

ARTICLES

THE REAL ESTATE POOLED INCOME FUND ---- PART I

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INTRODUCTION

Congress has instituted many recent changes in the tax law, totally rewriting the taxation of individuals, trusts, estates and corporations. The number of words in the tax law was nearly equaled by the “changes” of 1984.¹ The Internal Revenue Code of 1954 itself was re-written in 1986,² only to be followed immediately by changes in late 1987³ and the “technical corrections” of 1988.⁴

While there are negative aspects to these new laws, many changes have been for good reasons. Congress must balance the budget and deal with the trade deficit if the United States is to continue to be an economic and political force. Some of the changes have introduced an element of greater fairness into the tax system, since the wealthy by reason of the “minimum tax” now have to pay some taxes.⁵ Other changes, although well-intentioned, have been confiscatory, confusing and unnecessary, being imposed upon the public and the tax practitioner without much warning, time for discussion or contemplation.

The debate as to the need for such complex laws (or the political necessity therefor) will probably continue beyond our lifetime. Nonetheless, one assessment seems to be true: the new tax laws have created a huge problem for charities. From an after-tax perspective, it is no longer as advantageous as it once was for donors to make outright gifts to charity.⁶ As a result of this adverse tax environment, charities are finding it more difficult in today’s tax and economic environment to: (1) construct new buildings, (2) renovate old structures, (3) acquire new property, (4) restructure debt and (5) create an

¹ The Tax Reform Act of 1984, P.L. 98-369. See Eustice, J., *the Tax Reform Act of 1984 - A Selective Analysis*, Preface, iii (1984).

² The Tax Reform Act of 1986, P.L. 99-514, hereinafter sometimes referred to as “1986 TRA.”

³ The Revenue Act of 1987, P.L. 100-203, (1988), hereinafter referred to as “1987 TRA.”

⁴ The Technical Corrections and Miscellaneous Revenue Act of 1988, P.L. 100-647, hereinafter referred to as “TAMRA.” Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

⁵ Through many tax law changes to the minimum tax dating from 1977, Congress has effectively created a “flat tax” on gross income (a proposal which has been discussed for decades, at least in the classroom).

⁶ There are a number of tax and economic reasons why outright giving is not as predominant as it once was: (1) the reduction in the marginal income tax rates to a maximum of 33% has severely increased the after-tax cost of an outright gift; (2) the tightening of the alternative minimum tax (“AMT”) rules to include as a tax preference the difference between the adjusted basis and fair market value of a gift; and (3) negative predictions about the future economic climate (*e.g.*, depression), especially in light of our national, international and individual debt.

endowment.⁷

To encourage at least the same volume of charitable giving in light of the new tax laws and our current economy, some charities have turned to innovative methods of planned giving such as the real estate pooled income fund (the “PIF” or “fund”). The real estate PIF does not replace the outright gift, but is simply one alternative.⁸

The purpose of Part I of this article is to review the basics or essentials of a PIF from a tax standpoint, to present the structure of the real estate PIF, and to analyze the benefits of the real estate PIF from the perspective of the charity and the donor. In Part II of this article, to appear in the next issue of the *Journal*, the validity and viability of GCM 39709 will be analyzed, the implications of Rev. Procs. 88-53 and 88-54 (restricting private letter ruling requests and establishing a sample pooled income fund) will be reviewed, and the securities laws implications of establishing and marketing the PIF will be discussed.

Overview of the Pooled Income Fund

In 1969, Congress created the PIF under §642(c),⁹ along with the charitable remainder unitrust and annuity trust of §664.¹⁰ All three of these vehicles provide for an income beneficiary¹¹ to receive an income interest for life, with the remainder interest passing to charity upon the death of the (surviving) income beneficiary. In general, charitable remainder trusts were designed to permit only one or a limited

⁷ It is the authors' theory that charities cannot as easily achieve these financial objectives because the day of the substantial outright gift is perhaps not dead, but waning.

⁸ While the tax law and economic trends militate against the outright gift, these same forces encourage creative giving vehicles such as the real estate PIF. For example, the increase in the effective rate of the capital gains tax to 28% encourages potential donors to consider contributing property to a real estate PIF for sale, since the capital gains tax can be avoided and the economic return of the donor will be based upon the fair market value of the gift, unreduced by any taxes.

The AMT rules strike harder at outright gifts as opposed to gifts of a remainder interest because 100% of the appreciation in value is a tax preference in an outright gift, while only that percentage of the appreciation that is attributable to the value of the remainder interest is a preference item. For example, assume a 55-year old donor owns readily marketable stock which he purchased years ago and which had appreciated from his original cost basis of \$10,000 to be worth \$100,000 today. If he were to gift this stock to the PIF in January, 1989, his charitable income tax deduction would be \$22,406 (based upon the 9% tables discuss *infra* n. 21 and Table G in Regs. §1.642(c)-6(d)). For AMT purposes, the amount of his tax preference on the gift to the PIF is \$20,165 ($0.22406 \times \$90,000$ of appreciation). If the same stock were given outright to the charity, the tax preference would be \$90,000.

Recently, Congress and the Treasury have seen fit to: (1) tighten up on deductions (*e.g.*, at-risk loss limitations under §465 and limitations on interest deductions under §163); (2) restrict through passive loss rules the offsetting of earned and portfolio income against passive losses under §469; (3) reduce the amount and availability of investment tax credits under §§46-48 pursuant to modifications made by 1986 TRA and TAMA; (4) attack “tax shelters” as non-economic; (5) impose a “success tax” on distributions from qualified plans and IRAs under §4980A; (6) reduce the maximum amount of defined benefit and defined contribution benefits under §415; (7) cap contributions to §401(k) plans at \$7,000; (8) cap contributions to qualified and non-qualified plans under §457 for local governments and tax-exempt organizations; and (9) restrict participation in Individual Retirement Accounts under §§219 and 408, and so forth. In light of these changes, the PIF with its “clean” and unquestioned charitable deductions becomes increasingly attractive. Further, as the availability of conventional pensions decreases radically, the PIF with its income for life (or joint lives as assumed *infra* n.11) becomes a very attractive alternative.

⁹ The Tax Reform Act of 1969, P.L. 91-172. Some PIFs were created by charitable entities before 1969, but their statutory authority did not come into being until 1969. See 3 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, para 82.1.3 at 82.11.

¹⁰ The unitrust and annuity trust are technically known as “charitable remainder trusts,” although sometimes they are aggregated together with the PIF under the generic name “charitable remainder trusts.” As used herein, “charitable remainder trusts” will refer to unitrusts and annuity trusts only. An in-depth analysis of the PIF and charitable remainder trusts is beyond the intended scope of this article. For an excellent discussion of these three charitable giving vehicles, see 453 T.M., *Charitable Remainder Trusts and Pooled Income Funds*.

¹¹ For purposes of this article, we are assuming that the donor is a male, age 55, his wife is also age 55, and that they are the designated income beneficiaries.

number of donors, while the PIF was designed to permit numerous donors and a number of designated beneficiaries.

The specific rules for qualification as a pooled income fund are found in §642(c)(5) and the regulations thereunder. Section 642(c)(5) defines a pooled income fund as a trust:¹²

(A) to which each donor transfers property, contributing an irrevocable remainder interest in such property to or for the use of an organization described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)), and retaining an income interest for the life of one or more beneficiaries (living at the time of such transfer),

(B) in which the property transferred by each donor is commingled with property transferred by other donors who have made or make similar transfer,

(C) which cannot have investments in securities which are exempt from taxes imposed by this subtitle,

(D) which includes only amounts received from transfers which meet the requirements of this paragraph,

(E) which is maintained by the organization to which the remainder interest in contributed and of which no donor or beneficiary of an income interest is a trustee, and

(F) from which each beneficiary of an income interest receives income, for each year for which he is entitled to receive the income interest referred to in subparagraph (A), determined by the rate of return earned by the trust for such year.

In effect, the PIF is a common trust fund to which various donors may make contributions. Typically, on the date of a contribution to the PIF, the trustee of the PIF determines the fair market value of the contributed property and assigns to the donor a specific number of units. Each unit value is determined by dividing the entire fair market value of all assets in the fund (immediately before the contribution in question) by the then outstanding number of units.¹³ The donor is then assigned a specific number of units, based upon the unit value and the fair market value of his contribution. The number of units assigned to each donor serves as the basis for allocating net fund income. Net income (from a fiduciary accounting standpoint)¹⁴ is payable to each donor and his or her spouse for life based upon the number of units assigned. These units will automatically pass to the charitable remainderman upon the death of the last to die of the donor and his or her spouse.¹⁵

The donor and his or her spouse are taxable on the net fiduciary income of the fund under the general rules of Subchapter J (*e.g.*, §643(a) dealing with distributable net income).¹⁶ Unlike charitable

¹² In fact, a pooled income fund does not have to be a trust. *See* Regs. §1.642(c)-5(a)(2).

¹³ Regs. §1.642(c)-5(c)(2).

¹⁴ Regs. §1.642(c)-5(b)(7).

¹⁵ Regs. §1.642(c)-5(b)(8).

¹⁶ Regs. §1.642(c)-5(b)(7).

remainder trusts,¹⁷ the fund itself is not governed by the rules of §664, but is taxable under Subchapter J of the Code as a non-grantor trust.¹⁸ The fund is entitled to distribution deductions for all income earned which is distributed to the income beneficiaries. In addition and most importantly, the governing instruments of most funds provide that all capital gains of the PIF are “set aside” pursuant to §642(c)(2) for ultimate distribution to the charitable remainderman. Therefore, when determining the taxability of the fund, the fund is entitled under §642(c)(3) to a tax deduction for all long-term capital gains permanently set aside.

Each donor is entitled to an income tax deduction for the value of the remainder interest which will pass to the charity, based upon the fair market value of the gift, that age of the donors/income beneficiaries and the investment return of the fund.¹⁹ For gifts prior to April 30, 1989, the highest rate of return earned by the fund for the immediately preceding three years is the applicable investment return. If the fund has not been in existence three years, a 9% return is to be used for gifts prior to April 30, 1989.²⁰ For gifts made after April 30, 1989, this percentage will vary, under new §7520 and recent pronouncements of the Service, based upon changing interest rates.²¹

In addition, to this charitable income tax deduction, the donor to the PIF is entitled to a gift tax deduction under § 2522(c)(2)(A), and an estate tax deduction under §2055.²²

17 This distinctive is very important, since the Internal Revenue Service (herein sometimes referred to as “Service” and “IRS”) has informally taken the position that PIFs may “pass through” depreciation deductions to their income beneficiaries, (*see, e.g.*, PLR 8736008 to the contrary, which as in effect been overruled). Apparently, the Service bases its opinion on the fact the charitable remainder trusts are exempt from tax under §664 and PIFs are taxable under Subchapter J of the Code.

18 Regs. §1.642(c)-5(a)(2).

19 Regs. §1.642(c)-5(a)(4).

20 §642(c)(5); Regs. § 1.642(c)-6(b)(2).

21 In TAMRA, Congress created §7520, which requires that the value of an annuity, interest for life or for a term of years, or remainder or reversionary interest be determined under new interest and mortality tables prescribed by the Secretary. These new rules apply to gifts made after April 30, 1989, with a few exceptions.

The Secretary has prescribed new interest rates in Notice 89-24, 1989-10 I.R.B. 16, which establishes a variable rate based upon 120% of the applicable federal mid-term rate compounded annually (rounded to the nearest two-tenths of 1%). For example, 120% of the applicable federal rate (“AFR”) for July 1989 is 10.6% Rev. Rule 89-86, 1989-27 I.R.B. 8.

In addition, in Notice 89-60, 1989-22 I.R.B. 16 (May 30, 1989), the Service promulgated more information on the tables to be used, along with mortality tables containing actuarial factors for determining the value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest. These rules apply to transfers made and estates of decedents dying after April 30, 1989 (with a few exceptions, again).

Notice 89-24 institutes a special rule for pooled income funds:

In valuing a charitable remainder interest in a transfer that is made to a pooled income fund after April 30, 1989, the federal mid-term rate is disregarded. Instead, such interests are valued on the basis of the applicable _____ yearly rate of return of the pooled income fund at the time of the transfer and the applicable mortality table.

Notice 89-60 addresses the valuation of an interest when the PIF has no prior experience. Notice 89-60 addresses this issued as follows: (1) for the three calendar years preceding the gift, determine the average of the variable rates for each year (120% of the applicable federal midterm rate), (2) take the highest yearly average for the three year period, and (3) subtract 1%. The result of this calculation will be the applicable yearly rate for the new PIF. For PIFs created after April 30, 1989 and before January 1, 1990, the rate is deemed to be 9.4%.

22 If the donor is not the income beneficiary (as posted earlier), then the present value of the income interest will be chargeable to the donor for gift tax purposes. Under this scenario, the donor will still be entitled to a charitable gift tax deduction for the remainder interest under §2522.

The Real Estate Pooled Income Fund

Most pooled income funds historically have invested in conventional stocks and bonds. One enterprising individual, however, considered the possibility of the PIF investing in real estate, since the only investment restriction (statutory or otherwise) is that the fund cannot invest in “securities which are exempt from tax.”²³ This individual not only received a private letter ruling from the Service that real estate is an appropriate investment, but was told that a depreciation deduction could be passed through to the income beneficiaries, similar to any other trust taxable under Subchapter J of the Code.²⁴ Since this private letter ruling permitting a pass-through of depreciation on realty to income beneficiaries, real estate PIFs have evolved significantly.

Today, a typical real estate PIF could be structured as follows. The charity (*e.g.*, a college) leases land under and around specified buildings to the PIF at a nominal rent and on a long-term basis. Simultaneously, the fund purchases from the college the fee simple interest in the buildings for \$5,000,000. The PIF then re-leases the land and leases the buildings back to the college. Assuming renovations and construction on the buildings are necessary, the PIF enters into a development agreement with the college for the necessary construction. Lease payments from the college to the PIF will begin immediately, but the payment for the renovations will be delayed pending substantial completion of construction. Lease payments by the college to the fund are designed to produce a 7% (triple net) rate of return on the fair market value of the buildings. As set forth, this 7% (net of expenses) will be passed through to the donors/income beneficiaries.

Until such time as the PIF has raised sufficient capital from donors to equal the purchase price of the buildings, the PIF will execute an interest-bearing promissory note (and deed of trust) back to the college. The interest rate on the promissory note will equal, for the sake of argument, the same rate of return being passed through to the donors.²⁵

It is hoped that donors to the PIF will contribute appreciated long-term capital gain property. These appreciated assets will then be sold and reduced to cash by the PIF, but no capital gains tax will be imposed upon the sale.²⁶ The PIF will then use the cash to pay off its debt to the college which arose by reason of its purchase of the buildings. Exhibit A illustrates the structure of the real estate PIF.

Benefits of the Real Estate PIF to the Charity

There are significant benefits to the college which creates this real estate pooled income fund. First and foremost, the college has \$5,000,000 in cash after the PIF has been fully funded. These monies can be used for any purpose, such as (1) financing the costs of construction/renovation of this or another building, (2) paying off or restructuring current debt, (3) acquiring new property, (4) creating an endowment, (5) increasing faculty salaries, and (6) funding additional student scholarships and loans.

²³ §642(c)(5)(C).

²⁴ See PLR 8535048. It would appear that the mere fact that the Service granted a favorable ruling under §642(c)(5) is sufficient reason to believe (by negative implication) that real estate is an acceptable investment for PIFs.

²⁵ By making sure that the interest rate on the promissory note equals the rental income being paid to the PIF, there is a matching and “washing” of rental income and interest expense, thus allowing the earliest donors to the PIF to receive (after expenses) the anticipated cash-on-cash yield.

²⁶ See §642(c)(5) and (3) and discussion, *supra*.

The use of the monies is limited only by the imagination of the charity.

Second, the cost of renovating the buildings using the PIF will be significantly less than the cost of renovating the buildings using bond or conventional financing. The real estate PIF can be analogized to a low-interest (*e.g.*, 7%) loan, the interest payments of which decrease over time²⁷ and the principal of which never has to be repaid. Exhibit B compares the real estate PIF to bond/conventional financing and provides a mathematical computation demonstrating the superiority of the PIF over bond/conventional financing,

Third, there appears to be a significant beneficial fall-out from the promotion of the real estate PIF by charities to date. In a number of situations, for one reason or another, the PIF may not be ideally suited to the potential donor, whereas another form of charitable giving (especially if it is outright) is more appropriate under the circumstances. For example, if a donor wanted to make a gift of appreciated real property, but at the same time wanted to control the gifted property, he could create a unitrust or annuity trust, naming himself as trustee.²⁸ In short, during the charity's attempts to promote the PIF, gifts through other vehicles arise which would not have otherwise occurred.

Fourth, a broader donor base is created for the charity. The experience of some charities marketing the PIF has been that the contributors to the PIF tend not to be former donors, but new ones.

Fifth, because of the significant benefits to the donor (see discussion below), gifts tend to be larger in amount than might otherwise occur.

Sixth, unlike the unitrust and annuity trust, but law, the charity controls the trust.²⁹ This can be a significant factor for a charity that has seen negative results from the management by donors for their own unitrusts and annuity trusts.

Seventh, unlike the sale/leaseback transactions of the early 1980s, the charity is guaranteed that ownership of the buildings will be returned to it.

BENEFITS OF THE REAL ESTATE PIF TO THE DONOR

There is an unwritten rule in the planned giving community that a vehicle for giving is only as called as the benefit derived by the donor. In other words, if the vehicle does not benefit the donor, the charity will not adopt it and add it to its package of planned giving tools. This rule is not only appropriate, but must be the guiding force behind attempts to promote the interests of charitable clients.

The real estate pooled income fund is an appealing planned giving vehicle from the donor's standpoint for a number of reasons. First and foremost, the donor receives a cash-on-cash return of a projected percentage of the fair market value of his gift. For example, in the past we have used 7% as an appropriate return.

²⁷ Recall that as each donor/income beneficiary dies, his interest in the PIF (expressed as unites) will pass to the college. Therefore, although the rent technically will not be reduced when a donor dies, the income attributable to his interest will be paid by the PIF back to the college.

²⁸ This, of course, can not be accomplished with the PIF, since the trustee must be controlled by the charitable remainderman. Regs. §1.642(c)-5(b)(5).

²⁹ §642(c)(5)(E).

Second, if the donor holds highly appreciated property that is producing little or no return, then the donor's cash flow can be significantly improved by contributing the property to a PIF. For example, IBM is paying dividends of 4%, or less, and the return on other long-term capital gain property (e.g., the family farm) is even less. Because the PIF can receive and immediately sell such appreciated property without the necessity of having to pay capital gains tax,³⁰ in many cases the donor is able to significantly increase his cash flow by obtaining a higher rate of return (for example, from 4% on IBM to 7% from the PIF) and by basing his rate of return on the fair market value of the asset, not on the net after taxes. In fact, we will be shown below in the hypotheticals, given a normal factual scenario, the actual cash flow from the PIF can be greater than alternative forms of investment.

Third, upon the death of the last to die of the donor and his or her spouse, the net assets remaining for the heirs³¹ after estate taxes can be greater than if the same property had been held until death, or sold subject to the capital gains tax or given outright as a gift to the charity. This point will be analyzed more fully in the hypotheticals below.

Fourth, although there are no guarantees (and there can be none in light of the Service's incongruent position regarding passive income and passive loss), it appears that the income produced by the real estate PIF will be passive income.³² Consequently, this income can be set off against passive losses which the donor may have from other investments.³³

Fifth, there is a substantial charitable income tax deduction which offsets all types of taxable income for the year in which the gift is made, and which may be carried forward for an additional five years under the present tax law.³⁴

Sixth, depreciation on the real property owned by the PIF can be passed through to the donors/income beneficiaries.³⁵ These depreciation deductions will partially shelter the passive rental income payable by the PIF to the income beneficiaries.

Seventh, the donor can realize estate tax savings up to 60%,³⁶ which will significantly reduce the after-tax cost of the gift from the donor's perspective.

Hypotheticals

30 See §642(c)(5) and (3) and the discussion, *supra*.

31 As will be seen from the comparative analysis in the hypotheticals below, the net assets remaining for the heirs after estate taxes will increase in Alternative A (sell, reinvest) as the adjusted basis of the asset increases. (At an adjusted basis "cross-over" point, the gift to the PIF is not as economically beneficial to the heirs unless an asset replacement trust is created.)

32 See PLR 8806065.

33 Beware of the impact, however, of the alternative minimum tax in this area, since losses cannot be aggregated against gains for separate investment activities. See §§55-59.

34 § 170(b)(1)(C)(ii) and (d).

35 The rules governing the pass-through of depreciation are difficult at best, but have been made very uncertain by reason of GCM 39709. This complex issue will be discussed more fully in Part II of this article, to appear in the next issue of the *Journal*.

36 Under §2001(c)(3), the "tentative tax" is increased by 5% (i.e., up to 60% in total) for estates exceeding \$10,000,000 but not exceeding \$21,040,000 (\$18,340,000 in the case of decedents dying, and gifts made, after 1992). This change was made by the 1987 TRA and has the intended effect of eliminating the unified credit and the graduated rate structure.

In Exhibit B are a number of hypothetical situations which are intended to analyze the cash flow to the donor and the net assets being left to the heirs of a donor, given certain assumptions.

Note that the projections are comparative in nature. The "Present Situation" in each hypothetical is the benchmark for comparison and assumes that the donor holds the asset until his death. "Alternative A" assumes that the donor sells the asset in question and reinvests, after paying Federal and Maryland (7.5%) taxes, the net proceeds in a bond yielding 7%. "Alternative B" contemplates an outright gift to the charity, and "Alternative C" envisions a gift of the asset to the PIF.

Unless otherwise noted to the contrary, the underlying assumptions are as follows:

Male, age = 55; life expectancy in years:	29
Adjusted gross income	\$200,000
Taxable income	\$175,000
Annual income from subject property	\$8,000
Cash flow including subject property	\$225,000
Net estate (including subject property)	\$3,000,000
Fair market value of subject property	\$200,000
Adjusted basis of subject property	20,000
Discount (growth) rate after-tax	5%
Sales tax rate	7.5%
Estimated annual income from PIF	\$14,000
Estimated annual depreciation for PIF (40 yrs.)	\$2,500
Estimated annual income from reinvestment	\$9,792
Estimated annual depreciation from reinvestment	\$3,553
Charitable deduction factor remainder interest	0.22406
Annual insurance premium for 9 year (if any)	\$3,688
Face value of insurance (2nd to die policy)	\$200,000

In each hypothetical discussed below, the income taxes for each year are determined, the cash flow for the year is computed and this result is listed opposite the applicable year. Each year's net cash flow is future valued at 5% after-tax for the balance of the donor's projected life expectancy. As can be seen at the bottom of each hypothetical, the future values for each year are totaled, and then added to the present net estate. After the estate taxes are computed, the increase/decrease in property to heirs is compared, using the "Present Situation" as a benchmark.

As can be seen from Hypothetical No. 1, the net property passing to the heirs is greater for the PIF for the cash flow. In Hypothetical No. 2, all of the facts are the same except that the donor creates an irrevocable insurance trust to replace the asset which is gifted away. The insurance premiums are deducted from the net cash flow and no credit is given for any gift to the PIF results in a better cash flow for the donor and more net property available for distribution to heirs.

Hypothetical No. 3 presents a factual scenario at the other end of the spectrum from Hypothetical No. 1 in that the subject property has not appreciated at all. This hypothetical will be referred to as a gift of "cash." Obviously, the heirs are better off if the donor reinvests the asset (Alternative A) rather than making a gift to the PIF. However, the cash flow is approximately the same.