AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

REPORT TO THE HOUSE OF DELEGATES

RECOMMENDATION

RESOLVED, That the American Bar Association recommends that the Congress amend section 642(c)(5) of the Internal Revenue Code of 1986 in order to permit pooled income funds to be invested more prudently for total return and to permit the creation of a unitrust interest in assets transferred to pooled income funds.

REPORT

POOLED INCOME FUNDS - UNITRUST INTEREST

Background

A pooled income fund is a trust maintained by a charitable organization described in Section 170(b)(1)(A)(i)-(vi) of the Internal Revenue Code, to which many donors may make gifts, retaining income interests for themselves or their designated beneficiaries and naming the charity that maintains the fund as the remainder beneficiary.

Statutory and Regulatory Framework

The pooled income fund was created by the 1969 Tax Reform Act as part of an overall reform of split-interest charitable gift provisions. Section 642(c)(5) and the regulations promulgated thereunder define a pooled income fund. It functions much like a mutual fund for the commingling and investment of retained life income gifts. All the income earned by the fund is paid out on a current basis to the income beneficiaries. On the death of the last income beneficiary of a particular gift, the corpus attributable to that gift is severed from the fund and transferred to or for the use of the charity. Unlike the interests in charitable remainder trusts, the income interest must be created for the life or lives of one or more individuals; a term of years is not permitted. The measuring lives must be individual beneficiaries. As in the case of a unitrust, there is no prohibition against subsequent additions to a pooled income fund account. A donor to a pooled income fund is entitled to deduct, as a charitable contribution, the present value of the remainder interest that will eventually pass to the charitable remaindermen. This value is determined on the basis of the rate of return of the fund and actuarial tables published by the IRS.

As with a charitable remainder trust, a pooled income fund is a split interest trust that is subject to the self-dealing restrictions and the prohibitions on lobbying, political expenditures and grants to individuals.[1]

Unlike annuity trusts and most unitrusts, pooled income funds must be structured to pay out to the income beneficiaries a proportionate share of the income earned by the fund each year. An annuity trust pays the income beneficiary a fixed amount, calculated either as a fixed dollar amount or as a fraction or percentage of the initial fair market value of the trust assets, but in no event may the trust pay less than 5 percent of the initial fair market value of the trust assets. Most unitrusts pay a fixed percentage of the fair market value of the trust's assets, valued

[1] IRC Section 4947(a)(2). Because an income, gift and estate charitable tax deduction is allowable for the value of the remainder interest payable to charity, and because there is no charitable deduction allowed for amounts paid to an income beneficiary, the pooled income fund is not subject to the prohibitions on excess business holdings or on investments that jeopardize the charitable purpose of the trust. IRC Section 4947(b)(3)(B).

annually. The payout from a pooled income fund however is entirely dependent on the current yield of the pooled income fund's assets.

Existing Pooled Income Funds

Since the payout is based only on income from the pooled income fund's investments, rather than the total appreciation of the assets, trustees and charitable remaindermen find themselves compelled to invest for high income rather than total return. Funds are heavily invested in bonds and other low-growth investments that generate interest. These funds generally hold few stocks, which are often higher-growth investments but pay little or no dividends.

The Wall Street Journal reports that dividend yields started to diminish dramatically in 1995.[2] Citing Ibbotson Associates, the article states that the average dividend yield was 2.31% from 1995 through 1998, almost half the historical average of 4.5%.[3] The average dividend yield as of July 31, 2000 for Standard & Poor's index of 500 stocks was 1.13%.[4] Furthermore, the Wall Street Journal states:

> Not only are many dividend-paying companies reducing or even eliminating their payouts, but this year's Shareholder Scoreboard illustrates another difficult truth: Where there are dividends there are often disappointing returns.[5]

Commentators report that falling interestrates have damaged the funds' ability to produce income while the income-only restriction has diminished benefits from the soaring stock market.[6] The current system serves as a significant detriment to the eventual remainder value.

Evolution of Investment Theory

When pooled income funds were first created, the idea of distributing only income to donors was considered the most prudent method to protect the charitable remaindermen. However, the interest rate environment has changed, as has investment theory. Economists now

---

[2]Karen Hube, "More Dividends Go the Way of the Dinosaur," The Wall Street Journal, February 24, 2000.

[3]Id.

[4]Standard & Poor's, "Portfolio Characteristics of the S&P 500," July 31, 2000, <http://www.spglobal.com/ssindexmain500.html>.

[5]Karen Hube, "More Dividends Go the Way of the Dinosaur," The Wall Street Journal, February 24, 2000.

[6]Debra E. Blum, "Looking to Get Out of the Pool," Chronicle of Philanthropy, February 24, 2000.

recognize that portfolios invested for total return are more likely, in the long run, to generate better results for both the income beneficiary and the charitable remainderman.

If a trustee of a pooled income fund were free to build a diversified portfolio, including both stocks and bonds, the fund could be invested for total return. The interests of the remainderman and the beneficiary would be aligned since both would benefit as the market value of the fund grows. However, in an income-only fund, the desired level of current income dictates the portfolio mix and the higher the income target, the more bonds must be included in the portfolio in order to meet the income goal. Since most bonds offer little or no capital appreciation, the market value of the bonds asset may remain stable in nominal terms but actually fall in inflation-adjusted terms.

<u>Charitable Remainder Unitrusts and Recent Regulatory Changes</u>

Recent amendments to charitable remainder unitrust regulations issued in 1998 reflect the evolution of investment theory. The charitable remainder trust was, like the pooled income fund, created in its current form by the 1969 Tax Reform Act. Section 664(d)(2), as adopted in 1969, requires that payments to the individual beneficiary or beneficiaries of a charitable remainder unitrust take one of three forms:

(i) a fixed percentage of the net fair market value of the charitable remainder unitrust's assets, determined annually;

(ii) the lesser of the net income of the charitable remainder unitrust or a fixed percentage of the net fair market value of its assets, determined annually; or

(iii) the lesser of the net income of the charitable remainder unitrust or a fixed percentage of the net fair market value of its assets, determined annually, plus, to the extent that the net income for the year exceeds the fixed percentage amount, the difference (if any) between the aggregate amount that would have been distributed had the fixed percentage amount been paid out each year and the aggregate amount that has actually paid out to the individual beneficiary or beneficiaries.

The 1998 amendments permit a charitable remainder unitrust initially to use one of the lesser-of-net-income payout methods and, as of January 1 of the year following a fixed date or the occurrence of a specific event, to switch to a fixed percentage payout method. Treasury Regulation Section 1.664-3(a)(1)(i)(c) (published December 9, 1998). The new regulations provide that, by combining a lesser-of-net-income payout with a fixed percentage payout, a charitable remainder unitrust may be funded with assets that do not produce current income but, once those assets have been sold, may be invested for total return without affecting the payout to the individual beneficiaries. The trustee is allowed flexibility in investment choices and may invest for a combination of current interest and dividend income and long-term capital appreciation for total return. The 1998 regulations recognized the dramatic change in the investment climate by allowing pre-existing unitrusts paying the lesser of net income to be reformed by court action (or other appropriate action) to pay out the fixed percentage so long as the reformation proceeding was initiated not later than June 8, 1999 (which date was subsequently extended to June 30, 2000).

The 1969 Tax Reform Act was enacted to encourage charitable giving and allow donors of all means to make gifts. Usually donors fund charitable remainder trusts, such as unitrusts, with assets worth $100,000 or more. The pooled income fund was designed for the less wealthy. Since regulations governing the unitrust have evolved to reflect current investment theory, so should regulations on pooled income funds develop to give less wealthy donors the same opportunities.

Pooled Income Fund Definition of Income – Recent Regulatory Change

Proposed regulations which have dramatically changed the definition of net income under Section 643(b)[7] were promulgated on February 14, 2001 to permit distributable net income to include capital gain when permitted by the applicable trust investment and/or local law. This change has been proposed to reflect the fact that the Uniform Principal and Income Act has been recently adopted by statute in at least thirteen states and will shortly be adopted in many more. The change recognizes the importance for any fiduciary in today's investment climate to invest on a total return basis and allows some capital gain to be recharacterized as distributable net income under appropriate circumstances. The proposed regulations expressly exclude pooled income funds from the new interpretation. In other words, no pooled income fund will be permitted to utilize these new regulations redefine income to include capital gain.

[7] Proposed Treasury Regulation Section 1.643(a)-3

Legislative Relief

The proposed amendment would permit the creation of a unitrust interest in assets transferred to a pooled income fund. The unitrust interest would be in addition to the simple income interest currently permitted and would allow trustees to more prudently invest for total return. The amendment would encourage donors giving modest amounts to make charitable gifts while retaining an income interest using the same technique available to wealthy donors who are able to give to charitable remainder trusts.

Respectfully submitted,

Richard M. Lipton
Chair

August, 2001

GENERAL INFORMATION FORM

To Be Appended to Reports with Recommendations
(Please refer to instructions for completing this form.)

Submitting Entity: Section of Taxation

Submitted By: Richard M. Lipton

1. Summary of Recommendation(s).

   To amend Section 642(c)(5) of the Internal Revenue Code of 1986 to permit pooled income funds to be invested more prudently for total return and to permit the creation of a unitrust interest in assets transferred to pooled income funds.

2. Approval by Submitting Entity.

   This is submitted contingent on Section approval at the Annual Meeting on August 4, 2001.

3. Has this or a similar recommendation been submitted to the House or Board previously?

   No

4. What existing Association policies are relevant to this recommendation and how would they be affected by its adoption?

   None

5. What urgency exists which requires action at this meeting of the House?

   The pooled income fund is an important fundraising vehicle for donors who wish to make a charitable gift while retaining or creating a life income interest but who do not possess sufficient financial resources to establish a charitable remainder trust. Currently Section 642(c)(5)mandates that the payout to income beneficiaries consists of current interest and dividend income earned by the pooled income fund's assets, rather than being based on the total value of the fund's assets. This structure stunts the growth of assets in pooled income funds, and hinders the ability of smaller donors and charities to realize the kinds of investment returns possible from charitable remainder trusts. The inability of pooled income funds to offer donors the equivalent of a unitrust interest has resulted in these funds losing their attractiveness to potential donors.

6. Status of Legislation. (If applicable.)

   None

7. Cost to the Association. (Both direct and indirect costs.)

   None

8. Disclosure of Interest. (If applicable.)

   No member of the originating Committee or of the Council of the Section of Taxation is known to have a material interest in the Resolution by virtue of a specific employment or engagement to obtain the result of the Resolution.

9. Referrals.

   All Sections and Divisions.

10. Contact Person. (Prior to the meeting.)

James P. Holden
Steptoe & Johnson, LLP
1330 Connecticut Avenue, NW
Washington, DC 20036
202/429-6407

Stefan F. Tucker
Venable
1201 New York Avenue, NW
Penthouse
Washington, DC 20005
202/216-8570

Carolyn M. Osteen
Ropes & Gray
One International Pl
Boston, MA 02110-2602
617/951-7252

Christine A. Brunswick

American Bar Association
10th Floor
740 15th Street, NW
Washington, DC 20005
202/662-8675

11. Contact Person. (Who will present the report to the House.)

James P. Holden
Steptoe & Johnson, LLP
1330 Connecticut Avenue, NW
Washington, DC 20036
202/429-6407

Stefan F. Tucker
Venable
1201 New York Avenue, NW
Penthouse
Washington, DC 20005
202/216-8570

POOLED INCOME FUNDS - UNITRUST INTEREST

EXECUTIVE SUMMARY

1. The pooled income fund is an important charitable giving vehicle for donors who wish to make a charitable gift while retaining or creating a life income interest but who do not possess sufficient financial resources to establish a charitable remainder unitrust or annuity trust.

2. Because of the expense of maintaining a pooled income fund, small charities generally find it uneconomic to provide such vehicles for their smaller donors.

3. The current statute and the related regulation require the creation of an income interest for the life of one or more beneficiaries who are living at the time of the transfer. Each such beneficiary receives income based on his proportionate share of the annual income earned by the fund. I.R.C. Section 642(c)(5) and Regulation § 1.642(c)-5(b).

4. Since the payout is entirely dependent on the current interest and dividend income of the pooled income fund's assets, rather than the total appreciation of the assets, fund trustees usually invest heavily in bonds and other low-growth investments that generate ordinary income while avoiding investments in higher-growth stocks that pay little or no dividends.

5. The current state of the law stunts the growth of assets in pooled income funds thereby hindering the ability of smaller donors and charities to realize the same kind of returns possible from charitable remainder trusts.

Purpose of "Income-Only Provision"

1. At one time, the idea of limiting distributions to income only was considered the most prudent way to protect a charity's remainder interest in the fund. However, investment theory has evolved and economists now recognize that portfolios invested for total return are more likely, in the long run, to generate more for charitable remaindermen. In fact, while the current system preserves the principal of a pooled income fund in nominal terms, it does not necessarily preserve the fund's value in inflation-adjusted terms.

Purpose of the Proposed Revision

1. The statutory requirements of pooled income funds should evolve to allow trustees to invest assets more prudently for total return. The Internal Revenue Code and corresponding Treasury Regulations should be amended to permit the creation of a unitrust interest in assets transferred to pooled income funds.