

ARTICLES  
**THE REAL ESTATE  
POOLED INCOME FUND ----- PART II**

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**INTRODUCTION**

In Part I of this Article,<sup>1</sup> Kallina and Awalt discussed the origin of the real estate pooled income fund (the PIP or fund), reviewed the basics or essential of a PIF from a tax standpoint, introduced the structure of the real estate PIF and analyzed the benefits of the real estate PIF from the perspective of the charity and the donor.

In this Part II, Kallina and Awalt analyze the validity of General Counsel Memorandum 39709, which requires PIFs to maintain a depreciation reserve according to “generally accepted accounting principals” (GAAP), and the impact of this GCM on the continued viability of the real estate PIF. Kallina and Awalt also review Rev. Procs. 88-53<sup>2</sup> and 88-54,<sup>3</sup> which establish a model pooled income fund and restrict private letter ruling requests regarding PIF qualification, respectively. Finally, Shay and Wagner consider the implications of federal and estate securities laws upon the real estate pooled income fund.

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\* Kallina and Awalt would like to express their overdue appreciation to some individuals and entities, not necessarily in order of their contribution or importance. We thank Shay and Wagner for their assistance on securities and charitable solicitation matters in the past and for their contribution to this Article. Also, we thank Michael P. Goodrich, who initiated the authors' involvement in the PIF, and who (jointly with Kallina through Charitable Consultants, Inc.) has contributed immensely to the development of the underlying ideas and the resolution of problems as this charitable product has evolved. We express our appreciation to Gettysburg College and its professionals (especially Dr. Bruce E. Bigelow) for their foresight and support in developing the real estate PIF as a viable charitable giving vehicle. In addition, we thank Jerry McCoy for his help and assistance as a sounding-board for concepts and ideas.

**The Validity of GCM 39709**

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<sup>1</sup> Part I appeared in the July-August, 1989 issue of the *Journal* Vol. 14, No. 4, at p. 99.

<sup>2</sup> Rev. Proc. 88-53, 1988 2 C.B. 712.

<sup>3</sup> Rev. Proc. 88-54, 1988 2 C.B. 715.

The interesting GCM is well-considered and readable. Although the authors do not agree with many of its conclusions, the result is understandable from the Service's<sup>4</sup> standpoint. The IRS is to be congratulated on its clarity of thought and its preponderance of intellectual honesty. The good news concerning the GCM is that it is *not* as destructive or devastating as many practitioners (including the authors) initially perceived. The bad news is that the GCM might be improperly used by the Service to make future terrorist attacks against the real estate PIF and charities in general.<sup>5</sup>

To comprehend what initiated this GCM, some tax and historical background is helpful. Pooled income funds (and other nongrantor trusts) treat depreciation deductions differently than other entities for tax purposes.<sup>6</sup>

In general, the Code provides that a reasonable depreciation deduction shall be available for exhaustion and wear and tear for property used in a trade or business or held for the production of income.<sup>7</sup> A trust having income beneficiaries and a remainderman is entitled to a depreciation deduction.<sup>8</sup> A pooled income fund, regardless of whether it is a trust, is taxed as if it were a nongrantor trust under Subchapter J of the Code, and is entitled to take a depreciation deduction just as any other nongrantor trust.<sup>9</sup>

Sections 167(h) and 642(e) provide, among other things, that the depreciation deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation. If such a reserve is created (whether by local law, by mandate in the trust instrument or by the trust instrument), the depreciation deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve. Any part of the deduction in excess of the income set aside is apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each.<sup>10</sup>

For example, if a trust instrument provides that all net income earned by the trust is payable to the income beneficiaries, the income beneficiaries would be entitled to the entire depreciation deduction, unless the trustee creates a reserve for depreciation. If a depreciation reserve is established by the trustee, then the available depreciation deduction will be allocated first to the trust to the extent of the addition to the reserve, and the balance of the deduction will be allocated to the income beneficiaries since they are entitled to receive all net income.

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4 As used herein, the term "Service" and "IRS" shall refer to the Internal Revenue Service.

5 The immediately preceding paragraph should be stricken in the event of such unwarranted attacks.

6 See Regs. § 1.64(c)-5(b)(7). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

7 §167(a).

8 §167(h).

9 See §642(c)(5); Regs. §1.642(c)-5(b)(7); Rev. Rul. 79-387, 1979-2 C.B. 247. (PIF may purchase real estate).

10 Regs. §§1.167(h)-1(b) and 1.642(e)-1.

Since it is possible for a donor<sup>11</sup> to receive a depreciation deduction, one can understand the Service's significant interest in this issue.<sup>12</sup>

In meetings and conversations with the authors, the Service informally stated that is perceived the IF, because of the depreciation deduction, as a potential "tax shelter" which was open to abuse. It wanted to ensure that this charitable giving vehicle was not distorted, especially since the drafters of the law in 1969 did not envision a pooled income fund investing in real estate.<sup>13</sup>

Additionally and perhaps more importantly, the Service alleged that its concern extended beyond the conventional real estate PIF<sup>14</sup> to such things as cattle breeding and movie shelter PICS. The fear was that, without a depreciation reserve, there would be no corpus or remainder which would pass to the charity upon the death of an income beneficiary. For example, if a IF purchases a fleet of cars and if the average life expectancy of all donors is 20 years, then it is very likely that there will be no remainder interest passing to the charity.<sup>15</sup>

The Service also stated that it felt any rule concerning a real estate IF must extend to all other PICS, so that the tax law will be uniformly applied.<sup>16</sup> Finally, the IRS argued that it is in the "best interests" of charities for the IRS to require a depreciation reserve under generally accepted accounting principals, whether the charity desires to do so or not, and regardless of whether the IF's assets are actually depreciating in value.<sup>17</sup>

The Service fears eventually peaked and it informally announced that it was going to require a depreciation reserve according to GAAP. At first blush, the implications of a depreciation reserve created as a "sinking fund" are severe at best: (i) a substantial portion of net fiduciary income, which is intended to be paid to income beneficiaries, must instead be allocated to corpus; and (ii) depreciation, which is intended to pass through to such beneficiaries, must be first allocated to the IF.

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

12 The authors were told that the pass-through of depreciation deductions to income beneficiaries was the "hottest" matter before the Service in early 1987. Purportedly, a memorandum on the real estate PIF was circulated among all top officials and staff at 1111 Constitution Avenue. The mere fact that the real estate PIF was receiving this kind of attention caused the authors at the time to feel that the Service was overreacting. In today's tax climate, considering the budget deficit and the lack of economic viability in many real estate transactions over the last few decades, the Service will and should scrutinize "tax shelters" to safeguard the Treasury, create a tax system of perceived "fairness" and require business transaction to stand or fall on their economic substance.

13 The counter argument is: (a) how does the Service know this to be true since there was nothing in the legislative history or any other cited authority to prove this argument; and (b) even if the Service is right, what difference does it make - the law is the law.

14 Where, for example, a college sells a building to a PIF and leases it back, as discussed in Part I.

15 Obviously, we are assuming that the average useful life of a car is less than 20 years.

16 This argument is rather interesting. The Service maintains that it has the authority to require *all* pooled income funds to maintain a depreciation reserve. In the interests of uniformity, should not the Service also require all other trustees of non-grantor trusts (*e.g.* a trustee of a trust under a will) to create a depreciation reserve?

17 Throughout hundreds of years of trust law dating back to feudal England, lawyers generally have had the discretion to create the type of trust instrument requested by their clients. Historically, most lawyers have refused to mandate that the trustee create a depreciation reserve, and at worst have given the trustee discretion to create or not create such a reserve. Can the Service, by alleging it is in the "best interests" of a charity, change such long-standing principles?

A simple example will best illustrate the impact of the Service's position. Let us assume a pooled income fund has one donor (for the sake of simplicity), that it purchases a building on January 1, 1988 for \$100.00, and that it intends to depreciate the building for tax purposes on a straight-line basis over 40 years. Further, let us assume a 7% annual rent, that the useful life of the building for GAAP is 50 years and that the building has no salvage value.<sup>18</sup> Finally, let us assume that the trustee is given the discretion within the trust instrument to decide whether to create a depreciation reserve, and the trustee declines to do so in 1989 because the asset in question has appreciated (rather than depreciated) in value. Under such circumstances, the beneficiary of the pooled income fund would have taxable income of \$4.50, and a cash flow of \$7.00, computed as follows:

*Example 1:*

Rental	\$ 7.00
Depreciation (tax)	<u>(2.50)</u>
Taxable Income	\$ 4.50

If, however, the trustee is required by the IRS to create a depreciation reserve based upon GAAP, even if such a depreciation reserve is unnecessary, the income beneficiary would have the same \$4.50 of taxable income, but this time a cash flow of only \$5.00, computed as follows:

*Example 2:*

Rental	\$7.00
Deprec. & Inc. Reserve (GAAP) (\$100/50 years)	<u>(2.00)</u>
Cash to Beneficiary	\$5.00
Additional Tax Deprec. (\$2.50-\$2.00)	(.50)
Taxable Income	\$4.50

In short, the taxable income of the income beneficiary is the same, but in the former case the income beneficiary has an additional \$2.00 of after-tax income.

This "informal" position of the Service was documented in GCM 39709 almost one year after discussions initially commenced. The facts underlying the GCM are as follows. Attorneys representing a tax-exempt educational organization required a modification of a PIF's governing instrument created in 1974. The desired amendment would require the trustee of the PIF to establish a depreciation reserve "to the extent necessary to protect trust principal for the benefit of the charitable remainderman." After approval, the trustees intended to use funds in the PIF to purchase one or more buildings from the educational institution.<sup>19</sup>

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<sup>18</sup> It is unrealistic to assume that a building has no salvage value, especially if the lease terms require the tenant to maintain the building in good condition. Apparently, the Service agrees with this position, as can be seen from the latter part of GCM 39709 where it mentions a salvage value of 20%.

<sup>19</sup> The facts underlying GCM 39709 are not unusual. The Service used a common factual scenario underlying many real estate PIFs as the basis for its ruling.

Within this factual context, the Service asks two questions in GCM 39709:

*Issue (1):* Whether the Service may require that the governing instruments of pooled income funds contain a clause requiring establishment of a depreciation reserve fund to preserve the corpus for the charitable remainderman.

*Issue (2):* Whether the Service may require that the governing instruments of pooled income funds contain a clause requiring establishment of a depreciation reserve fund pursuant to Generally Accepted Accounting Principles (“GAAP”).

Needless to say, the Service answers both questions with what appears to be a resounding “yes”. It begins its analysis of Issue (1) by noting the value of money<sup>20</sup> and the anticipated number of years the charity must await possession of the remainder interest. In this connection, the Service very significantly points out:

The charitable deduction...is directly related to the amount transferred in trust by utilizing two factors specific to each transfer: the discount rate and the number of years of deferral of the charity's possession. *By limiting the contingencies to these two factors alone, Congress has assumed that the deduction taken by the donor will bear a reasonable relationship to the value of the property actually received by the charity.*<sup>21</sup>

At this point, the Service makes an astounding statement which serves as the linchpin of its entire argument:

Implicit in this concept of present value [the discount rate plus the years of deferral], however, is the assumption that the value of the contributed property, the *corpus of the trust, will remain constant*, and will be delivered to the charity after the death of the income beneficiary with a value equivalent to its value on the date of contribution of the remainder interest.<sup>22</sup>

The Service explains that the time value of money does not take into account "risk of destruction," "real" depreciation, wear and tear or any other factor, nor does it include "market value" fluctuations. On the other hand, "real" depreciation is ascertainable and reduces the "constant" value of the corpus. Thus, the Service continues:

In our view, the only way, to offset the effect of depreciation in order to ensure that the charitable

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<sup>20</sup> According to GCM 39709, “‘The MORE DISTANT the deferred service (or income, or goods) the LOWER its present price. A dollar deferred two years is worth less today than a dollar deferred one year, if the rate of interest is positive’. A Lchian and A llen. University Economics 2 05 (2nd ed. 1967), quoted in Chirelstein, Federal Income taxation 341 (4th ed. 1985)” (emphasis in original).

<sup>21</sup> GCM 39709 (emphasis added). According to footnote 4 of GCM 39709, market value fluctuations are taken into account “to some extent.” Market forces are captured, to some extent, in the determination of the discount rate. To the extent that actual market conditions over the period of deferral differ from the discount rate, the calculation takes no account of the difference. In our view, such market forces differ materially from depreciation as they are incapable of systematic and rational prediction at the time of the gift. Thus, ignoring the effect of market forces offers no justification for ignoring the effects of depreciation.

<sup>22</sup> *Id.* (Emphasis added). After reviewing a number of accounting texts defining “present value” and reviewing pertinent valuation regulations, it remains a mystery how the Service concludes that the *corpus* should remain *constant*. This is particularly true since Congress only permitted “two factors alone” to effect the charitable deduction. One must wonder under what circumstances has the Service ever argued before that the corpus of a charitable remainder trust or PIF must remain “constant” especially since it has always been at least tacitly understood that the fair market value of split-interest trusts will vary.

remainderman receives value which bears a reasonable relationship to that upon which the donor's deduction was based is to require that a pooled income fund include in its governing instrument a clause requiring the trustee to establish a reserve for depreciation as a condition of approval of the fund as a pooled income fund.<sup>23</sup>

Without the depreciation reserve, the Service concludes, the integrity of the corpus given to the remainderman "and indeed the integrity of the pooled income fund as a device for charitable giving. . . ." <sup>24</sup> will be jeopardized. Thus:

We believe that the authority to require the insertion of this clause [requiring a depreciation reserve] is *implicit* in the method of valuation set forth in the regulations adopted by the Secretary.<sup>25</sup>

To summarize, it seems fair to restate the Service's position as follows: (1) the valuation of the remainder interest is based upon the discount rate and the deferral period; (2) the present value of the remainder interest (the corpus passing to the charity at the end of the deferral period) must remain constant during the deferral period; (3) "real" depreciation reduced this corpus and thus reduces the present value of the remainder interest; and (4) in order to protect the integrity of the deduction and the charitable giving vehicle itself, a depreciation reserve to replace the reduced corpus is not only proper, but just, and is authorized by the Secretary's regulatory authority.

Simply by the Service's use of the words "implicit" and "Congress assumed," one develops the sense that the GCM might have a number of theoretical problems. It does, and these problems raise questions concerning the Service's authority to impose a depreciation reserve:

(1) According to the GCM, Congress limited the factors which may be considered in determining a donor's charitable deduction to the discount rate and the deferral period. How can the Service then add the requirement of a depreciation reserve?

(2) The IRS will not issue a favorable ruling unless the governing instrument of the PIF requires a depreciation reserve. Section 642(c)(5), enacted over 20 years ago, governs pooled income funds and does not mention a depreciation reserve. Does the Service have the authority to amend the requirements of a PIF, without Congressional approval?

(3) Congress addressed the issue of depreciation as it affects the value of the remainder interest and the amount of the charitable deduction under §170(f)(4).<sup>26</sup> Why didn't the Service raise §170(f)(4) as authority for its position? In light of this explicit statute, how can the Service state that "Congress assumed" and that a number of conclusions and assumptions are "implicit"? Does the Service believe that Congressional action is required and thus does not want to impair its arguments by citing a similar statute?

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23 *Id.*

24 *Id.*

25 *Id.* (Emphasis added).

26 §170(f)(4) reads: VALUATION OF REMAINDER INTEREST IN REAL PROPERTY. - For purposes of this section, in determining the value of a remainder interest in real property, depreciation (computed on the straight line method) and depletion of such property shall be taken into account, and such value shall be discounted at a rate of 6 percent per annum, except that the Secretary may prescribe a different rate.

(4) When Congress wants to grant the IRS authority to legislate by regulation, it specifically provides such authority in the law.<sup>27</sup> Under §642(c)(5), however, the Service’s authority is “interpretive,” not “legislative.” Is the Service in GCM 39709 merely interpreting?

The Service attempts to validate its authority to require a depreciation reserve by citing as “additional support” the Uniform Revised Principal and Income Act (the Revised Act).<sup>28</sup> The Service quotes the Revised Act for the proposition that “a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles shall be charged against income.”<sup>29</sup>

The Service seems to be stretching the intent and spirit of the Revised Act. According to §2(a) of the Revised Act, the governing principle is that a trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen, and in accordance with the trust instrument. To reinforce this general rule, the Revised Act similarly grants the trustee discretion in crediting a receipt of charging an expenditure to income or principal or partly to each, stating that “no interference of imprudence or partiality arises from the fact that the trustee may have made an allocation contrary to a provision in [the] Act,”<sup>30</sup> if such allocation was in accordance with the trust instrument.

The rest of the Revised Act elaborates upon §2 of the Act and provides rules for specific situations where the trust instrument is silent. It is within this framework that the revised Act requires as a charge against income “a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles. . . .”<sup>31</sup>

According to Bogert on *Trusts and Trustees*, §829 and Scott on *The Law of Trusts*, §239.4, this language regarding a depreciation reserve was inserted in the Revised Act because many trustees in the past failed to consider, to the detriment of the remainderman, that trust assets were depreciating and that at the end of the income beneficiaries’ lifetime there would be no trust corpus left for the remainderman. Thus, the revised Act added language regarding a depreciation reserve, subject to the general rule of §2 of the Act, in the event that the trust instrument was silent on the issue. In short, the Revised Act does not mandate a depreciation reserve, it makes such a reserve optional.

Despite the discretionary language of the Revised Act, despite the fact that a number of states have not adopted the revised Act, despite the right of lawyers for decades to draft trust instruments in accordance with their clients’ wishes, the Service concluded “for Federal tax purposes” such a reserve is necessary to protect the remainderman.

In light of the history of abusive tax schemes, the ITS properly should focus on such matters. However, the pooled income fund has distinctions which inherently prevent such abuses. First, by law,

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27 See e.g., §§ 385(a), 414(o), 595(d), 1286(f), 6049(d)(7)(D), 6421(h), 6621(c)(3)(B).

28 Unif. Revised Principal and Income Act, 7B U.L.A. 176 (1985). Many states have adopted the Revised Act. See e.g., Md. Est. & Trusts Code Ann. §14-201 *et seq.* (1974).

29 Unif. Revised Principal and Income Act §13(a)(2) (emphasis added).

30 *Id.* at §2(b)

31 *Id.* at §13(a)(2)

the charity is responsible for “maintaining” the pooled income fund.<sup>32</sup> This “maintenance” of the PIF is usually achieved by the charity’s right and obligation under the governing instrument (usually a trust) to select and replace the trustee. Many times, the trustee of the PIF is the business manager or controller of the charity.

It is obvious that a charitable remainderman of a PIF would not allow the trust to invest in speculative assets or in assets which would be non-existent upon the death of the income beneficiaries. This would be clearly against the charity’s best interests. If a trustee nonetheless wanted to so invest, the charity could simply remove the trustee. If such an investment were made before the charity had a chance to object, the trustee could use its discretion to create a depreciation reserve under the authority granted by most state laws and governing instruments. Failure to create a reserve under these circumstances would be a clear breach of fiduciary duty. If the charity wanted the reserve created and the trustee refused, the charity would simply remove the recalcitrant trustees and appoint another one.

Just because a transaction involved a depreciation deduction and also happens to be related to a charitable gift is no reason to arbitrarily “outlaw” or emasculate a charitable giving vehicle. The vehicle developed because charities need to raise capital funds to fulfill their charitable and educational purposes. If charities do not fulfill their tax-exempt purposes, then the Government will have to do so, at a much greater cost to the taxpayer.

Regardless of the merits of the arguments proffered by both sides, the Service has ruled there will be a depreciation reserve and such will be the law for at least all “new” pooled income funds.<sup>33</sup> If a reserve is to exist, it is clear that the Service is correct that the reserve must be maintained according to GAAP.<sup>34</sup>

The GCM states that “[u]nder GGAP the goal of a depreciation method should be to provide for a reasonable, consistent matching of revenue and expense, by systematically allocating the cost of the depreciable asset over its estimated useful life.”<sup>35</sup> According to the Service, the purpose of the depreciation reserve in the context of a pooled income fund “is analytically similar to the matching of costs and income over the useful life of an asset.”<sup>36</sup>

As partial support for its conclusions in the GCM, the Service cites Statement of Financial

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<sup>32</sup> §642(c)(5)(E); Regs. §1.642(c)-5(b)(5).

<sup>33</sup> Assuming that the Service requires a depreciation reserve, the charity finds itself in an untenable position if it wants to challenge the Service. No charity will endanger its donor base by subjecting them to IRS audit and the potential assessment of taxes, penalties and interest. Nor would any lawyer or accountant risk subjecting himself and his client to civil and/or criminal penalties for purposely violating a published ruling (even if it is only a General Counsel Memorandum). Further, litigation is not a viable recourse for the charitable institution because of the expense and time consumed. In short, it seems that the only alternative left open to charities is for them to petition Congress for legislative action.

<sup>34</sup> The principles which constitute the “Ground rules” for financial reporting are termed GAAP. GAAP is intended to be “a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting.” FASB, Statement of Financial Accounting Concepts No. 5, “Recognition and Measurement in Financial Statements of Business Enterprises.” See, *Generally*, Meigs and Meigs, *Accounting: The Basis for Business Decisions*, at 6, 15-17, 511-522 (7th ed. 1987).

<sup>35</sup> GCM 39709.

<sup>36</sup> *Id.*

Accounting Standards No. 93, which was promulgated by FASB<sup>37</sup> to address the issue of tax-exempt organizations. The Service admits that there is no rule or standard which establishes the “amount” of depreciation to be recognize for a particular accounting period. Instead, the Service concludes: The Board reaffirmed its conclusion that each organization needs to consider the characteristics of individual assets in making the estimates necessary to determine the amount of depreciation to be recognized. Measuring the extent to which the future economic benefits or service potential of a particular asset is sued up during a period or in a particular use requires estimates of salvage values and useful lives requires *the exercise of judgement considering all the facts and circumstances*. That estimation and evaluation process is not unique to particular assets or particular kinds of entities.

GAAP requires a “systematic and rational” procedure to account for depreciation, rather than leaving these matters entirely to the trustee’s discretion.<sup>38</sup>

As an example of a “systematic and rational” means of accounting for depreciation within the context of a building owned by a real estate PIF, the IRS gives the example of a building worth \$100,000, with a salvage value of \$20,000. In this situation, the Service argues that a depreciation reserve is required. The “amount” of the reserve will apparently vary, depending upon the salvage value and “all the facts and circumstances.”<sup>39</sup>

## The Impact of GCM 39709

It is difficult at best to determine the impact of GCM 39709. If Examples 1 and 2 above prove to be the typical scenario of the economic and tax consequences, the impact could be substantial.

In reality, however, the GCM is not harmful if one starts with the assumption that a reserve in some amount is required for economic (not legal) purposes. No building could survive a 25-year period and still be functional without capital repairs and maintenance.

Assuming that some reserve is necessary, the following examples attempt to quantify the impact of GCM 39709. Suppose in Hypothetical #1 a PIF purchases a building from a charity for \$10,000,000, and the accountant assigns a useful life of 80 years to the structure.<sup>40</sup> Further, suppose the effective rate of the lease is 7%, the charity creates a depreciation reserve *outside* of the PIF of 1.25% of the purchase price to fund repairs and maintenance and the charity actually uses the reserve for such purposes.

Compare this with Hypothetical #2, which is based on the same facts. This time, however, suppose that a depreciation reserve is established within the PIF and that the lease rate is increased to 8.25% to take into account the reduced cash flowing to the donors by reason of the creation of the

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37 Officially known as the Financial Accounting Standards Board and herein referred to as FASB or the Board.

38 GCM 39709 (emphasis added).

39 The Service in this example attempts to discount the potential appreciation of the underlying asset by arguing that, if the building appreciates in value after 40 years, such appreciation is attributable to the “salvage value” and not to the asset as a whole (presumably, 80% of which has wasted away).

40 It would not be difficult, depending upon the underlying asset, for the accountant, backed by an engineer’s report, to assign a useful life of 80 years. Admittedly, useful life and depreciation contemplate not only the duration of existence but obsolescence. However, if a well-constructed building were to be used currently and for the indefinite future as classrooms, it is easy to comprehend an 80-year useful life, since obsolescence is not a significant factor.

depreciation reserve. Here, as in Hypothetical #1, assume that the reserve is used for capital maintenance and repair. Economically, in each case, the charity will be paying out \$825,000 to either the PIF alone (Hypothetical #2) or to the PIF (\$700,000) and presumably a general contractor for maintenance and repair (\$125,000) (Hypothetical #1). Thus, the charity is no better or worse off.

When comparing the hypotheticals from the donor's perspective, the results are essentially the same. He receives a 7% cash-on-cash return on his contribution, but loses some depreciation deductions since he is entitled in Hypothetical #2 to only 50% of those depreciation deductions previously available. If the donor had contributed \$100,000 of appreciate property to the PIF, the after-tax difference between the hypotheticals amounts to only \$1,250 in lost depreciation deductions.<sup>41</sup>

The question which naturally arises is: "What happens to the PIF, the donor and the charity if part or all of the depreciation reserve is not actually used for capital improvements?" To answer this question, the authors ran two projections, reproduced as Exhibits A and B. Exhibit A<sup>42</sup> shows the results where the depreciation reserve within the PIF is actually used to pay for capital improvements, and Exhibit B shows the results where, to the other extreme, none of the reserve is used for capital improvements. In both cases, the proceeds from the sale of the building to the PIF are placed into an endowment fund and not spend until the death of the last income beneficiary 38 years later. It is clear from these two Exhibits that the average rate of return is substantially improved (from a net of 7% to 8.4%) and that the endowment for the charity in year 38 is substantially greater (from approximately \$138,000,000 to over \$700,000,000) when the reserve is not used.

There are other ways to avoid the potential adverse impact of GCM 39707. For example, a lease could require a tenant to maintain the real estate in as good a condition at the end of the term as the date upon which the term commenced. If such were the case, the lease would become a significant factor in analyzing, as required by GAAP and the GCM, all of the facts and circumstances in order to determine the proper "amount" of the depreciation reserve.

## **The Specimen Pooled Income Fund**

In the latter part of 1988, the Service issued two revenue procedures regarding PIFs. In Rev. Proc 88-53, the Service provided taxpayers with a sample form of declaration of trust and instruments of transfer that meet the requirements of §642(c)(5). A close examination of the trust reveals that its provisions virtually mirror the regulations<sup>43</sup> and illustrative sample provisions proposed by the Service in earlier revenue rulings<sup>44</sup> for qualification as a pooled income fund. However, where optional provisions for PIF governing instruments are made available by the regulations, the sample trust only provides for one option and disregards other variations for establishing a PIF, thereby making the scope of the sample

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<sup>41</sup> If our 55-year old donor were to make a gift to a PIF in the amount of \$100,000, the present value difference between Hypothetical #1 and #2 (over a 29-year life expectancy and assuming an 8.25% discount rate) would amount to approximately \$1,250.00. It is the authors' opinion that this differential is not large enough to deter the average \$100,000 donor. However, if such were the case, the charity could make a business decision to increase the projected net rate of return by 0.4%. Further, the "after-tax cost" to the donor of \$1,250 may be altogether illusory in today's tax climate, unless he has passive gains to offset these passive losses.

<sup>42</sup> The first portion of Exhibit A is similar to Exhibit B of Part I of this Article.

<sup>43</sup> Regs. §1.642(c)-5.

<sup>44</sup> Rev. Rul. 72-196, 1972-1 C.B. 194; Rev. Rul. 82-38, 1982-1 C.B. 96; Rev. Rul. 85-57, 1985-1 C.B. 182.

trust extremely narrow. Furthermore, when compared to the regulations and other proclamations of the Service governing PIF qualification, the language of Rec. Proc. 88-53 and sample trust contain numerous problems and discrepancies.

First, §2 describes the impact of utilizing the sample trust provided by the Service as follows: [T]axpayers who make transfer 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*.<sup>45</sup>

Therefore, one of the requirements for receiving the blessing of the Service is that the PIF be a valid trust under local law. However, the regulations provide that a fund that meets the requirements of a qualifying pooled income fund does not have to be a trust under local law.<sup>46</sup>

Second, the introduction of the sample trust designates and initial trustee and paragraph 5 gives the charity the power to remove and appoint new trustees. However, the Rev. Proc. Fails to include a sample trust agreement between the charity and an outside trustee. In addition, the sample trust does not specify removal requirements or procedures, nor does it address the powers and responsibilities of the appointed trustee. These omissions could be interpreted as preventing a charity from engaging an outside trustee which is contrary to the regulations under §642(c)(5).<sup>47</sup>

Third, the last paragraph of paragraph 7 of the sample trust provides that 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.”<sup>48</sup> The problem with this provision is that the regulations permit an option, so that one may elect instead to have the income interest of the beneficiary prorated to the date of the beneficiary’s death.<sup>49</sup> Thus, the Service has selected one option over the other and effectively constrained the use of the other.

Fourth, paragraph 9 of the sample trust lists prohibited transactions for the trustee. Specifically, this paragraph provides that the trustee is prohibited from making investments that jeopardize the charitable purpose of the fund as in §4944 and from retaining excess business holdings as provided in §4943. Generally, these sections would be applicable to a PIF because a PIF is a split-interest trust.<sup>50</sup> However, where a split-interest trust is allowed a deduction under §§170, 642(c), 2055, or 2522 for amounts payable to every remainder beneficiary but not to any income beneficiary (e.g., where the charity’s only interest in the trust is an remainderman, such as with a PIF), §§4943 and 4944 do not

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45 Rev. Proc. 88-53 (emphasis added).

46 Regs. §1.642(c)-5(a)(2).

47 See Regs. §642(c)-5-(b)(2). According to this regulation, a charity maintains the control required over a fund for qualification under §642(c)(5) when it has the power to remove trustees of the fund and appoint new ones. As long as a charity has these powers, the regulations permit the charity to appoint an outside trustee.

48 Rev. Proc. 88-53.

49 Regs. §1.642(c)-5(b)(7).

50 See §4947(a)(2).

apply.<sup>51</sup> Therefore, inclusion of the §§4943 and 4944 prohibitions was unnecessary.

Fifth, paragraph 10 of the sample trust provides that “the trustee shall not accept or invest in any depreciable or depletable assets.” Here, the sample trust fails to address an obvious available option, *i.e.*, that a PIF can hold real estate.<sup>52</sup> Once again, the Service has selected one PIF form over another and effectively constrained the use of options.

Sixth, the Instruments of Transfer include the donor’s reservation of the right to revoke, solely by will, a beneficiary’s income interest. According to the regulations, the retention of this right to revoke is optional.<sup>53</sup> The purpose of including this right to revoke is to prevent a completed gift of the income interest. This, however, prevents the use of the donor’s annual exclusion.<sup>54</sup> Here, by automatic inclusion of this right to revoke, the Service is effectively usurping the ability of donors to a PIF to coordinate their estate planning to meet specific needs. It may be preferable for some donors to take advantage of the annual exclusion and prevent the income interest from being included in their estate, thereby saving some of their unified credit.<sup>55</sup>

Despite, these inherent problems with the sample trust, if a public charity responsible for the creation of a PIF makes reference to Rev. Proc. 88-53 and adopts *substantially similar documents*, the Service will recognize the trust documents as satisfying the requirements for a PIF under §642(c)(5) and the regulations thereunder.<sup>56</sup> The advantage of complying with the sample trust is that it ensures that contributions to the PIF will qualify for a charitable deduction for the remainder interest under §§170(f)(2)(A), 2055(e)(2)(A), and 2522(c)(2)(A) for income estate, and gift tax purposes, respectively.<sup>57</sup>

Although the Service views this Procedure as a service to taxpayers by providing a document which guarantees PIF qualification and saves taxpayers the time and expense of requesting a favorable ruling,<sup>58</sup> the benefits of the Procedure do not extend to real estate pooled income funds. According to the Service: 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

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51 4947(b)(3)(B).

52 See Rev. Rul. 79-387, 1979-2 C.B. 247, and PLR 8535048. In PLR 8535048, the Service ruled that real estate is an appropriate investment for a PIF and permitted a pass-through of depreciation on realty to income beneficiaries.

53 Regs. §1.642(c)-5(b)(2). The regulation provides that “[t]he donor *may* retain the power exercisable only by will to revoke or terminate the income interest of any designated beneficiary other than the public charity.” (Emphasis added.)

54 Section 2503(b) provides that “[i]n the case of gifts (*other than gifts of future interests in property*) made to any person by the donor during the calendar year, the first \$10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year.” (Emphasis added).

55 Section 2038 provides that transfers made by a decedent where the enjoyment of the transfer was subject at the date of his death to any change through the exercise of a power to alter, amend or revoke the transfer shall be included in the value of the gross estate.

56 Rev. Proc. 88-53.

57 *Id.*, §3.

58 *Id.*, §2.

provisions of this revenue procedure.<sup>59</sup>

A real estate PIF trust instrument will include additional substantive provisions permitting the PIF to accept or invest in real estate and requiring the trustee to establish a depreciation reserve. These additional provisions will in all likelihood prevent the real estate PIF from being considered “substantially similar” to the sample trust. As a result, the real estate PIF is probably outside the scope of the sample trust, preventing it from “safe harbor” qualification under the provisions of Rev. Proc. 88-53 and the assurance that the fund will qualify for available charitable deductions.

In addition to Rev. Proc. 88-53, the Service issued Rev. Proc. 88-54. In this Procedure, the Service amplified Rec. Proc. 88-3 which lists those areas in which the Service will not ordinarily issue rulings or determination letters.<sup>60</sup> The Procedure specifically makes reference to the sample trust provided by Rev. Proc. 88-53 and indicates that rulings and determination letters will not ordinarily be issued regarding the following: (1) whether a PIF satisfies the requirements of §642(c)(5) and (2) whether a transfer to a PIF qualified for a charitable deduction under §§170(f)(2)(A), 2055(e)(2)(A), or 2522(c)(2)(A).<sup>61</sup>

The issue surrounding Rev. Proc. 88-54 is how the Service will interpret the work “ordinarily.” Will it continue to issue rulings on those PIFs whose substantive provisions differ from those of the sample trust? To what degree must those provisions differ from the provisions of the sample trust before the Service will grant a ruling, if at all? Unfortunately, the Service has not addressed or answered these issues in Rec. Procs. 88-53 or 88-54.

Furthermore, it does not seem likely that the Service will address these issues in the future. As of this writing, since the issuance of Rev. Procs. 88-53 and 88-54, the Service has had once occasion to rule on the qualification of a PIF submitted after the effective date of the procedures. In answer to a request for a ruling regarding the qualification of a PIF under §642(c)(5) and the regulations thereunder, the Service replied as follows:

Pursuant to Rev. Proc. 89-3, 1989-1 R.B. 9, and Rec. Proc. 88-54, 1988-48 I.R.B. 16, the Internal Revenue Service has *discontinued* issuing rulings concerning whether pooled income funds satisfy the requirements of section 642(c)(5) of the Code.

In lieu of seeking the Service’s advance approval of a pooled income fund, taxpayers are directed to follow the sample provisions for a pooled income fund as outlined in Rev. Proc. 88-53, 1988-48 I.R.B. 13. By following the model contained in Rev. Proc. 88-53, taxpayers can be assured that the Service will recognize the trust as meeting all of the requirements of a qualified pooled income fund, provided that the trust under applicable local law.<sup>62</sup>

This private letter ruling is unclear for three reasons. One, the ruling conveniently omits any reference to the provisions of the governing instrument submitted by the taxpayer who requested the

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59 *Id.*, §8.

60 Rev. Proc. 88-54.

61 *Id.*, §2.

62 PLR 89 29070 (em phasis adde d).

ruling. What types of additional provisions, if any, did the trust document contain? Did the Service consider the document to be substantially similar to the sample trust? Two, the Service states that it has discontinued issuing rulings concerning PIF qualification. This statement contradicts the language of Rec. Proc. 88-54 which states that the Service will not ordinarily issue rulings regarding PIF qualification. Does this mean that the Service is interpreting “not ordinarily” as “not at all?” Three, the Service suggests that the taxpayer follow the sample trust in lieu of seeking advance approval of a PIF. Does this mean that the Service will no longer recognize PIFs whose trust documents contain language other than language contained in the sample trust?

It is difficult, at best, to be certain what Rev Procs. 88-53 and 88-54 mean in conjunction with the real estate pooled income fund. However, the Service does not appear to be jaundiced toward the real estate PIF.<sup>63</sup> Instead, the Service indicates the basis for their action in creating a sample trust is that they receive many requests for rulings regarding PIF qualification and that “[i]n many of these requests, the trust instruments and charitable objectives are *very similar*.”<sup>64</sup> Since the provisions of a real estate PIF are not very similar to the provisions of the sample trust, Rec. Proc. 88-53 does not seem to be including real estate PIFs in its scope.

It is likely that the Service will continue to rule on real estate PIF qualification because the provisions of the real estate PIF are not substantially similar to those of the sample trust and the Service left an opening to issue such rulings in Rev. Proc. 88-54 by using the phrase “will not ordinarily issue rulings” rather than “will not issue rulings.”<sup>65</sup> So, while real estate PIFs do not have the automatic assurance, provided by the sample trust, that they qualify under §642(c)(5) or that contributions will be deductible, Rec. Procs. 88-53 and 88-54 do not preclude a charitable organization from establishing a real estate PIF or from obtaining ruling regarding their qualification and the deduction of charitable contributions to them.

## SUMMARY

The real estate pooled income fund is a new variation on a 20-year old law. In today’s economic and tax environment, it has unique and considerable economic benefits for the charity and the donor.

The Service’s attempts in GCM 39709 to prevent the PIF from being abused as a charitable

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<sup>63</sup> In fact, the IRS has attempted to curtail the number of private letter rulings it issues in all areas. In Rec. Proc. 89-34, the Service revised the procedure for issuing letter rulings by adding a new section providing that it “will not issue a ruling with respect to an issue that is clearly and adequately addressed by a statute, regulation, decision of the Supreme Court, tax treaty, revenue ruling, revenue procedure, notice or other authority published in the Internal Revenue bulletin except in extraordinary circumstances...” The Service, which recently decided to delay implementation of this policy until February 5, 1990 in response to concerns expressed by tax practitioners (Announcements 89-104 and 89-105, 1989-35 I.R.B. 19, 20) restrictions and limited resources available for taxpayer guidance. See *8 Tax Mgmt. Wkly Rpt.* 765 (6/19/89). Furthermore, the IRS indicated that it expected to “issue additional guidance in revenue rulings and revenue procedures that will eliminate the need for ...additional rulings...” *Id.* According to the Service, these decisions to reduce the number of private letter rulings issued are not to be interpreted as an attempt by the Service to turn its back on its commitment to the private letter ruling process. *Id.*

<sup>64</sup> Rev. Proc. 88-53, §2 (emphasis added). The pooled income fund is not the only charitable giving vehicle for which the Service has supplied sample trust documents. In Rev. Proc. 89-20, 1989-9 I.R.B. 59, the Service adopted a sample form declaration of trust for a charitable remainder unitrust that meets the requirements of §664(d)(1). In each of these Procedures, as with Rec. Proc. 88-53, the Service explained that it receives many trust instruments that are very similar and that the sample trust documents is being provided to taxpayers in an attempt to save the time and expense associated with requesting and processing private letter rulings.

<sup>65</sup> In conversations with the authors, the Service indicated that it intends to continue issuing private letter rulings regarding the qualification of real estate PIFs because the trust document for a real estate PIF differs substantially from that of a conventional PIF and because “ordinarily” does not currently apply to real estate PIFs.

giving vehicle are understandable, but not justified. There is no practical need for a depreciation reserve according to GAAP, because of the distinctions of the vehicle itself. Nor does the Service have the legislative authority to require such a reserve.

Nonetheless, the Service has required a depreciation reserve, and if one must exist then it can only be established according to generally accepted accounting principles, taking all facts and circumstances into account. The establishment of a depreciation reserve does not damage the real estate PIF to any great extent. Neither the charity nor the donors are affected significantly by such a requirement. The economics of the transaction are essentially the same.

By limiting the issuance of private letter rulings in this area, it does not appear that the Service is discriminating against the real estate PIF. However, the stage is set for the Service to exercise its “discretion” by refusing to rule on real estate PIFs in an attempt to eliminate this vehicle for charitable giving purposes. This has not occurred, and the authors have been informally told that this is not the Service’s intention. Nevertheless, it would seem that the time is ripe for establishing a real estate pooled income fund. The rules may change some day, and the process of remedial legislation is slow

## **FEDERAL AND STATE SECURITIES LAW IMPLICATIONS**

Any charity that considers using a pooled income fund for planned giving should be aware that the fund, the interests in such fund and the persons soliciting gifts by means of such fund may be subject to the provision of both the federal and state securities laws. In addition, certain states, either by express statutory provisions or in practice have made funds subject to state charitable solicitation laws. The effect of the application of the foregoing laws to PIFs vary widely from jurisdiction to jurisdiction. These regulations relate to fundamental structural and marketing issues such as who may be solicited and accepted as a donor to a PIF, where such solicitation and acceptance may occur, what written materials must be provided to prospective donors and what advertising and promotion may be done. It is important to consider the application of all such laws early in the process of organizing a PIF in order to ensure compliance with applicable law and, at the same time, to create a PIF that is marketable for the beneficiary charity.

## **FEDERAL SECURITIES LAW**

The Securities and Exchange Commission (SEC) issued a release in 1980<sup>66</sup> (Release) that set forth its position with respect to the applicability of the federal securities laws to PIFs. The SEC took the position that “an acquisition of an interest in a pooled income fund for consideration may be an investment. In that case the interest would be a security of which the pooled income fund would be the issuer. Furthermore, if the pooled income fund were an issuer of a security, it would, if primarily engaged in the business of investing in securities, be an investment company.”<sup>67</sup>

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<sup>66</sup> Pooled Income Funds Release No. 33-6175, 34-16478, IC-11016, Fed. Sec. L. Rep. (CCH) ¶47,374 (Jan. 10, 1980).

<sup>67</sup> *Id.* at 36,168. The SEC based its conclusion on certain federal securities law definitions such as §3(a)(1) of the 1940 Act [15 U.S.C. §80a-3(a)(1)], which defines “investment company” to mean any issuer which is or holds itself out as being primarily, or purposes to engage primarily, in the business of investing, reinvesting, or trading in securities; §2(a)(22) of the 1940 Act [15 U.S.C. §80a-2(a)(22)], which defines “issuer” to mean every person who issues or proposes to issue any security, or has outstanding any security which it has issued; and §2(a)(36) of the 1940 Act [15 U.S.C. §80a-2(a)(36)], which defines “security” to mean, among other things, any investment contract. The test for an investment contract, as cited by the SEC in the Release, is “whether the scheme involves an investment of money in a common enterprise with

The SEC considered whether a PIF satisfies the requirements of the so-called “charitable organization exception” contained in §3(a)(4) of the Securities Act of 1933<sup>68</sup> (the “1933 Act”), §12(g)(2)(D) of the Securities Exchange Act of 1934<sup>69</sup> (the “1934 Act”) and §3(c)(10) of the Investment Company Act of 1940<sup>70</sup> (the “1940 Act”). These provisions exempt an issuer from the registration provisions of the 1933 Act and the 1934 Act and from the definition of an “investment company” in the 1940 Act if: (1) an issuer is organized and operated exclusively for religion, educational, benevolent, fraternal, charitable, or reformatory purposes, and (2) no part of its net earnings may inure to the benefit of any private shareholder or individual. The SEC concluded that although PIFs are usually formed to benefit a charity, the PIF itself is not a “charitable organization.” The SEC observed that “it is questionable whether a pooled income fund could be deemed to be organized and operated exclusively for charitable purposes, since it is organized and operated to produce a regular income which must be currently distributed to beneficiary who are for the most part private individuals. [And, in] any event, the second part of the test would seem not to be met by a pooled income fund because of the distribution of its income to beneficiaries.” The SEC also confirmed its position that a “sale” for “value” may occur in the exchange of property for life income interests in a PIF.<sup>71</sup>

However, the SEC reiterated its belief that the primary purpose of persons who transfer property to a PIF is to make a gift to a charity and that this donative intent and the applicable Code provisions make registration under the federal securities law unnecessary.<sup>72</sup> Therefore, the SEC created a “safe harbor” for certain PIFs and will not seek enforcement if interest in PIFs are offered to the public without registration, provided the following circumstances exist:

- (a) The fund qualifies as a recipient of tax deductible contributions under §642(c)(5);
- (b) Each prospective donor is furnished written disclosures which fully and fairly describe the operation of the fund;<sup>73</sup> and
- (c) Each person soliciting gifts by means of the fund is either a volunteer, or a person who is employed in the public charity’s overall fund-raising activities who receives no commissions or other special compensation based on the amount of gifts transferred to the pooled income fund.<sup>74</sup>

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profits to come solely from the efforts of others” SEC v. *W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

68 15 U.S.C. §§77a-77aa.

69 15 U.S.C. §§78a-78jj.

70 15 U.S.C. §§80a.

71 Release at 36,169-36,170.

72 See e.g., American Council on Education, SEC No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶79,179 (Dec 14, 1972).

73 The SEC has expressed the view that as a matter of policy it will not review these disclosures and that the responsibility for determining compliance with this requirement lies with the charity. Release at 36,169, n.2.

74 Release at 36,169. The SEC, in subsequent no-action letters, has considered the circumstances under which contributions to PIFs or charitable remainder trusts or charitable remainder unitrusts may be commingled. See e.g., *Princeton University*, SEC No-Action Letter [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,246 (July 27, 1982); and *National Foundation for Philanthropy*, SEC No-Action

While thus providing a means to sell interests in PIFs without registration, the SEC emphasized that the antifraud provisions of the federal securities laws do apply to sales of interests in a PIF.<sup>75</sup>

Although many charities may find that creating a PIF which satisfies the “safe harbor” guidelines is feasible from both an organizations and marketing perspective, some charities may find that their particular needs require the professional solicitation assistance of individuals who would receive commissions or compensation based on the amount of gifts transferred. In this case, the safe harbor provided by the Release would no longer be available and the interest being offered and sold in the PIF must be sold pursuant to a registration statement or an exemption from registration. Likewise, the fund, the charity and any trustee may be required to register under the 1940 Act.<sup>76</sup>

The requirements to register interests in a PIF are no different than the requirements to register any other security. A registration statement on the appropriate form must be filed and is subject to SEC review. Upon effectiveness, the prospectus can be widely distributed. An exemption from registration involves a much more limited dispersal of information. Because the tax benefits associate with investment in PIFs are usually beneficial to persons who meet the qualifications for accredited investors,<sup>77</sup> the most commonly used exemption from the registration requirement of the 1933 Act is that provided pursuant to Regulation D of the 1933 Act.<sup>78</sup> Both the 505 and 506 exemptions, which may be used for offerings exceeding \$1,000,000, permit sales to an unlimited number of accredited investors (provided the offering remains private), but limit sales to no more than 35 non-accredited investors. Because this is a ‘private’ offering, general advertising is prohibited. As with any offering, when evaluating the availability of an exemption from registration for a PIF, it is important to weigh the benefits of not registering against the limits imposed by such exemptions, such as the limits on advertising, on the number of offerees and purchasers and on the aggregate offering amount.

## State Securities Law

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Letter, [1984-1985 Trans fer Binder] Fed. Sec. L. Rep. (CCH) ¶77.902 (Feb. 19, 1985). Discussion of these issues is beyond the scope of this article.

<sup>75</sup> Release at 36,169-36,170. The general pattern for defining fraud under the securities laws is set forth in §17(a) of the 1933 Act, which makes it unlawful to: (1) employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

<sup>76</sup> In a 1987 no-action letter, Gustavus Adolphus College Pooled Life Income Fund, SEC No-Action Letter (Oct. 19, 1987) (LEXIS, FED SEC library, NO ACT file), the SEC considered a request for a no-action position under the 1940 Act with respect to a real estate PIF that planned to issue units that would be registered under the 1933 Act and that would be offered by a registered broker-dealer. In its request letter, *Gustavus* noted that the investment of the fund primarily in depreciable property differs from conventional PIFs because such investment would result in depreciation deductions to the income beneficiaries and such income would constitute passive income that may shelter passive losses. *Gustavus* went on to conclude that because of these tax benefits, contributions to the fund would be somewhat more attractive than donations to a conventional PIF. The SEC concluded that the *Gustavus* fund was not of the type described in the Release because of the use of the broker-dealer and because the more attractive tax benefits suggest that “the contributors’ primary intent may not be donative.” Nonetheless, the SEC concluded that the fund would be excepted from the definition of “investment company” under the provisions of 1940 Act if, prior to the effective date of its registration statement under the 1933 Act, the fund sold all of its securities holdings and invested in a note secured by real estate and thereafter invested substantially all of the fund’s assets in only real estate secured exclusively by real estate, or both.

<sup>77</sup> Accredited investor, with respect to natural persons, is defined in Rule 501(a) to mean any person who comes within the following categories: (1) any person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000; or (2) any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

<sup>78</sup> 17 C.F.R. §230.501 to 508.

An offering of interests in a PIF must also meet the requirements of the securities laws of the jurisdictions in which the PIF investors reside. State securities laws applicable to PIFs are remarkable in the number of different approaches that individual jurisdictions have taken to regulating PIFs. Only a small minority of jurisdictions have expressly provided in their applicable laws and regulations for the treatment of PIFs. Some of these jurisdictions have generally adopted the approach taken by the SEC in the Release, finding that a PIF interest is a security subject to state securities law which may be offered and sold when certain circumstances exist.<sup>79</sup> While the required circumstances are generally similar to those set forth in the Release, including the requirement that state antifraud provisions apply, one should be aware that some of these jurisdictions impose additional filing and disclosure requirements, limits on the use of promotional material, and investment advisor requirements. Other jurisdictions have crafted exemptions for PIF interest that do not follow the Release,<sup>80</sup> or that expressly include PIF interests within the general charitable organizations exemption,<sup>81</sup> or that, in contrast to the SEC, exclude PIF interests from the definition of “security.”<sup>82</sup>

In the majority of the remaining jurisdictions, securities of charitable organizations are generally exempt from the registration provisions of their respective securities laws, but a PIF does not qualify as a charity. Therefore, in many jurisdictions it may be necessary to register the interest in a PIF. It is advisable, however, to make inquiries of the appropriate securities authorities in these jurisdictions even if an exemption for PIFs does not appear to be available because certain jurisdictions may, in practice, interpret their general charitable organizations exemption to cover PIFs.

## State Charitable Solicitation and Trust Laws

With all PIFs it is important to evaluate the application of state charitable solicitation and trust laws. While these laws may seem to be applicable only to the charity and not to the fund, as suggested above, some jurisdictions may find that a PIF is a charity within the meaning of their charitable organizations security exemption and expect that the PIF comply with the charitable solicitations laws. Other jurisdictions may incorporate the requirements of the charitable solicitation and trust laws in their securities laws by reference, by requiring that PIF comply with such laws as a condition to availing itself

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<sup>79</sup> Code of Alabama, 1975, Securities Act of Alabama, Blue Sky Policy Statements, Opinion Letter, Pooled Income Trust for Charity (May 17, 1977) 1 Blue Sky L. Rep. (CCH) ¶7554; Florida Statutes, 1987, Florida Securities and Investor Protection Act, Rules of the Department of Banking and Finance, Division of Securities, Ch. 3E-500, Rule 3E500.512. 1 A Blue Sky L. Rep. (CCH) ¶ 17450A; Official Code of Georgia, Georgia Securities Act of 1973, §10-5-9 (15), 1A Blue Sky L. Rep. (CCH) ¶28,139; Michigan Compiled Laws, Uniform Securities Act, Blue Sky Policy Statements, Pooled Income Funds Release No. 89-5-S, Michigan Corporation and Securities Bureau (Mar. 28, 1989), 1A Blue Sky L. Rep. (CCH) ¶32,617; and Pennsylvania Statutes, Pennsylvania Securities Act of 1972, Registration of Securities, §202, 2 Blue Sky L. Rep. (CCH) ¶48,112, and Regulations of the Securities Commission, §202.093, 2 Blue Sky L. Rep. (CCH) ¶48,431b.

<sup>80</sup> General Laws of Massachusetts, Uniform Securities Act, Code of Massachusetts Regulations, 14.402(b)(13)(f), 1A Blue Sky L. Rep. (CCH) ¶31,472; and Oregon Revised Statutes, Oregon Securities Law, Oregon Administrative Rules, Rule 441-25-040, 2 Blue Sky L. Rep. (CCH) ¶47,550.

<sup>81</sup> Arizona Revised Statutes, Title 44, Ch. 12, Art. 4, §44-1843 (6), Blue Sky L. Rep. (CCH) ¶9133 (approved May 9, 1989, effective 90 days after adjournment of the Legislature).

<sup>82</sup> California Code Corporations Code, Corporate Securities Law of 1968, §25019 (1), 1 Blue Sky L. Rep. (CCH) ¶11,121, and Code of Regulations, Rule 260.019.1, 1 Blue Sky L. Rep. (CCH) ¶11,751; Indiana Code, Ch. 1, Securities Regulation, §23-2-1-1 (i)(ii), 1 A. Blue Sky L. Rep. (CCH) ¶24,101; Revised Code of Washington, The Securities Act of Washington, Washington Administrative Code, Securities Rules, WAC 460-52A 3 Blue Sky L. Rep. (CCH) ¶61,763; and Wisconsin Statutes, Uniform Securities Law, Blue Sky Policy Statements, Pooled Income Trust Fund and Interests as Securities, Opinion letter, Office of Commissioner of Securities (Feb. 4, 1983), 3 Blue Sky L. Rep. (CCH) ¶64,946.

of the applicable securities exemption.<sup>83</sup> In either case, the filing and disclosure requirements imposed by charitable solicitation laws are often substantially similar to those imposed by the securities laws.

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Pennsylvania Securities Act, §202.093 (a) (3); and Oregon Securities Law, Rule 441-25-040 (1) (b).