund, taxpayers who make transfers to a trust that substantially follows the model trust instrument contained herein can be assured that the Service will recognize the trust as meeting all of the requirements of a qualified pooled income fund, provided the trust operates in a manner consistent with the terms of the trust instrument and provided it is a valid trust under applicable local law.

SEC. 3. SCOPE AND OBJECTIVE

The sample declaration of trust and instruments of transfer made available by this revenue procedure meet all of the applicable requirements for a pooled income fund under section 642(c)(5) of the Code, if the trust document also creates a valid trust under local law. If the public charity responsible for the creation and maintenance of a pooled income fund makes reference in the trust instrument of the fund to this revenue procedure, and adopts substantially similar documents, the Service will recognize the trust documents as satisfying all of the applicable requirements of section 642(c)(5) of the Code and the corresponding regulations. Moreover, for transfers to a qualifying pooled income fund, the remainder interest will be deductible under sections 170(f)(2)(A), 2055(e)(2)(A), and 2522(c)(2)(A) of the Code for income, estate, and gift tax purposes, respectively. Therefore, it will not be necessary for a taxpayer to request a ruling as to the qualification of a substantially similar trust, and the Service generally will not issue such a ruling. See Rev. Proc. 88-54, page 16, this Bulletin.

SEC. 4. SAMPLE DECLARATION OF TRUST

On this __ day of __________, 19__, the Board of Trustees of the __________ Public Charity (hereinafter referred to as "Public Charity") desiring to establish a pooled income fund within the meaning of Rev. Proc. 88-53 and section 642(c)(5) of the Internal Revenue Code (hereinafter referred to as "the Code"), hereby creates the __________ Public Charity Pooled Income Fund (hereinafter referred to as "the Fund") and designates _________ as the initial trustee to hold, manage, and distribute such property hereinafter transferred to and accepted by it as part of the Fund under the following terms and conditions.

1. GIFT OF REMAINDER INTEREST. Each donor transferring property to the Fund shall contribute an irrevocable remainder interest in such property to Public Charity.

2. RETENTION OF LIFE INCOME INTEREST. Each donor transferring property to the Fund shall retain for himself or herself an income interest in the property transferred, or create an income interest in such property for the life of one or more named beneficiaries, provided that each income beneficiary must be a living person at the time of the transfer of property to the Fund by the donor. If more than one beneficiary of the income interest is named, such beneficiaries may enjoy their shares concurrently and/or consecutively. Public Charity may also be designated as one of the beneficiaries of the income interest. The donor need not retain or create a life interest in all of the income from the property transferred to the Fund and any income not payable to an income beneficiary shall be contributed to, and within the taxable year of the Fund in which it is received paid to, Public Charity.

3. COMMINGLING OF PROPERTY. The property transferred to the Fund by each donor shall be commingled with, and invested or reinvested with, other property transferred to the Fund by other donors satisfying the requirements of this instrument and of section 642(c)(5) of the Code or corresponding provision of any subsequent federal tax law. The Fund shall not include property transferred under arrangements other than those specified in this instrument and satisfying the said provisions of the Code.

All or any portion of the assets of the Fund may, however, be invested or reinvested jointly with other properties not a part of the Fund that are held by, or for the use of, Public Charity. When joint investment or reinvestment occurs, detailed accounting records shall be maintained by the Trustee specifically identifying the portion of the jointly invested property owned by the Fund and the income earned by, and attributable to such portion.

4. PROHIBITION AGAINST EXEMPT SECURITIES. The property transferred to the Fund by any donor shall not include any securities whose income is exempt from taxation under subtitle A of the Code or the corresponding provisions of any subsequent federal tax law. The Trustee of the Fund shall not accept or invest in such securities as part of the assets of the Fund.

5. MAINTENANCE BY PUBLIC CHARITY. Public Charity shall always maintain the Fund or exercise control, directly or indirectly, over the Fund. Public Charity shall always have the power to remove any Trustee or Trustees and to designate a new Trustee or Trustees.

6. PROHIBITION AGAINST DONOR OR BENEFICIARY SERVING AS TRUSTEE. The Fund shall not have as a Trustee a donor to the Fund or a beneficiary (other than Public Charity) of an income interest in any property transferred to the Fund. No donor or beneficiary (other than Public Charity) shall have, directly or indirectly, general responsibilities with respect to the Fund that are ordinarily exercised by a Trustee.

7. INCOME OF BENEFICIARY TO BE BASED ON RATE OF RETURN OF FUND. The taxable year of the Fund shall be the calendar year. The Trustee shall pay income to each beneficiary entitled thereto in any taxable year of the Fund in the amount determined by the rate of return earned by the Fund for the year with respect to the beneficiary's income interest. Payments must be made at least once in the year in which the income is earned. Until the Trustee determines that payments shall be made more or less frequently or at other times, the Trustee shall make income payments to the beneficiary or beneficiaries entitled to them in four quarterly payments on or about March 31, June 30, September 30, and December 31 of each year. An adjusting payment, if necessary, will be made during the taxable year or within the first 65 days following its close to bring the total payment to the actual income to which the beneficiary or beneficiaries are entitled for that year.

On each transfer of property by a donor to the Fund, there shall be assigned to the beneficiary or beneficiaries of the income interest retained or created in the property the number of units of participation equal to the number obtained by dividing the fair market value of the property transferred by the fair market value of a unit in the Fund immediately before the transfer. The fair market value of a unit in the Fund immediately before the transfer shall be determined by dividing the fair market value of all property in the Fund at that time by the number of units then in the Fund. The initial fair market value of a unit in the Fund shall be the fair market value of the property transferred to the Fund divided by the number of units assigned to the beneficiaries of the income interest in that property. All units in the Fund shall always have equal value.

If a transfer of property to the Fund by a donor occurs on other than a determination date, the number of units of participation assigned to the beneficiary or beneficiaries of the income interest in the property shall be determined by using the average fair market value of the property in the Fund immediately before the transfer, which shall be deemed to be the average of the fair market values of the property in the Fund on the determination dates immediately preceding and succeeding the date of transfer. For the purpose of determining the average fair market value, the property transferred by the donor and any other property transferred to the Fund between the preceding and succeeding dates, or on such succeeding date, shall be excluded. The fair market value of a unit in the Fund immediately before the transfer shall be determined by dividing the average fair market value of the property in the Fund at that time by the number of units then in the Fund. Units of participation assigned with respect to property transferred on other than a determination date shall be deemed to be assigned as of the date of the transfer.

A determination date means each day within a taxable year of the Fund on which a valuation is made of the property in the Fund. The property of the Fund shall be valued on January 1, April 1, July 1, and October 1 of each year; provided, however, that where such date falls on a Saturday, Sunday or legal holiday (as defined in section 7503 of the Code and the regulations thereunder), the valuation shall be made on the next succeeding day which is not a Saturday, Sunday or legal holiday.

The amount of income allocated to each unit of participation in the Fund shall be determined by dividing the income of the Fund for the taxable year by the outstanding number of units in the Fund at the end of the year, except that income shall be allocated to units outstanding during only part of the year by taking into consideration the period of time the units are outstanding during the year.

For purposes of this instrument, the term "income" has the same meaning as it does under section 643(b) of the Code or corresponding provision of any subsequent federal tax law and the regulations thereunder.

The income interest of any beneficiary of the Fund shall terminate with the last regular payment of income that was made before the death of the beneficiary. The Trustee of the Fund shall not be required to prorate any income payment to the date of the beneficiary's death.

8. TERMINATION OF LIFE INCOME INTEREST. Upon the termination of the income interest of the designated beneficiary (or, in the case of successive income interests, the survivor of the designated beneficiaries) entitled to receive income pursuant to the terms of a transfer to the Fund, the Trustee shall sever from the Fund an amount equal to the value of the remainder interest in the property upon which the income interest is based. The value of the remainder interest for severance purposes shall be its value as of the date on which the last regular payment was made before the death of the beneficiary. The amount so severed from the Fund shall be paid to Public Charity. If at the time of severance of the remainder interest Public Charity has ceased to exist or is not a public charity (an

organization described in clauses (i) through (vi) of section 170(b)(1)(A) of the Code), the amount severed shall be paid to an organization selected by the Trustee that is a public charity.

9. PROHIBITED ACTIVITIES. The income of the Fund for each taxable year shall be distributed at such time and in such manner as not to subject the Fund to tax under section 4942 of the Code. Except for making the required payments to the life income beneficiaries, the Trustee shall not engage in any act of self-dealing as defined in section 4941(d) and shall not make any taxable expenditures as defined in section 4945(d). The Trustee shall not make any investments that jeopardize the charitable purpose of the Fund within the meaning of section 4944 or retain any excess business holdings within the meaning of section 4943.

10. DEPRECIABLE OR DEPLETABLE ASSETS. The Trustee shall not accept or invest in any depreciable or depletable assets.

11. INCORPORATION BY REFERENCE. The provisions of this document may be, and are intended to be, incorporated by reference in any will, trust, or other instrument by means of which property is transferred to the Fund. Any property transferred to the Fund whereby an income interest is retained or created for the life of one or more named beneficiaries, where this document is not incorporated by reference, shall become a part of the Fund and shall be held and managed under the terms and conditions of this document, unless the instrument of transfer is inconsistent with such terms and conditions, in which case the Trustee shall not accept the property.

12. GOVERNING LAW. The operation of the Fund shall be governed by the laws of the State of __________. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualification of the Fund under section 642(c)(5) of the Code and the corresponding regulations.

13. POWER OF AMENDMENT. The Fund is irrevocable. However, Public Charity shall have the power, acting alone, to amend this document and the associated instruments of transfer in any manner required for the sole purpose of ensuring that the Fund qualifies and continues to qualify as a pooled income fund within the meaning of section 642(c)(5).

IN WITNESS WHEREOF __________ [PUBLIC CHARITY] AND __________,

[TRUSTEE] by their duly authorized officers have signed this

agreement the day and year first above written.

____

[PUBLIC CHARITY]

By _________________

____

[TRUSTEE]

By _________________

[Acknowledgements, Witnesses, etc.]

SEC. 5. SAMPLE INSTRUMENT OF TRANSFER: ONE LIFE

On this __ day of __________, 19__, I hereby transfer to the __________ Public Charity Pooled Income Fund, under the terms and conditions set forth in its Declaration of Trust, the following property: ____________________.

The income interest attributable to the property transferred shall be paid as follows:

__ A. To me during my lifetime.

__ B. To __________ during his or her life. However, I reserve the right to revoke, solely by will, this income interest.

Upon the termination of the income interest, the Trustee of the Fund will sever from the Fund an amount equal to the value of the remainder interest in the transferred property and transfer it to Public Charity:

__ A. For its general uses and purposes.

__ B. For the following charitable purpose(s): ______________ _______________________________.

However, if it is not possible for Public Charity in its sole discretion to use the severed amount for the specified purpose(s), then it may be used for the general purposes of Public Charity.

This instrument and the transfer of property made pursuant thereto shall be effective after acceptance by both the Donor and the Trustee.

IN WITNESS WHEREOF __________________ and __________________,

[TRUSTEE] by its duly authorized officer have signed this agreement

the day and year first above written.

____

[DONOR]

____

[TRUSTEE]

By _________________

(Acknowledgements, Witnesses, etc.)

SEC. 6. SAMPLE INSTRUMENT OF TRANSFER: TWO LIVES, CONSECUTIVE INTERESTS

On this __ day of __________, 19__, I hereby transfer to the _________ Public Charity Pooled Income Fund, under the terms and conditions set forth in its Declaration of Trust, the following property: ____________________.

The income interest attributable to the property transferred shall be paid as follows:

__ A. To me during my lifetime, and after my death to __________ during his or her lifetime. However, I reserve the right to revoke, solely by will, his or her income interest.

__ B. To __________ during his or her lifetime, and after his or her death to _________ during his or her lifetime. However, I reserve the right to revoke, solely by will, the income interest of either or both beneficiaries.

Upon the termination of the income interest, the Trustee of the Fund will sever from the Fund an amount equal to the value of the remainder interest in the transferred property and transfer it to Public Charity.

__ A. For its general uses and purposes.

__ B. For the following charitable purpose(s): ______________ ___________________.

However, if it is not possible for Public Charity in its sole discretion to use the severed amount for the specified purpose(s), then it may be used for the general purposes of Public Charity.

This instrument and the transfer of property made pursuant thereto shall be effective after acceptance by both the Donor and the Trustee.

IN WITNESS WHEREOF _______________ and _______________,

[TRUSTEE] by its duly authorized officer have signed this agreement

the day and year first above written.

____

[DONOR]

____

[TRUSTEE]

By __________________

(Acknowledgements, Witnesses, etc.)

SEC. 7. SAMPLE INSTRUMENT OF TRANSFER: TWO LIVES, CONCURRENT AND CONSECUTIVE INTERESTS

On this __ day of __________, 19__, I hereby transfer to the __________ Public Charity Pooled Income Fund, under the terms and conditions set forth in its Declaration of Trust, the following property: ____________________.

The income interest attributable to the property transferred shall be paid as follows:

__ A. __% to me during my lifetime, and __% to __________ during his or her lifetime. After the death of the first income beneficiary to die, the survivor shall be entitled to the entire income. However, I reserve the right to revoke, solely by will, __________'s income interest.

__ B. __% to __________ during his or her lifetime and __% to __________ during his or her lifetime. Upon the death of the first income beneficiary to die, the survivor shall be entitled to receive the entire income. However, I reserve the right to revoke, solely by will, the income interest of either or both beneficiaries.

Upon the termination of the income interest, the Trustee of the Fund will sever from the Fund an amount equal to the value of the remainder interest in the transferred property and transfer it to Public Charity.

__ A. For its general uses and purposes.

__ B. For the following charitable purpose(s): _______________ __________.

However, if it is not possible for Public Charity in its sole discretion to use the severed amount for the specified purpose(s), then it may be used for the general purposes of Public Charity.

This instrument and the transfer of property made pursuant thereto shall be effective after acceptance by both the Donor and the Trustee.

IN WITNESS WHEREOF _______________ and _______________,

[TRUSTEE] by its duly authorized officer have signed this agreement

the day and year first above written.

____

[DONOR]

____

[TRUSTEE]

By _________________

(Acknowledgements, Witnesses, etc.)

SEC. 8. APPLICATION

The Service will recognize a trust as meeting all of the requirements of a qualified pooled income fund under section 642(c)(5) of the Code if the public charity responsible for the creation and maintenance of the trust makes reference in the trust instrument of the fund to this revenue procedure and adopts substantially similar documents, provided the trust operates in a manner consistent with the terms of the trust instrument, and provided it is a valid trust under applicable local law. A trust that contains substantive provisions in addition to those provided by this revenue procedure (other than provisions necessary to establish a valid trust under applicable local law) or that omits any of those provisions will not necessarily be disqualified, but neither will it qualify under the provisions of this revenue procedure.

SEC. 9. EFFECTIVE DATE.

This revenue procedure is effective for ruling requests received in the National Office after November 28, 1988, the date of publication of this revenue procedure in the Internal Revenue Bulletin.

