

ANNUITY AGREEMENTS

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METHODS AND PLANS

*of*

CHARITABLE ORGANIZATIONS

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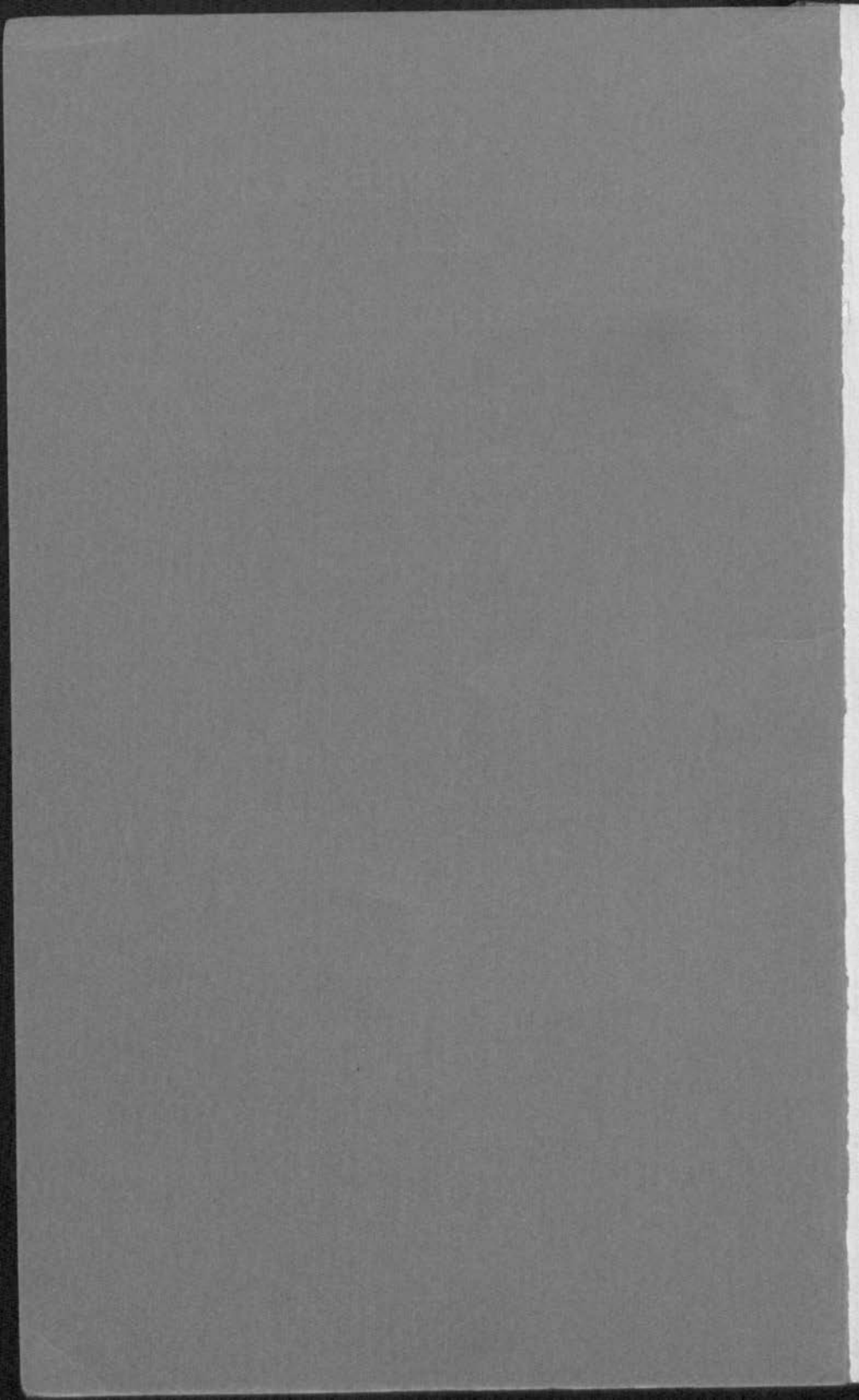
THIRD CONFERENCE

WISE PUBLIC GIVING SERIES

No. 34

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1931



METHODS AND PLANS  
*in using*  
ANNUITY AGREEMENTS

PAPERS PRESENTED AT A  
THIRD CONFERENCE ON ANNUITIES  
ATLANTIC CITY, N. J.  
NOVEMBER 17, 1930

*Edited by*

ALFRED WILLIAMS ANTHONY

*for*

THE SUB-COMMITTEE ON ANNUITIES OF THE  
COMMITTEE ON FINANCIAL AND FIDUCIARY MATTERS  
(To Study and Promote Wise Public Giving)  
OF THE FEDERAL COUNCIL OF THE  
CHURCHES OF CHRIST IN AMERICA

105 East 22nd Street, New York, N. Y.

WISE PUBLIC GIVING SERIES No. 34

1931

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NEW YORK  
MORTIMER AND WALLING, INC.  
460 WEST 34TH STREET  
1931



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## P R E F A C E

Three major conferences on annuities have been held, attended by from forty to sixty-five representatives of nearly as many charitable organizations in the fields of religion, education and general philanthropy. Several less formal conferences have given attention in a preliminary way to the subjects more fully dealt with in the larger gatherings.

Following the Conferences of April 29, 1927, and November 9, 1928, both held in New York City, booklets containing the papers presented have been published and circulated quite widely, which have had an important effect upon standardizing and stabilizing policies and methods in harmony with sound principles of law and of ethics.

This present volume contains the papers and addresses given at the Third Conference, held in Atlantic City, November 17, 1930. It penetrates somewhat more fully into the principles and details of methods and plans than its predecessors have done.

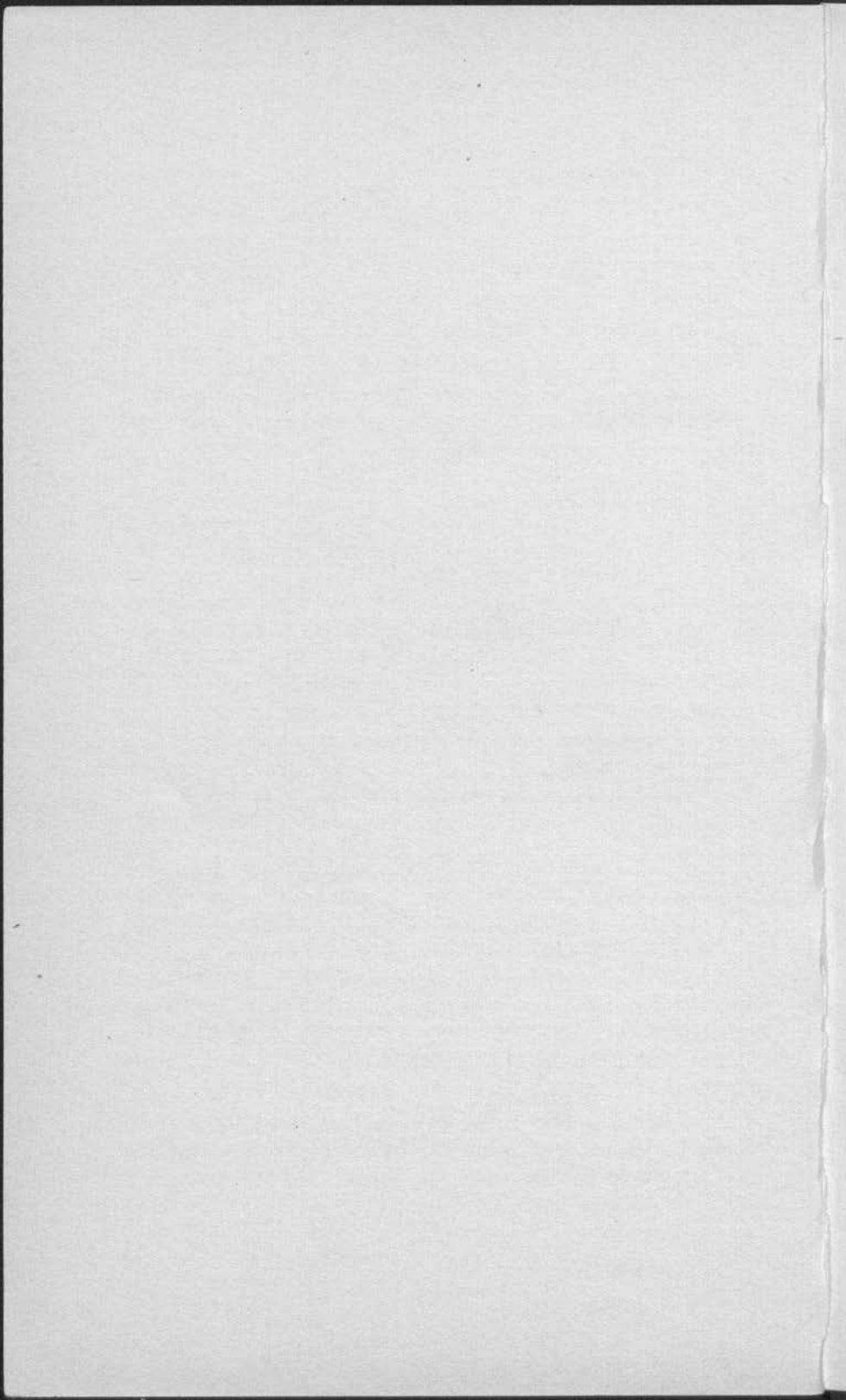
The price of these booklets, one dollar each, is intended to cover the cost of printing with but a small balance for circulars, postage and clerical work. Copies of this, and of the preceding volumes, may be had by addressing the Committee on Financial and Fiduciary Matters, 105 East 22d Street, New York, N. Y.

In behalf of the Sub-Committee on Annuities,

ALFRED WILLIAMS ANTHONY.

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## ANNUITY AGREEMENTS: CAUTIONS AND RESTRAINTS

ALFRED WILLIAMS ANTHONY

*Chairman, Committee on Financial and Fiduciary Matters,  
New York.*

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Annuity agreements are useful and valuable under certain conditions. They must, however, be employed with no little restraint and not a few cautions. The secretary of a charitable organization which has had experience in writing annuity agreements since 1867, states that his board has ceased to write such agreements and uses words such as these: "In spite of the amount realized a distaste for annuities has characterized the trustees of the society ever since" (referring to the time when they ceased the business); and the secretary adds, "We (meaning charitable bodies), are even now in danger of grievous scandals on account of the reckless misuse of annuity funds."

Certain perils may be named as follows:

1. *Misleading Terminology.*—The word "Bond" is frequently employed in this connection. Annuity agreements have nothing to do with "bonds" in the ordinary investment and financial sense of that word, for they are not secured by any mortgage upon real estate or other real property. They are bonds only in the sense that they are written contracts which bind two parties. The word "interest" should not be used in connection with an annuity payment. The payment is a stipulated sum, determined by a rate; it is not interest depending upon earnings. If it be called interest, it may be regarded as income to the recipient and become taxed as income.

2. *Rates.*—The rates may be and usually are in excess of the earnings of the funds involved. An excess annuity payment must be taken either from other funds or out of the principal itself. No charitable

organization has a right to use its general funds or its specific funds, as a premium to be turned over to an individual who has put a sum of money in a trust for a contingent possible benefit after death. It is not legally right to accept Smith's money for a charitable purpose and then to pay any part of it over to Jones, who may need more than the earnings of his gift, or think he needs it, for his own personal uses.

3. *Mixed Motives.*—It is not a real charitable gift if a person pays a sum of money with the chief thought in mind that he will receive in return a larger income from that money than if he invested it in any other way. Giving is no longer giving if the chief thought is that of getting.

4. *Legal Complications.*—The annuity business is based upon the expectancy of death. This brings it into the field of life insurance. An increasing number of states are regulating, or are proposing to regulate, the business with restrictions, liabilities, and registration, such as apply to the life insurance business.

5. *Reserves.*—Since obligations are assumed, both law and ethics require that funds shall be in hand to meet these obligations, as they accrue.

6. *Taxation.*—Since an annuity gift has in it the element of profit to the giver, laws are being framed, some have been framed, in different states which tax at least a portion of the gift and sometimes its payments to the annuitant, either as property not yet irrevocably released from his estate which will be taxable at least at the time of his death, or partly as income, taxable as received by him.

7. *Relations with Insurance Companies.*—Insurance companies do an annuity business as a part of their life insurance business. They understand actuarial risks, build up proper reserves, are under statutory rules and regulations, and have ample experience in administration and in the investment of funds, which by



the law of averages reduces and limits the risk they run. Charitable bodies have in some cases begun to reinsure their risks with life insurance companies, but if reinsurance of annuity risks is practiced by a charitable body, then it lays itself open to several challenges: (1) Has it not entered into partnership with insurance companies? (2) At least may it not, in the eyes of the law, be regarded technically as an agent of insurance companies? (3) Will prospective annuitants welcome the idea of having at least a portion of their funds, which they mean to designate to charity, shared with a commercial insurance company? (4) Will not the psychology of giving be yet further confused if at any turn it appears to involve a commercial transaction with outside parties? (5) If prospective annuitants know that insurance companies, on a commercial basis, can pay much larger annuity rates because their risks are relatively smaller, will not a good share of the annuity business be diverted to the insurance companies?

8. *By Way of Substitution.*—Who knows yet to what extent annuity agreements, attractive because of larger payments than the funds can earn, may become a substitute for other kinds of giving, and thereby, while seeming to be valuable in procuring funds, yet really undercut methods, free from objections, which would yield larger net returns?

The real merits and virtues of the annuity agreement lie in its adaptation to specific needs, usually such as the following: A person 65 years of age, let us say, is obliged to cease work; his savings are \$10,000, the income of which is about \$500 a year. He cannot live on \$500 a year and he must encroach upon his principal. He can live on \$700. In such a case a charitable organization might, under proper conditions, accept the \$10,000 and agree to pay \$700 a year so long as the annuitant lives. There might be an ultimate residuum of sufficient size to more than make up the difference between the earnings of the sum and the total of the annuity payments.

An unquestionably safe method of issuing annuity agreements is, as the colleges quite generally are doing, to agree to pay the *net earnings* of a sum of money so long as the annuitant lives. This method is essentially the acceptance of a living trust—it has no risks, it makes the annuity gift a gift in its entirety and benefits the annuitant through relieving him of care and responsibility and by settling his estate at least to the extent of this gift while he is living.

The Sub-Committee on Annuities was appointed by the Committee on Financial and Fiduciary Matters under instruction of the Conference held in March, 1927, as follows:

The Committee was appointed "to study and recommend the proper range of rates, the form of contracts, the amount and type of reserve funds and the nomenclature to be used, to ascertain and advise as to the legislation in the United States and the various states regarding annuities, their taxability, etc. This Committee is requested to make an immediate study of the matter of rates and to call a conference of interested parties on this matter at the earliest possible date. This Committee should be guided in its study by an early determination as to what is the primary motive in the writing of annuity contracts."

The preface to the first volume on annuities, issued in 1927, contains the following paragraphs, important still to hold in mind:

"As here used the word *annuity* has a technical meaning. It refers to the entire agreement and the execution of it, in accordance with which a person gives money, or other substantial equivalent, to an organization, which binds itself by contract, or agreement, to hold and administer the gift, and to pay to the donor an annual sum, varying according to the age and therefore according to the expected life of the donor, and ceasing only at the donor's death. The donor becomes an *annuitant* and the money paid him annually is, strictly speaking, the *annuity*, although the name has become expanded to cover the whole transaction.



“As rates have differed, as methods of soliciting and handling the annuity business have varied, as more organizations, educational, religious and secular, have begun issuing annuity contracts, and as laws in some of the states have already been enacted to regulate and safeguard the practice, it has become highly important, almost imperative, that some common standards and uniform methods should be agreed upon, lest financial weaknesses develop, disaster follow and heavy reproach ensue, damaging to all parties concerned and to the interests which they represented.”

# UNIFORM RATES: AGREEMENTS AND TERMINOLOGY: RESERVES AND ACCOUNTING

GEORGE A. HUGGINS

*Consulting Actuary, Philadelphia, Pa.*

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*Uniform Rates.*—It would be highly desirable, if all organizations, that issue annuity agreements, would use the same annuity rates, because this would eliminate competition in rates. While healthy competition is generally a good thing for any of us, nevertheless, such competition in annuity rates, as may result in constantly increasing the rates, might well bring about the end of the whole movement. As the rates increase at given ages, there is less to gain on the part of any organization issuing the annuity agreements, since under each agreement the residuum would be reduced correspondingly.

Furthermore, as the rates increased, there would be growing conflict with the insurance companies, since the organizations would soon be encroaching on their field. Destructive legislation would probably result instead of healthy, regulatory legislation. Further, and perhaps more widespread in its effect, would be the effect on prospective donors. After all, our organizations need the whole-hearted moral support as well as the funds of donors. If competition materially increased the rates, the desire to have larger returns might become of greater moment in the minds of many donors than the cause itself. This would react most unfavorably against these organizations, and, undoubtedly, would bring about, in the end, reduced financial support.

We probably cannot expect the adoption of uniform rates without quite a period of education and preparation, but we can reaffirm here the declarations that have been made in the two previous conferences; that is, to urge the adoption of rates which will not be greater

than the limits specified. These limits are rates that will produce a reasonable residuum, such as those based on an average of 70%, with a limiting annuity rate of 9%. These standards should be applied to the single life and also to the joint-life-and-survivorship cases where more than one life is involved.

*Agreements.*—There is submitted herewith a suggested form of agreement\* for the consideration of this conference—at least the basic principles involved in the suggested form should be observed in the one adopted by any particular organization. Variations as to details will be desired by some. For example: some may not wish to pay the fractional part of the final semi-annual period; others may wish to make their annuity payments monthly or quarterly, rather than in semi-annual instalments. The payments may be made on dates other than January 1st and July 1st.

*Terminology.*—As to the terminology, it is suggested that the term annuity agreements be used, rather than annuity bonds, contract annuities, or conditional gifts. It is also suggested that the return to the donor be referred to always as annuities, rather than as interest. In a similar vein, it is suggested that the solicitation for funds, to be administered in connection with annuity agreements, be on the basis of featuring the service being rendered by the organization, rather than as an investment; nor should the annuity return be stressed too greatly as the appeal for the gift.

No organization should consider itself to be selling annuities as such—the annuity feature should be subordinated to the real purpose of the gift, it bringing the income to the donor solely because of the donor's inability to make the gift and forego the income from that gift.

*Reserves.*—Certainly, every organization that is administering annuity agreement funds should maintain

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\* Action on the form of certificate was deferred until the next conference.

those funds as a separate trust, and not as part of the funds used in carrying on the work of the organization. The measure of the fund, to be carried back of the annuity agreements, while on the books, can be obtained by use of standard tables of mortality among annuitant lives, such as the McClintock Table of Mortality, with interest at the rate adopted as a basis for the calculations, or in accordance with the requirements of the particular state in which the business is being transacted. The lower the rate of interest assumed in the calculation of the reserve factors, the larger will be the reserves maintained.

For instance: reserves maintained on the McClintock Table, with interest at  $3\frac{1}{2}\%$ , will necessarily run higher than those maintained on a  $4\%$  or  $4\frac{1}{2}\%$  basis. Under the laws of the State of California, the McClintock Tables, with  $3\frac{1}{2}\%$  interest, loaded  $15\%$ , are deemed to be commensurate values. If the actual experience of the organization among its annuitant lives shows that their rate of mortality is less than that of the McClintock Tables, it means that the annuity payments will be continued beyond the periods provided for under that table, and, therefore, it would be necessary to maintain reserves on a basis higher than those determined according to that table. This would be accomplished by the use of a lower mortality table, or an increase in the McClintock reserve factors by, say,  $10\%$  or  $15\%$ .

*Accounting.*—Previous conferences have taken the position that separate accounts be set up with each annuitant, so that each case would be credited with its share of the interest earnings and charged with the actual annuity payments. In this way, the actual balances are known for each account at any date. Then, there can be measured against the total of the balances, the cash or securities belonging to this fund. This is a very sound principle and worthy of following as a guide, even though it involves some more detailed clerical work than is required by analyzing the account through group methods. Group methods may be used

to advantage with larger funds, but there is always danger of inaccuracies for lack of proper spread in groups limited as to numbers.

Periodical valuations, based on standard tables of reserves, will also be a measure against the sum total of the balances of the accounts, whether handled individually or as a group.

## REINSURANCE OF ANNUITIES

T. A. STAFFORD

*Treasurer, Board of Pensions of the Methodist Episcopal Church, Chicago, Ill.*

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The inception of financing the work of religious, educational and charitable organizations by means of annuity agreements about fifteen years ago, is recent enough to make it difficult to survey comprehensively and critically operations in that line. In the course of fifteen years, the business has grown from merely trifling commitments to a total of imposing proportions. Its checkered course and uncertain results up to the present time suggest comparison with the early stages of the life insurance business; haphazard rate making based on inadequate statistical information, imperfect technique of handling, etc. However, those who have amateurishly ventured in the life-annuity field in recent years are without the excuse of the pioneer underwriters of life insurance because they might have benefited by accumulated actuarial wisdom, if they had so desired.

Only recently have the organizations doing a considerable life annuity business become acutely aware of the real dangers involved. This is due to the fact that in conducting long-term operations in financing, the evil results of bad foundation policies do not begin to show up for a considerable period of time after inception, and do not seem to call for effective remedial measures until a state of crisis makes remedies imperatively necessary.

Among the hazards of the life annuity business, as conducted by religious, educational and charitable organizations, the following may be mentioned:

1. Spread of risk over too small a number of lives, say less than five hundred, and uneven distribution of the amounts on the lives, so that a major portion of the



risk may rest on a small minority of the group insured, thus magnifying the danger likely to proceed from bad balance in selection.

2. Crude schedules of annuity rates (especially rates on two or more lives), which neglect both the interest and mortality factors and employ instead some wholly arbitrary rule of convenience.

3. Neglect in accounting for the overhead expense involved in soliciting, writing and administering the business.

4. Lack of technical checks and valuations which would have a tendency to indicate danger points and which might suggest changes of policy in time to avoid disaster.

5. The apparently steady increase of longevity of American annuitants reflected in recent tables compiled by various actuarial societies from insurance companies' experience. While insurance companies are exposed to a conscious adverse selection which is not usually present in the negotiations of life annuity contracts with donors to a cause, nevertheless, this hazard is also a component part of the complex of handicaps to be faced.

6. Unwise or non-productive investments, or premature absorption of the reserve funds necessary to be maintained; thus throwing the burden of annuity costs on the resources of current income and thereby exposing the annuitant himself to hazard.

7. Long deferment or depletion of residual returns in contracts on young lives, especially when written at rates in excess of the normal earning power of the reserve fund.

As a test of the soundness of the life annuity business of religious, educational and charitable organizations one might propose the question: How long could the organization carry this part of its business successfully, if it were strictly departmentalized and deprived

of all subsidy whatever from other sources? I am of the opinion that, in a great many cases, the answer would be to the effect that for lack of resources the business would collapse long before the annuity obligations could be completely met, because it would have to carry an annual overhead of from five to ten per cent. of its outgo and, perhaps, a much larger amount in the early stages. Furthermore, it would face the immediate depletion of its principal funds, because of the adverse differential charge against them arising from excess of annuities above earnings. Even with the great advantage of subsidization, the outcome is far from certain, but if deprived of subsidy, most of the smaller annuity funds could not be operated at all. This is the acid test. It should be a strong deterrent from entering this field of financial operations, especially on a small scale.

Another acid test of the life annuity business as now conducted by many organizations is involved in the following questions: Suppose, in the case of a fifteen-year-old organization conducting a subsidized life annuity department, that from the time of beginning its annuity operations, it had instead invested the expense subsidy annually in a fund to be accrued at compound interest at five per cent. per annum for a period equivalent to the life of its assumed annuity obligations. Would the accumulated subsidy compare favorably with the net residual results of the annuity operations for a properly comparable period? I am bound to say that in my judgment most organizations would find the simple, inexpensive and sure process of accumulating the expense subsidy would equal in results if it would not outstrip the ultimate net returns from the annuity operations. An examination of annuity business along this line might cause disagreeable surprise, and perhaps in some cases might raise a subordinate question with reference to the soundness and perhaps the propriety of appropriating moneys given for benevolent purposes so as to make entry possible into a field of long-term finance beset with such complex hazards. In many cases the accumulation of a permanent fund by annual ab-



stractions from current income, if legally and morally proper, would be more simple, sensible and sure.

The considerations mentioned above have been strongly upon my mind for a number of years past, and I have been seeking for some way of escape from the dangers mentioned. I think that the organization which I represent as Treasurer has not only discovered a sound means of safeguarding its annuity interests, as well as those of its clientele, but it has actually proceeded to make use of such safeguards by effecting with an old-line life insurance company a wholesale reinsurance of the major part of its outstanding annuity obligations. This is a new departure and it can scarcely fail to be of considerable interest to the administrators of other funds who find themselves in a somewhat similar situation, particularly of those funds which have commitments on too few lives to insure a reasonable degree of safety and ultimate profit.

The Board of Pensions and Relief of the Methodist Episcopal Church has a total annuity fund of \$809,925.97. This fund has a reserve of \$206,262.11, which has been created by discharge of annuities through death. Although a considerable portion of this money has been released from obligation within the last decade, no part of it or of its interest has been utilized for the work of the board up to the present moment. The reason for this administrative conservatism is to be found in the uncertainty of the board as to the ultimate results to be obtained from the settlement of the annuity obligations outstanding. Actual valuations made annually have indicated a residual return on these obligations of approximately fifty per cent. of the stipulated payment first made by the annuitant. Up to the present time, the rate of earning assumed in the valuations has been four and one-half per cent., which is none too conservative. It has been the unanimous conviction of the members of the board that they must maintain a strong reserve position so long as there are so many elements of uncertainty involved in forecasting the ultimate outcome.

It was directed at the last annual meeting of the board, held February 19, 1930, (a) that all outstanding annuity obligations acceptable to a life insurance company be immediately reinsured and (b) that the residuum of funds, left after the requisite premiums for the reinsurance had been paid, remain invested and the interest compounded until such time as the board directs otherwise.

This order has been put into effect, and a contract of annuity reinsurance has been entered into with one of the largest legal reserve reinsuring life insurance companies in the United States of America. The board has further directed that no future business shall be accepted by its annuity department unless the proposed agreement is not only reinsurable but indicative of a substantial margin of immediate gain for the cause. This means that contracts with contingent clauses shall be no longer accepted, because they introduce a non-insurable element. The organization has outstanding thirty-nine agreements of this character, and it has agreed with its reinsurers that as soon as the several contingencies in these agreements are resolved into settled facts, such agreements shall also be reinsured upon the same definite considerations as the others.

We consider that the following distinct advantages for the board result from this contract:

First, all annuity risks on the lives involved rest definitely hereafter with the reinsurer.

Second, the board has a substantial margin free of liability at its command for immediate use or for accumulation, as it may desire.

Third, the board has escaped the danger involved in handling a life annuity business on an imperfect distribution of life risk, although the board has a much better position in this respect than a good many other organizations.

Fourth, there will be a decided gain in the confidence of the clientele, without any apparent impairment of appeal.

Fifth, a stricter regime will cause the annuity de-

partment to look well to the size of the margin of gain for the cause and it will also tend to inhibit unwise commitments; this is a new and very valuable factor of safety in the conduct of the board's annuity business.

I offer the following data which may be of interest to you in this connection. The board has reinsured 248 single life annuity agreements, covering annuities amounting to a gross payment of \$24,493.61 per annum and 93 annuity agreements on two lives, covering a gross annual payment of \$15,308.97. In most cases, the reinsurance leaves a substantial margin of gain for the board, but in a few cases, to effect the reinsurance has cost considerably more than the balance to the credit of the particular annuity agreement. The loss has been charged off to experience. Unless one bears in mind the long term character of such an operation, he is apt to be disappointed at the immediate results. Only when it is borne in mind that the immediate residuum can and ought to be invested at interest compounded for a period co-terminous with the close of the annuitant's lifetime, can the true result be evaluated. A useful approximation of such result can be obtained by measuring the accumulation in terms of "life expectation" of the annuitant, in the case of single lives, and in terms of the longest "life expectation," in cases where a pair of lives is involved. This method of calculation is somewhat crude, but for the purpose in mind it is legitimate and gives a reasonably satisfactory result.

In Exhibits B and C attached hereto, I have set up a computation of such results, using the annuity rate bases upon which most of the ordinary annuity business of the board has been conducted.

You may be interested also in the following technical details connected with the inception and operation of the reinsurance. The rates used in figuring the cost of reinsurance are those in common use by more than a dozen of the largest life insurance companies in America. A great deal of actuarial finesse was eliminated by figuring the annuities in groups assuming within a group an average integral age, and assuming average

intervals between the dates of valuation and the dates of the next payments. The interval between the dates of valuation and the dates of annuity payments was assumed to be one-half the actual interval between payments. For example, an annuity with semi-annual payments was assumed to have the first payment three months hence, etc. While these methods did not give exact figures for individual valuations, nevertheless, the total valuation was substantially exact, and agreed very closely with the exact calculations made in our actuarial department. Of course, future agreements will be valued individually.

The board agreed with the company to handle all payments to the annuitants. The expense of acquisition of the business by the company was confined to direct negotiations with its officers at headquarters, thus eliminating commissions. In consideration of the handling of the annuity payments by the board, the company made a commensurate adjustment in its single premium rates applicable to individual cases. The purpose of the board in retaining its contact with the annuitants is that the service rendered in connection with such contacts tends to bring repeat business which has been previously found to be quite worth while.

The board files a monthly report with the reinsurer which exhibits on the one hand the amounts due the company for reinsurance of new annuities, such amounts to be ascertained by correspondence with the reinsurer during the month, and on the other hand, there is shown the payments on annuities made by the board for which reimbursement by the reinsurer is claimed. This record of payment is supported by vouchers detached from the annuity checks, such vouchers showing all necessary details and affording self-evident proof that the annuitant was living at the date of payment. On the other hand, the report of new business is supported by photostatic copies of the agreement and the annuitant's application therefore which is an integral part thereof; it is also supported by separate proof of age when obtainable. The difference between the two sides of the account is

paid either way, according as the reinsurer or the board is the debtor. On the back of the report there is a form of journalization of the necessary entries on the books of both parties.

The board conducts a fairly extensive annuity business in the State of California and has a resident agent at Los Angeles. On this account, it is licensed by the State Insurance Department of California, and in its annual report is required to give a complete statement of its entire annuity business. Hereafter, this statement will show the item of reinsurance as it affects our contracts on lives of annuitants resident in California.

While the negotiations involved in this reinsurance deal were somewhat complex in character, I do not hesitate to say that they were carried out with unusual facility and dispatch upon the part of the company. Through the courtesy of its treasurer, we were enabled to transfer high-grade securities in sufficient amount to cover the total "stipulated payment" required, thus avoiding the sale of securities so as to make payment in cash. From this time forward, the technique of handling will be extremely simple, and in fact will reduce the amount of our office work by eliminating certain records which are no longer necessary.

There is practically no literature on this subject, excepting, perhaps, an excellent little booklet, which came to my attention a short time ago. It is entitled "A New Approach to Annuities." The author is Dr. Charles L. White. I can commend it as containing sound, trustworthy advice. We cannot but regret that it was not available at the time we were thinking our way through the reinsurance problem. It states in succinct form many of the considerations which moved the Board of Pensions and Relief to take the action which I have described in some detail above.



## ANNUITY AGREEMENTS

EXHIBIT B  
\$1,000 STIPULATED PAYMENT TO ANNUITY FUND  
SINGLE MALE LIVES

| (1)                            | (2)                                 | (3)              | (4)                                   | (5)                 | (6)   | (7)   |
|--------------------------------|-------------------------------------|------------------|---------------------------------------|---------------------|---|---|
| Age of Annuitant Last Birthday | Annuity Granted by the Organization | Reinsurance Cost | Balance in the Fund After Reinsurance | Expectation of Life | Balance Col. (4) Accumulated for period in (5) at 5% Interest | Time necessary to restore (4) to \$1,000 at 5% Interest |
| 60                             | \$60                                | \$671.34         | \$328.66                              | 15.79 yrs.          | \$710.24  | 22.80 yrs.  |
| 65                             | 65                                  | 626.93           | 373.07                                | 12.74 yrs.          | 694.79  | 20.20 yrs.  |
| 70                             | 70                                  | 569.73           | 430.27                                | 10.06 yrs.          | 702.97  | 17.28 yrs.  |
| 75                             | 80                                  | 537.60           | 462.40                                | 7.78 yrs.           | 676.01  | 15.81 yrs.  |
| 80                             | 95                                  | 516.14           | 483.86                                | 5.88 yrs.           | 644.72  | 14.88 yrs.  |

EXHIBIT C  
\$1,000 STIPULATED PAYMENT TO ANNUITY FUND  
JOINT LIFE AND SURVIVORSHIP ANNUITIES

| (1)  |        | (2)              | (3)                                 | (4)              | (5)                                   | (6)                        | (7)   |   |
|------|--------|------------------|-------------------------------------|------------------|---------------------------------------|----------------------------|---|---|
| Male | Female | Age Combinations | Annuity Granted by the Organization | Reinsurance Cost | Balance in the Fund After Reinsurance | Longer Expectation of Life | Balance Col. (4) Accumulated for period in (5) at 5% Interest | Time necessary to restore (4) to \$1,000 at 5% Interest |
| 60   | 55     | \$53             | \$836.00                            | \$164.00         | 22.14                                 | \$483.11                   | 37.05   |   |
| 60   | 60     | 54               | 797.99                              | 202.01           | 18.49                                 | 498.07                     | 32.78   |   |
| 60   | 65     | 55               | 761.93                              | 238.07           | 15.79                                 | 514.47                     | 29.41   |   |
| 65   | 60     | 55               | 779.72                              | 220.28           | 18.49                                 | 543.12                     | 31.01   |   |
| 65   | 65     | 58               | 760.12                              | 239.88           | 15.15                                 | 502.43                     | 29.26   |   |
| 65   | 70     | 60               | 731.39                              | 268.61           | 12.74                                 | 500.25                     | 26.94   |   |
| 70   | 65     | 60               | 748.60                              | 251.40           | 15.15                                 | 526.56                     | 28.29   |   |
| 70   | 70     | 64               | 730.53                              | 269.47           | 12.17                                 | 488.05                     | 26.87   |   |
| 70   | 75     | 66               | 693.94                              | 306.06           | 10.06                                 | 500.04                     | 24.26   |   |
| 75   | 70     | 66               | 711.66                              | 288.34           | 12.17                                 | 522.23                     | 25.48   |   |
| 75   | 75     | 70               | 681.88                              | 318.12           | 9.57                                  | 507.57                     | 23.47   |   |
| 75   | 80     | 74               | 655.71                              | 344.29           | 7.78                                  | 503.34                     | 21.85   |   |

NOTE: Annuities payable quarterly.

Reinsurance cost based on annuity rates of Reinsuring Co.  
Expectation of Life from Combined Annuity Table.

## REINSURANCE OF ANNUITIES

CHARLES L. WHITE

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In June, 1930, my brief monograph, "A New Approach to Annuities," was published and two hundred copies were distributed. Since then several hundred have been mailed on request.

Judging from the cordial letters received the plan to provide through reinsurance with an insurance company an annuity guarantee to the annuitant has met with a growing interest and has already in a half year led to positive results.

In a paper read in one of our annuity conferences, several years ago, I suggested that the reinsurance of annuities might well be considered. This incidental remark was not commented upon, but subsequent events led me to explore the matter. A college president who had been successful in soliciting annuity funds told me that he was asked by his committee to discontinue the quest, as they found it difficult to provide for the annually resulting deficit, while the entire number of annuitants continued to live.

About this time an institution with a long line of graduates collapsed financially. Its annuity funds went into the wreckage and the annuitants suffered disappointment and hardship. A denominational secretary who brought me this information remarked that the search for annuity funds in the area contiguous to this unfortunate institution would be hopeless. It is clear that reinsurance of its annuities would have averted loss to the annuitants and would have helped this university in its long financial struggle. Another college, a few hundred miles distant from the second, sent to me printed material explaining the immediate need of additional gifts for its maintenance, because certain annuity funds had been spent for construction purposes.

While hearing these regrettable reports, my mind was led to consider a way in which a newly formed organization might profit by means of annuities and in which a larger number of state and local religious agencies, and even a local church, might safely go to their constituencies for annuity funds. While I was turning these matters over in my mind, a friend, who had been very generous in his gifts to missions, education, and numerous philanthropies, expressed to me his conviction that the best treatment of gifts for the welfare of mankind is to use them for their present betterment. His feelings are doubtless shared by an increasing number of persons who prefer to have large gifts distributed over a period of years varying from ten to twenty-five or to be used immediately in a worth-while cause.

These currents of thought led to conferences with life insurance officials, and with others skilled in the solicitation of annuities. All of these gentlemen encouraged the publication of my conclusions. Before doing so, however, the tentative manuscript was read to a group of friends in New York who were called together in informal conference. I was at considerable pains to make no reference then, or in the printed announcement, to the wisdom of reinsuring annuity commitments already made, knowing the facts presented in my paper would early lead to heart searchings on that point.

In October of this year the Board of Pensions of the Methodist Episcopal Church reinsured its annuities with an insurance company and henceforth will reinsure all annuity contracts. Before the Methodist Board thus acted, another church missionary society in April, 1930, voted to solicit annuity funds on the plan advocated in "A New Approach to Annuities," in its appeal for gifts for specific projects.

If the matter of reinsurance of annuities is stressed by even one or two great boards and societies whose appeals are nation-wide, every religious, philanthropic and educational organization soliciting annuity funds will be compelled immediately to study this matter with



meticulous care. One of the first men to whom I explained the suggestion for the reinsurance of annuities, a few weeks later went to an insurance company for advice concerning a gift of ten thousand dollars, a part of which he wished to use in securing an annuity for the donor. Soon after the matter was presented to the finance committee of an educational institution in New York City, one of its representatives secured a gift of ten thousand dollars on which an annuity was purchased from an insurance company.

The representative of a well-known university which has received huge sums on the annuity plan reports that his institution had never paid an annuity larger than the amount earned on the donation and did not wish to do so. But when my pamphlet arrived it was facing the difficulty of probably having to pay an annuity rate slightly larger than could be earned on the investment and the suggestion of insuring promised a happy issue out of the perplexity.

Several months ago three educational institutions of one denomination voted to solicit annuities in accordance with the plan advocated.

It has been my privilege to read an address on "A Plan to Aid the Boards in Securing Larger Gifts and Endowments," made last May to the General Council of the Presbyterian Church, U. S. A., which is now considering the matter. A former member of that body spoke as follows:

*Annuities.*—Under the present annuity plan the boards agree to pay to a donor or to a beneficiary designated by him a life annuity in amount determined by the age of the annuitant. The board must invest the principal and must make good from it or from board reserves or current budget any difference between the income received and the annuity paid. Lacking a large number of active annuities a board has difficulty in determining the net residuum and must assume the hazard that a particular annuitant will survive until the principal of his gift is exhausted, or even until the payment

of the annuity draws from other funds of the board. This would, of course, defeat the original purpose of the gift."

The life insurance companies offer a service whereby the donor may be guaranteed a life annuity equal to normal income on his investments, and the board has for immediate use the entire residuum after paying the required premium to the insurance company.

In the case, for example, of a man of 75, desiring an annuity of 5% on his gift of \$100,000.00, the board would have \$68,400.00 free and clear. The result is accomplished through the underwriting of annuities by life insurance companies. The board is relieved from all responsibility and from investment problems and can put the residuum of the gift to immediate use while the donor lives. The donor can have the satisfaction of seeing his gift at work as well as knowing the net amount of that gift. For a proportionately small adjustment in the cost of underwriting the annuity, the life insurance company will further contract, in the event of the death of the annuitant to pay to the board the difference between the annuity payment received by the annuitant and the total sum paid to the life insurance company when the annuity was underwritten. The advantages of an annuity underwritten in this manner are obvious.

Such an annuity becomes attractive at the age when bequest insurance loses its appeal by reason of heavy premiums required. The annuity plan is also open to a donor whose physical condition renders him uninsurable.

Use of life insurance companies to underwrite annuities has the added advantage that the services of underwriters can be used to arrange same, which opens the way to the enlistment of life underwriters carefully selected. A constant income for current budgets and enterprises of the boards may be assured if annuities were written regularly on this plan.

The organization required to make use of the services of life insurance companies and of the life under-

writers for the development of contributions and bequest insurance for the benefit of the boards of the Church is simple but important.

The plan is not offered as one which will immediately produce a flood of large gifts. It may, conceivably, do even that. Its by-products also are many, and as net result it promises in future years a stream of gifts increasing in number and in size and maturing with more and more regularity as the stream grows.

A prominent actuary has prepared an opinion under date of March 19, 1930, concerning the problem of small annuity funds which I am privileged to present.

#### *Problems of Small Annuity Funds*

"As promised, I am glad to give you some information regarding certain risks encountered in annuity funds. Some of these risks become particularly pronounced when the number of annuities outstanding is small; others are common to all annuity funds. They may be stated briefly as follows:

"(1) Wide fluctuations from the average due to the small size of the annuity fund.

"(2) Future increase in community longevity due to further conquests of disease by science. Any such increase in longevity beyond the point anticipated in the premium originally charged, would cause a distinct loss to the annuity fund.

"(3) Other administrative problems, such as the effect of a fall in interest rates, investment losses (which may or may not be offset by investment gains), etc.

"I shall comment only on the first two items, as the last one is better understood.

#### *Possibility of Adverse Fluctuation Due to Small Size of Fund*

"It is possible to demonstrate by involved mathematical analysis, that the smaller the annuity fund, the greater the likelihood of a serious unfavorable fluctuation in mortality, because the law of average cannot

come into play. This fact, however, can be more easily appreciated by a review of actual annuity funds of life insurance companies. Thus I have obtained some information from the New York insurance reports which should be sufficient to show the risk of fluctuation which must be faced by a small annuity fund.

"During the ten year period 1908-1917, when the annuity gains and losses of the companies were published, the following interesting results were indicated:

| Co. | Average No. Annuities In Force | Average Annuity Fund Reserve Outstanding | Net Mortality Gain (+) or Loss (-) Over 10 Years | Per cent. of Net Gain or Loss to Reserve |
|-----|--------------------------------|--|--|--|
| A   | 14                             | \$52,000                                 | -\$19,500  | -37%                                     |
| B   | 42                             | 138,000                                  | - 31,800   | -23                                      |
| C   | 45                             | 21,000                                   | - 9,200  | -43                                      |
| D   | 51                             | 91,000                                   | + 8,600  | + 9                                      |
| E   | 5,600                          | 12,736,000                               | -297,000   | - 2                                      |
| F   | 8,600                          | 15,693,000                               | -219,000   | - 1                                      |

"You will see that all but one of the companies experienced a mortality loss on their annuity business. The most significant point is, however, that, in the larger companies, this mortality loss was only about 1% or 2% of their annuity fund, whereas in the smaller companies it ranged from 23% to 43% of the annuity fund. In other words, a large number of annuities is needed in order to bring the law of average into full play, so that extreme fluctuations can be avoided. This illustrates clearly the danger inherent in a small annuity fund with, say, less than 1,000 annuitants.

"A life insurance company, with its large surplus funds, can afford to make an investment in annuities, expecting that in the long run the fund will grow to such a size that the law of average will take care of the situation. The small annuity fund of a charitable organization, however, may become a cause of serious embarrassment to that organization. An unfavorable fluctuation in mortality might consume a large portion of the "residual fund" which that organization expected to have in hand when all of the present annuitants will have died. In other words the very purpose of the annuity fund may be defeated.

"The situation might further be aggravated by an increase in the longevity of annuitants, as may very easily happen if such diseases as cancer, pneumonia or other common ills of old age are brought under greater control through advances in medical science.

"While I would not wish to make too sweeping a statement, it does seem wise for charitable organizations with small or moderately small annuity funds, to consider seriously the risks which they incur in the handling of such funds. Life insurance companies are organized to handle annuities involving such risks. If the life annuities promised by charitable organizations are reinsured in good life insurance companies, the charitable organizations have relieved themselves of all risk and care under the annuity and can determine definitely how much of the donor's gift can be freed for immediate use. It seems to me that this whole question is one which could well receive the consideration of a number of charitable organizations granting life annuities."

The plan for reinsurance of annuities published last June in a *New Approach to Annuities* has certain advantages.

The society does not assume the obligation to pay the annuity, but arranges for the annuitant to have the strongest possible guarantee that the annuity will be regularly and promptly paid.

The society has in its hands a balance after it has used a part of the gift to purchase the annuity for the annuitant.

The society knows exactly what its gain is on each transaction, and if the donor believes, as many will believe, that the balance in the hands of the society will achieve the largest spiritual result by its immediate use, then the society's income will be at once increased.

The society is relieved of the necessity of investing all of its funds received from its annuitants in the securities of a certain state and making satisfactory reports thereon to its officials, as in Texas.

The society will avoid embarrassments which will



doubtless multiply if it tries to conduct its own annuity business in the various states.

The society voids the dangers in the promise to pay an annuity during a long term of years, when the interest earned on the invested funds may become much smaller than was anticipated.

The society does not have to set up a reserve fund to safeguard the payment of the annuity and to keep the same invested in certain types of securities as required by law, as in New York.

The society can begin with safety to use for its purposes the residuum when it has secured its first annuity gift, and has no financial embarrassment, if it never secures another.

The society is relieved of the expense of operating its own annuity business and of the meticulous care which such an operation entails.

A society does not need to abandon its present annuity plan, but can supplement and strengthen it by the method proposed.

The society can assure the donor that in a reasonable number of years and perhaps within his lifetime it will have the amount originally given and possibly more, if he prefers that the balance remaining shall be increased by interest accumulation.

The society is enabled to make appeals for special needs, which cannot be cared for in its regular budget, by interesting certain persons to make gifts on which they shall continue to receive an annuity equal to their average income, while the balance remaining after the annuity is purchased is used for emergencies.

The society in this way can make an attractive canvass for needed funds, when it has a conditional offer of a gift of dollar for dollar or in some other proportion.

The plan herein advocated may be widely used.

Orphanages, hospitals, homes for the aged, and any charitable agencies which have friends who are in the habit of contributing to their maintenance, may annually persuade a few of their constituency to adopt this method of giving.

Churches planning to erect edifices or educational buildings or to secure organs or chimes, which find it relatively easy to receive pledges on a two or three year basis for the major part of the amount needed, may appeal to a part of their membership to make additional contributions without lessening, during their lifetime, their regular income.

A church that finds it difficult to raise its full missionary quota can complete it, by persuading one or more of its members to co-operate by making gifts as small as two hundred dollars. By this method it will have sufficient money in hand to make up the required amount.

Any missionary society or denominational collecting agency, threatened with lessened contributions, may thus increase its giving within a fiscal year.

Universities and colleges may find, through this plan, a way of securing larger amounts than usual from its graduates, who are in the habit of making special class gifts to their Alma Mater on the fortieth, forty-fifth and fiftieth anniversaries of their graduation. As these classes are annually recurrent, a custom thus instituted may yield large financial results.

Theological seminaries may well use this form of appeal with those who wish to have a large part of their annuity gift used at once in the training of men and women for ministerial and missionary work, believing that their gifts thus expended will bring vast spiritual results at home and abroad.

It is my conviction that all life annuities now in force with benevolent institutions on a group of lives less than one thousand in number should be reinsured and that future annuity commitments should be treated in the same way.

The success of the Northwestern University in securing great gifts on which the smaller annuities are paid, indicates that large donations may be obtained on the same basis by missionary societies. Indeed, such an appeal may well be made to generously disposed men and women, who are concerned over present world con-

ditions and the immediate hardships of their beloved benevolent organizations.

We know now that six million dollars of new annuity funds were last year received by the groups reporting to this committee and that these groups have now in force forty-three million dollars on which annuities are being paid.

If these annuities should be reinsured, a great sum would be available at once to pay debts, to avert the abandonment of key enterprises whose continued life hangs in the balance, and to maintain strongly the present work during a period of world depression.

If our equities in these large annuity funds should prove to be the unexpected way out of our present financial problems and organization embarrassments, we might well thank God and take courage.



# ANNUITY AGREEMENT BUSINESS: EXTENT AND CHARACTERISTICS

## *Report on Two Surveys of Annuity Policies and Procedure*

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In presenting a report on two separate surveys, one relating to the annuities of educational institutions and the other concerned mainly with religious organizations, it may well be interesting for us to watch for variations in policy and differences in practice between the two groups.

Many think of annuity procedure as being divided between the business policy of life insurance companies with high rates and with no attempt to retain the original principal, and that of those organizations, which, with a much lower schedule of rates, have been able to retain from 70% to 85% of the original principal for their respective institutions.

Within the past few years another group, that of the colleges and universities, has been working out its annuity plans and I give you first a summary of the information gained last spring as a result of a questionnaire sent to more than 400 colleges and universities.

Many colleges and universities do not write annuities, but the data from 91 institutions in 29 states was collated and the following analysis prepared. It does not claim to be a complete and inclusive study. It simply states the facts as reported by these colleges and universities.

A number did not report the amount of annuities written, but the total of annuity funds in force on December 31, 1929, as reported from these institutions was \$17,906,690.41. If we had a complete total of college annuity funds, it would undoubtedly be well over \$20,000,000. A larger number did not give the amount

written during the year 1929 but the total of annuities as reported was \$3,914,471.48. Annuity funds amounting to more than \$15,000,000 were established during the past five years alone, a total almost as great as the sum now in force.

In answer to the question, "Are your annuity funds invested separately or consolidated with other funds?" 45 reported consolidation, 28 stated that they were separately invested, one replied "both" and 17 did not answer. Most of the institutions having small annuity totals reported consolidation of investment with other funds, while many of the institutions with the larger totals reported separate investments. A number of those who reported separate investment probably referred to the investing of all annuity funds separately from other endowment funds but did not so specify. Undoubtedly the trend in investment toward greater safety through diversification applies here as elsewhere and the institution having but few annuities may well consolidate those investments with other trust or endowment funds and allocate income received pro rata. Unless required by law to invest annuities separately, consolidated investment with separate accounting for each fund greatly increases the safety factor.

Information was requested as to what proportion of each annuity fund was required to be set aside by the laws of the state as a reserve fund. Many of the colleges did not answer the question at all and many others admitted their ignorance on the point. This can partially be excused by the fact that most of these colleges, as will appear later, are holding their annuity funds at their original principal and in such cases 100% of the fund would be the perfect reserve. It is quite true, however, that in many instances educational institutions, which issue annuities, have not been careful enough to check up on the laws of their states in regard to this question of reserve. This matter is referred to later in this report.

The question, "Is any part of your annuity gift used prior to the death of the annuitant?" brought a heavy

negative majority; 70 replied "No"; 11 wrote "Yes"; and 10 did not answer. In most cases those answering "Yes" qualified their replies by saying that such deductions were made only by special agreement, or more often, only to take care of small excess annuity payments. It should be pointed out here that practically all of the large holders of college annuity funds follow the policy of holding the original gift intact. Whether this is accomplished by low rates or by annual appropriations from the budget to take care of the excess annuity payments was not clear in all cases. But it is clear that a policy is in the making which treats annuity funds on almost the same basis as that of trust or endowment funds, and makes them similar to living trusts.

In most cases full information was given as to the schedule of rates, too full and too diverse to admit of classification in this summary. The decimal plan of providing 10% of the age as an annual payment, i.e., 6.3% at age 63, seems a popular plan, with variations both below and above that proportion. Minimum rates in a few cases were as low as 3% and 3½% for younger ages but the average minimum was from 4% to 5%. Maximum rates, when definitely stated, averaged lower than those approved by the Sub-Committee on Annuities of the Committee on Financial and Fiduciary Matters. We find only 5 colleges admitting that they give as high as 9%, and 4, 8½%, while 15 claimed 8% as a maximum, 14 gave 7% and 16 gave 6%. A number treat their annuities as living trusts and pay interest as received. Almost one-third did not reply as to the maximum rates and it is likely that in several of these instances much higher rates are granted under pressure, and covered by some such remark as "No definite schedule published," or "Each case treated on its merits." Here is where one may put his finger on practices that are discriminating and policies that are wholly inconsistent and we trust that as time goes on, we will see much less of this sort of thing. We all can help the annuity cause by rapping hard this unfair competition in rates.

In an attempt to check up on excess of annuity payments over income from investment of the funds we asked for these excess amounts for the past year 27 did not answer; 22 claimed there was no excess; 1 stated that they had a surplus of income over payments, and 31 reported a total excess of \$54,076.27. This is just over 1% of the principal of all annuities held in these 31 institutions. This average would not be considered excessive by institutions which aim at 70% residuum of their annuity funds, but it is rather high for those colleges which try to hold to 100% residuum.

In reply to the inquiry as to whether there was a guarantee fund to meet these excess payments, only three answered "Yes." There were 63 replies in the negative and 25 blanks.

These excess payments in 26 institutions were charged to the budget, in 7 cases to the annuity funds themselves, in 6 to "Endowment Fund Income" and in 1 to "General or Current Accounts." The two latter undoubtedly should be included with those who charge these excess amounts to the budget. Forty-five did not answer this question. This large number was undoubtedly due to those claiming no such excess charges.

Lastly, as to administrative costs, only one institution replied that any charge was made against the annuity funds themselves; 23 made no answer, and 67 stated that they were charged into the budget for administration. Very few of these colleges have expenses worth segregating for solicitation and administration of annuities and since administration costs are not charged to other funds there has apparently been no such expense allocated to the annuities.

To my mind the most interesting points in this summary are the facts, (a) that the large majority of the institutions co-operating in the questionnaire maintain 100% of the principal until the death of the annuitant, (b) that in general their rates are in keeping with that fact and not as high as the group which figures on an 80% or a 70% residuum and (c) that their average excess of annuity payments over income

is not over 1% of the annuity funds in less than one-half of these institutions and nothing at all in the remainder. These three facts go far to prove a contention held by some of us that there are now three fairly well defined groups writing annuities.

The first group consists of the life insurance companies whose rates are so high that they expect to use the whole of the original principal by the time of the deaths of all in the annuitant group.

The second group includes scores of religious and charitable organizations who plan to use a portion of the principal of the annuity in paying rates up to 9%, and sometimes over that, on the assumption that there will be a residuum of from 70% to 80%.

Many of the colleges and universities may well be classed in a third group which accepts as an ideal the 100% residuum and keeps its rates to a lower level where the small excess of annuity payments over income is taken care of by the current budget or is charged to the annuity funds without seriously depleting them. If the fund is depleted and it is desired, the fund may then be restored after the death of the annuitant to its original principal by applying annual income to the principal; 100% of the original gift is then put to use with little more delay than it would have taken to close an estate and secure payment of a bequest.

If you will now turn to the mimeographed copies of the questions asked in the annuity survey which was conducted by the Chairman of the Sub-Committee on Annuities this fall, we will proceed to an analysis of the replies.

The questionnaire was sent to approximately 90 religious and charitable organizations and replies were received from more than 50. A number of these simply expressed interest or did not handle annuity business or declined to give us the information requested. We have tabulated the replies of 38 church boards and other religious organizations of the Methodist, Baptist, Presbyterian, Congregational, Lutheran, Reformed, and other denominations, as well as undenominational bodies.



"How do you designate your annuity contract?" A wide divergence is found in the names given to annuity gifts. Of 37 answers, 12 use the term "annuity bond" and 11 "annuity agreement." Others are "conditional gift agreement," 4; "conditional gift certificate," 3; "special gift agreement with annuity return," 2; "conditional gift," 1; "annuity policy agreement," 1; "life annuity policy," 1; "life income contract," 1; "contract annuity gift," 1. This well illustrates our diverse ideas on nomenclature. Many feel that the use of such words as "policy" and "bond" is open to criticism, because of the more commonly accepted meanings of such terms.

"How long have you been receiving gifts on the annuity plan?" Out of a long list, the American Bible Society seems to be the pioneer, reporting a period of 80 years. The American Baptist Home Missionary Society began writing annuity agreements 69 years ago, while others range all the way from 6 to 60 years.

"What is the total amount of these gifts during that period?" Several organizations did not answer this question and a number of the largest boards stated that they were unable to give the total; 28 reports gave a total of \$18,517,018.99. It is quite likely that if we had the total of annuity gifts to all these organizations since the inauguration of the annuity plan, the total would be between \$25,000,000 and \$30,000,000.

"Total amount and number of annuity gifts received during each of the last six years." It must be explained here that while some of the replies are for the calendar year, most of them are for the fiscal years ending at various dates. The totals show a constant and consistent type of giving that is striking. The lowest year was 1926 with \$1,911,049.02; the highest, 1928, with \$2,709,031.44, with an average of \$2,316,000 annually. The total of gifts received for these six years as reported was \$13,897,524.92. The number of individual gifts is an approximate figure as a few did not report on this. The year 1928 again heads the list with 1,622 gifts and the total for the six years as re



ported is 8,039. One organization alone wrote more than 3,300 of this total of 8,039.

"What was the total amount of annuity gifts on which your organization was paying annuities at the close of your last fiscal year?" Two of the reports did not give this figure but 36 organizations reported a total of \$25,114,523.30; add to this the college figure of approximately \$18,000,000 and we have a total of over \$43,000,000. If our information were complete, in all likelihood the total would be approximately \$50,000,000.

"Do the laws of the state under which your organization is incorporated require you to set aside a portion of each annuity gift as a reserve guarantee fund?" Many were not clear as to what the laws require, as 10 did not answer and 3 admitted ignorance. Only 6 answered affirmatively and 18 in the negative. All the affirmative answers were from organizations incorporated in New York, while several negative replies were also from New York. Others were from Massachusetts, Pennsylvania, Ohio, Indiana, Illinois and Tennessee.

"If so, what portion of the gift must be reserved?" A number of institutions incorporated in New York reported "None," whereas the New York State laws require them to "maintain a reserve fund at least equal to its contract liabilities, calculated according to McClintock's Table of Mortality among annuitants with interest at four per centum per annum." The answers to this question, with rare exceptions, showed no knowledge of the situation.

"Do you invest the entire amount of an annuity gift and hold it invested during the lifetime of the annuitant?" The answer was unanimous in the affirmative.

"Do you use any portion of an annuity gift prior to the death of the annuitant?" The answer was unanimous in the negative.

"If the income from your invested annuity gifts is less in any year than you pay to annuitants, on what fund can you draw to cover the difference without drawing on your current expense funds?" The answers to

this question are the most diverse of any in the survey and uncover a situation which is the opposite of uniformity; 8 organizations did not reply to this important question; 9 stated that the excess is charged against the principal of the gift or the "annuity account itself." Please note this, in view of the fact that in answer to the previous question "Do you use any portion of an annuity gift prior to the death of the annuitant?" no one admitted such reduction! How can one say that no use is made of the annuity fund, if these excess charges are made directly against the fund? Only 4 organizations draw upon their annuity reserve funds, while others state that the loss is covered "from surplus." This may or may not mean an annuity reserve surplus; it may refer to surplus from current operations. Closely akin to the reserve accounts are the matured undesignated annuity funds which 5 state take care of these excess charges. One reply reads: "The difference overpayment or shortage, is provided for from unrestricted matured annuity gifts and when these are insufficient, the balance is carried forward to the succeeding years." But how carried? Who provides the cash? Four institutions state that they use interest from general or permanent invested funds for this purpose. This amounts to the same thing as drawing upon their funds for current expenses. Four state that the excess is covered by the current expense budget while two more charge it to a general fund. One organization pays such charges from interest on daily balances, while another pays them from "uninvested cash in annuity account." Uninvested cash is as much a part of the annuity principal as the invested cash and the charge is in reality against the funds.

Surely the lack of uniformity shown above may well be considered one of our serious problems and definite recommendations in regard to this phase of accounting should be prepared.

"In what types of securities do you invest annuity gifts?" Only 3 organizations reported that their securities were limited to "legals"; 1 "legal for trusts";

1 "legal for savings banks"; 1 "funds legal for trust funds and life insurance companies in New York State." First mortgages on real estate were the most common investment, 29 including them in their replies. Many specified guaranteed mortgages, but a large number have the unguaranteed as well. Bonds of various sorts were mentioned by most of the replies. They included not only "legals" but other rails, public utilities, industrials and real estate bonds. One stressed particularly railroad equipment trust certificates. One reply included preferred stocks in its list. While any schedule of a large consolidated investment may well include a number of the best preferred stocks, there is doubt whether separate annuity funds should be so invested. Two replies indicated that funds were invested in local building and loan associations. This type of investment offers difficulties as to safety and marketability which are patent to all.

"Is it your practice to invest any of the principal of annuity gifts in real estate in the United States?" All reports were unanimously against this practice.

"Is it your practice to invest any of the principal of annuity gifts in real estate in mission fields?" One organization replied "Yes," 37 answered "No."

"Do you segregate your annuity investments from your other investments?" Several did not answer this question but 29 replied in the affirmative and 15 in the negative. It is taken for granted in this paper that where annuity investments are reported as segregated this means the investment of all annuities as a whole and not separate investment of each annuity. Such an investment policy would inevitably lead to the loss of some annuity gifts from time to time.

"Do you accept real estate as a gift on the annuity plan and agree to pay a fixed annuity on its estimated value?" Eight replied "Yes," while 29 answered "No." One answer was full of meaning: "Once, but never again." Many instances have come to light where property transferred under an annuity agreement became a heavy liability instead of an asset. The organi-

zation that holds to cash and marketable securities will find them far preferable.

"If an annuity gift is made to establish a special fund, do you establish that fund when the gift is made or after the death of the annuitant?" Thirty-three answered that such funds would be established after the death of the annuitant, while 1 admitted the establishment of the fund when the gift agreement was made. Three did not establish any such funds. It is difficult to see how an endowment or trust fund could be established at the same time that the annuity fund is in force, unless the annuity payment is limited to the income received from the fund.

"In establishing such special funds after the death of the annuitant, if the total annuities paid exceed the income received from the invested gift during the life of the contract, the amount of the gift thereby becoming diminished, do you restore it to the original amount? If so, by what process?" Seventeen replied that funds were not so restored, while 5 stated that they had had no occasion so far to restore the funds in this way. Quite a number did not answer this question, but 3 stated definitely that funds were restored to the original principal. Others admitted that it was done in special cases by adding income to principal, by keeping annuity invested, by appropriation from general funds, and "by vote of the board." One replied that the question was now under study. Such a restoration is probably feasible only when the amount of the annuity payment is not greatly in excess of the actual income received and does not entail too large a loss of the principal. In the case of memorials and special gifts, it has often, however, been found worth while to bring the depleted principal back to its original amount.

"Does your treasurer keep a separate account for each of your annuity gifts?" We regret to report that 6 answered "No"; 28 answered "Yes." One stated that separate records but not separate accounts were kept, while another reported separate accounting for annuity payments but not for income received. Sound account-

ing approves consolidated investment for annuity funds with income allocated pro rata to each annuity fund and with each annuity payment charged against this fund income and principal. Separate records should be kept for each annuity fund, principal and income.

"Out of what fund do you pay your annuity promotional and administrative expenses?" "General funds, general administration funds, general promotional account, general expense account"; grouping these together, 16—3 claimed no such expense, and 12 charged costs to "current funds," or "current expenses." Only two charge expenses to the annuity funds themselves, while a third charges cost of actuarial services only to the annuity funds. Miscellaneous answers included charges to "annuities terminated by death," 1; "income of all invested funds (annuities and invested funds)," 1; "Field Secretary account," 1; "Absorbed by Treasurer and Department of Church Relations," 1.

"Will you endeavor to get your organization to cooperate in securing the adoption by all organizations of a schedule of uniform maximum annuity rates, in order to overcome competition among organizations and bargain hunting by donors?" The unanimous reply to this was most encouraging. There were 35 affirmative replies and no negatives, although several did not answer the question.

Question 22 deals first with administrative and promotional literature. In reading over some of the forms and booklets submitted, there are some terms which may be referred to. The annuity agreement or contract is much better presented as a form of gift rather than as an investment. The term "Annuity payment" should be used in preference to the word "Income." On the formal agreement annuity payments should be stated in terms of dollars and not in percentages or rates. We should be careful to keep away from terms used by the insurance companies in order that we may not be accused of competition and commercialism.

Question 22 also referred to the schedules of an-



nunity rates in force. A study of these schedules brings out interesting facts. 4% is the usual minimum rate, although the range is from 3% to 4½%. The increase of 1/10% each year is very common. Changes in rate are generally made each year rather than for a period of years. According to the published schedules, the rates do not vary much from ages 55 to 70 but those for age 80 and above vary from 6% to 10%. What the rates may be for exceptional cases not covered by the schedule was not divulged in these replies.

"How can the Committee on Annuities be of service to your organization?" Although one answer read "Nothing suggests itself at this time," this question brought a large number of requests for current information regarding all phases of the annuity business. An officer of one of the largest boards where the maximum rate is 8% replied "By helping to secure reduction of rates higher than ours." May he get the necessary cooperation! One inclusive answer deserves quoting: "The Committee on Annuities can be of service by collecting authoritative information that is available to all. It can also help to set standards and to establish principles that will be mutually beneficial. It can bring to the attention of the members new information and help to crystalize their common judgment about annuities."

The questions hereafter which deal with Federal and State taxation brought us meagre and in some cases uninformed replies. This important phase of the annuity business seems to be studied in too many cases only when some emergency demands it. We will hear shortly from one who is in close touch with taxation matters and who will probably deal with many of these questions. The replies to the questionnaire indicate how much such up-to-date information is needed.

"Have any attempts been made to tax any of your annuities?" 10 answered "Yes"; 13 replied "No" with an additional 9 who give conditional negatives, "Not recently," "Not that we know of." 5 did not answer the question.

"Do you wish to co-operate with the committee in



collecting information about this matter?" 26 stated that they would be glad to co-operate while a few were hesitant and in 8 cases this question was not answered.

"Are you familiar with the rulings of the Treasury Department under the Federal Income Tax Law on payments to annuitants?" 16 answered "Yes," 9 "No," while 5 stated that they were partially or slightly acquainted with the question.

"Can you determine the amount of exemption granted to an annuitant under the Federal Income Tax Law?" Only 14 replied in the affirmative. 9 admitted their inability to figure this exemption and 17, almost one-half, side-stepped the question entirely. Mr. Darlington will discuss this problem fully later on.

"Has the Treasury Department endeavored to tax an annuity purchased by a living annuitant, after his death and as a part of his estate?" Only 2 organizations had record of such an attempt (1 Illinois, 1 New York). 22 answered "No" and 16 did not commit themselves either way.

"Does your state have an income tax law?" There were 17 affirmative answers representing the States of New York, Pennsylvania, Ohio, Illinois, Missouri, Tennessee and Massachusetts. 12 answered in the negative, representing New York, Pennsylvania, Ohio, Illinois, Indiana, Maryland and New Jersey!!!. 11 did not reply at all.

"If so, does it follow the Federal Income Tax Law with regard to annuities?" But 5 replies were made to this question, 4 being affirmative (3 in New York, 1 Ohio), and 2 negatives (1 Illinois, 1 Massachusetts). The large majority was apparently not informed.

"If not, how does it differ?" One lone answer "Yes" does not throw very much light on this question.

"If your State has no Income Tax Law, are annuities taxable

- (1) As Capital or Principal
- (2) As Personal Property
- (3) In some other way
- (4) Under a County or other tax?"

There was no information given on any reply that annuities are so taxable. 5 answered "No" and the remainder did not reply. In Pennsylvania where there is an income tax law, annuity payments in excess of \$200 are subject to a four mills tax assessed on personal property.

"How can you determine the amount taxable?" But one answer was given, which is the correct one I believe, "All that is paid after full principal is returned."

"Has your State attempted to tax annuities purchased by an annuitant in his lifetime under the Inheritance Tax Law as

- (1) Gift in view of death?
- (2) Donation taking effect at annuitant's death?
- (3) On any other ground?"

There was but one affirmative answer while 12 asserted they knew of no such attempts to tax annuities. The large majority offered no information.

"Has such a tax been collected? If so, how?" But one affirmative answer again was recorded, "Yes, under protest."

"Are you keeping in touch with changes in legislation and taxation affecting annuities in your state?" 2 answered "Yes," 4 frankly answered "No," while 16 more might just as well have done so!

"Can you name anyone in your state whom you believe would be willing to aid our Committee in keeping in touch with these matters? If so, please give name and address." 16 organizations were kind enough to submit names and addresses of such persons and the Committee will be glad to get in touch with them in the future.

In concluding the report on this survey, it may not be out of place to mention certain items which have arrested attention throughout our study of the replies. Many answers to both questionnaires were accompanied by letters expressing a deep interest in the annuity plan and a willingness to keep in line with more uniform

procedure. There is a widespread desire for news in regard to annuity business.

The annuity business can now properly be called Big Business. But it was somewhat disconcerting to discover how small a number of gifts and how meagre a volume of funds some organizations have. The annuity business is only worthwhile where a generous residuum can be saved for future work. This residuum can be increased only by a decrease in rates and an increase in the number of risks carried. Any institution which has but one or two hundred annuity funds is subject to serious loss because of unfavorable fluctuations in mortality. The smaller the number of funds the greater is the likelihood of trouble in this direction, because the law of averages cannot properly apply.

Since the number of annuities cannot automatically be raised over-night to provide a greater factor of safety, the other alternative may be a decrease in rates. Not a few organizations have expressed a desire for such a lowering of rates but to be effective it would need to be uniform and even more widely accepted than was the schedule of rates adopted in 1927. The serious reduction in security yields and the likelihood that that situation will not change in the near future makes the question all the more timely but the need for a greater residuum all along the line is more important than any temporary factors. If annuity funds are to be invested to yield  $4\frac{1}{2}\%$  or even lower in the future, how are our organizations going to be able to pay 9% or even 8% when we further consider the decided increase in the longevity of annuitants during the past few years?

I saw a pamphlet the other day from an organization which is just beginning to write annuities. They offered to accept any funds up to \$1,000,000, paying the rates as approved by this conference  $3\frac{1}{2}$  years ago. If they should invest a sum of \$100,000 at the present time at  $4\frac{1}{2}\%$  and pay an annuity at 9% for an annuitant who lived 5 years more than his allotted span, say 11 years after he had signed the annuity agreement at 76, there would remain of the original principal just \$37,-

710. You may well say this is an extreme case, but the history of annuities is full of the exceptional cases. And those who enter the game may well do so with a very decided leaning toward the conservative side of things.

# TAXATION AND LEGISLATION

GILBERT DARLINGTON

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"Taxation and Legislation" affecting annuities is a large subject. It is not possible to cover all the ramifications of the subject in a short paper. Only those aspects, therefore, that seem to be of general interest at the present time to religious, educational and charitable groups will be considered. This means that no attempt will be made to advise those who are not issuing annuities how they may obtain the right to do so in the state in which they are incorporated. In some states it may be very difficult. This is a local problem and one on which competent legal advice should be secured.

No effort will be made to record the laws, if any, limiting the type of investment of annuity funds in each of the forty-eight states. Surely each group should be able to obtain this information for their own state and decide whether to avail themselves of all the freedom that is offered. The conservative principles of investment of funds and of accounting for the same as outlined and approved by this conference are worthy of serious attention no matter how liberal the laws of any particular state may be.

Another important question is that of legislation passed by one state with regard to insurance companies or corporations issuing annuities from other states who do business within its borders. We have previously mentioned the situation in California and also to a less extent that in Texas. If no personal representatives or agents are sent into these states, nor any office or offices maintained where the business of insurance within the meaning of the law is carried on, then it may not be necessary to comply with all the requirements. If, however, it is decided to carry on an active work in the state and to send representatives there to do business, the laws must be scrupulously complied with.

TAXATION OF ANNUITIES UNDER THE FEDERAL INCOME  
TAX LAW

In a paper of November 9, 1928, published in *Wise Public Giving Series No. 31* by the Sub-Committee on Annuities, the important ruling I.T. 2397 published in the *Internal Revenue Bulletin*, Vol. VII., No. 5, Page 3, was given in full. A letter of the Treasury Department dated May 15, 1928, was also printed for it explained and amplified the ruling I.T. 2397.

The positions taken by the Treasury Department were not at that time accepted as final by everyone. In fact, there are some who still believe that an appeal to the Board of Tax Appeals might change such a construction of "an annuity purchased at a price in excess of the value of the annuity based on the life expectancy of the annuitant at the time" the annuity was purchased.

The reason for such an appeal to the Board of Tax Appeals would be because there are annuitants who cannot claim the value of the gift made when the annuity is purchased because their income in that year is not large enough to allow them to do so. For them the exemption from federal income tax of the whole principal amount parted with would be of more value. On the other hand many annuitants do not pay any income tax at any time and neither the gift nor the tax free refund of principal affects them. Often when the annuity is purchased the annuitant is not much worried about a loss of tax exemption several years later. He does not know whether he will be alive then, but for a donor of large means the deduction of the gift value for the current income tax year may be an added inducement if he is not a man who is regularly giving away 15% or more of his income to the various causes in which he is interested.

On June 11, 1929, a letter was written by C. B. Allen (N.F.A.) of the Treasury Department, Washington, D. C., to John G. Touzeau of 2889 San Pasqual



Street, Pasadena, California, which appears to treat an annuity purchased from the Board of Foreign Missions of the Presbyterian Church in the United States of America in the manner in force before the ruling I.T. 2397. Mr. Touzeau gave \$6,000.00 for an annuity of \$360.00 a year. He purchased the annuity June 24, 1912, and he received \$96.00 on October 1, 1912, and \$90.00 quarterly thereafter. By April 1, 1929, he had received \$6,036.00 and the Treasury Department ruled the \$36.00 and all subsequent sums as taxable. No deduction from the principal amount parted with by Mr. Touzeau was made for the gift value as defined in I.T. 2397.

This, of course, called for some explanation and this letter (1) and a letter of September 21, 1928, in reply to an inquiry about this from my office (2) are given herewith. It is seen from these that no change is contemplated in the I.T. 2397 ruling.

For the sake of completeness, letters of December 21, 1928 (3), January 5, 1929 (4), and January 12, 1929 (5), are given in full. These all have to do with different aspects of the same ruling and its application.

Further letters from the Treasury Department discuss other aspects of this problem. The following conclusions seem to be justified by this correspondence:

(1) A definite gift is made to a religious, educational or charitable corporation by whoever purchases one of its annuities.

(2) This gift is made at the time that the annuitant parts with his principal and can only be claimed as a deduction for federal income tax purposes in a return for that calendar year or an amended return for that year.

(3) The amount of principal that is returned to the annuitant free of the federal income tax is reduced by the amount of the gift.

(4) The estate tax tables (i.e., Actuaries or Combined Experience Tables) with interest at 4% are to be used to find the cash value of the annuity. The differ-

ence between the cash value and the principal amount parted with by the annuitant is the deductible contribution or gift.

(5) If two or more individuals unite to purchase an annuity, each is allowed his proportionate share of the gift value.

(6) Each does not get a proportionate share of the tax exempt refund of principal parted with if the first payments are made only to one individual during his lifetime and then to one of the other, if surviving.

(7) The first payments carry the tax exempt refund of principal no matter to whom paid. Even if the first annuitant pays no income tax, and the second annuitant is the one whose principal bought the annuity, this does not alter the case.

If any of these rulings appear to be unfair in any way, an appeal may be taken to the Board of Tax Appeals.

#### TAXATION OF ANNUITIES UNDER STATE LAWS

It is not always easy to answer a question as to whether an annuity is taxable under the laws of a specific state. This may be because the law as embodied in the Constitution, and/or political code or statutes of the state, is not plain; because the interpretation of the Constitution and/or the statute law by different authorities varies; and/or because for some reason or other the law is not being complied with at the moment. Either it may be in process of being changed or the method of arriving at the tax may be in doubt.

Just what is an annuity? Is it personal property, intangible property, capital, a solvent credit, etc.? Or, if it is any or all of these, does the Constitution of the state or the laws of the state or any other code or authority show that an annuity is clearly intended to be classed under any of these heads? If there is doubt as to this or as to the method of computing its value or of paying the tax, then it is hard to advise others what to do.

In some states—Indiana, Ohio, Pennsylvania—there is a statute expressly dealing with the taxation of annuities. This statute expressly directs the manner and method of the tax. In Ohio, however, annuities “shall be valued at the sum which the person listing them believes them to be worth in money at the time of listing.” This reference to individual judgment undoubtedly leads to all sorts of results. In 1931 it is believed that there will be a general revision of the tax laws of Ohio by the Legislature.

So it is evident that this question is a very complex one. Final information is hard to get in all states but a tentative table has been prepared on the best information obtainable and in the hope that it will be useful. If there are errors in the table, it is hoped they can be corrected. This table should not be used as a final answer to any question of taxation of annuities in the different states but as a suggestion of what the situation is considered to be at the moment.

1. Does the state have an Income Tax Law?

This is important for if it does then the annual annuity may be considered as *income* after the principal paid has been returned. Of course, an annuity may be taxable on the capital or principal value if the state laws should so provide, but that would be double taxation if both methods were used and it is difficult to believe it will be even attempted. Georgia and North Carolina adopted a new income tax law in 1929 and other states are considering similar action or revision of the present laws. No final statement therefore is possible, but if there is an Income Tax Law, then this should be considered.

2. After we know whether the state has an Income Tax Law, then the next step is to learn if it follows the federal ruling about the refund of principal being exempt from tax. This is indicated by question “2.” It is seen that Massachusetts and Oklahoma do not follow the federal. It is presumed that the others do, although definite authorities cannot be obtained in each case. It

has not been thought best by the writer to take up with these states specifically the Treasury Department ruling I.T. 2397 because it has not been established long enough to do so. If, however, this conference should decide it is advisable, the writer will be pleased to try to obtain rulings on this also. Therefore, in the attached table when an authority or advisor says he believes his state income tax department will follow the federal, this answer is entered as Yes without meaning that I.T. 2397 is particularly intended.

3. Is an annuity taxable under the state laws on any other condition? This column in the table is again a guide and not a complete answer. Such taxes are based on the capital, personal property, intangible property, solvent credit, etc., values of annuities under state, county or city taxes and based on different methods of valuation and with various exemptions. If No appears in this column it may be safe for a time to pass this information on to others, but it is best to refer all inquiries to responsible advisors in their own states. A list of mortality tables used by the different states is given below. The writer is indebted for this table to Mr. Albert Handy, LL.B., member of the New York Bar who prepared it for Prentice-Hall, Inc. Mr. Handy has been most generous with his time and help and his article "Subjection of Life Insurance to Death Taxes," published in April, 1926, Illinois Law Review, and also his book "Inheritance and Other Like Taxes," published 1929 by Prentice-Hall, Inc., are of great value.

## FEDERAL AND STATE TAXATION OF ANNUITIES UNDER THE ESTATE TAX LAW

### TAXATION BY THE FEDERAL GOVERNMENT

When an annuitant dies his annuity agreement are apt to be in his safe. As such they come into the hands of his executor and he may account for them a part of the estate. If the annuity agreement is on on life only, the temptation to include it in the estate is not great for it is evident that it is of no value except

possibly for the last payment if this was due. If, however, one or more alternate annuitants are included, then the executor may consider this as part of the estate depending on the wording of the agreement. It may be claimed by the Federal Estate Tax authorities that it is either

- a. A gift in contemplation of death, or
- b. A gift intended to take effect at or after death.

The writer does not know of any attempt of the Federal Government to collect an estate tax on what is a bona fide annuity. The recent ruling of the Treasury Department I.T. 2397 would appear to make it very difficult where the annuity agreement is a bona fide annuity of a religious, educational or charitable corporation to tax either the gift part which is deducted as a gift in the income tax for the year in which it was made or the annuity part which is the cash or market value of the benefits granted. However, if the annuity was taken out immediately before death and was a major part of the annuitant's estate, this claim might be made at some time. It is believed, however, that the large life insurance companies and particularly those who issue annuities will oppose any such ruling as it affects the value of the annuity apart from the gift.

Recent decisions of the Supreme Court of the United States appear to contradict or modify the Estate Tax Regulations, namely Articles 15, 17, 18 and 19 of Regulations 70. These call for most careful interpretation by trustees, executors and administrators until the Supreme Court has further defined the statute. See *Reinecke vs. Northern Trust Company*, 278 U. S. 339. In 1918-1919 the decedent, who died in 1922, created certain trusts for his children. He reserved the income for life for himself and the right to supervise the investment of the funds, vote the stock held and at his option control leases and appoint successor trustees. He also reserved the power to alter, change or modify the conditions of the trust with the consent of the bene-

ficiary or a majority of the beneficiaries, if there was more than one. The Circuit Court of Appeals held that these trusts were intended "to take effect in possession or enjoyment at or after his death" and so were taxable. The Supreme Court held, however, that there was no "property passing out of the control, possession or enjoyment of the decedent at his death." The property was transferred by the instrument executed at the conveyance. Even though the decedent had the right to modify or revoke the trust, still this right was not vested in him alone. He needed the consent of the person or persons entitled to the beneficial interest. This took the power to revoke or alter out of his control for all practical purposes "as if the gift had been absolute." It is interesting to note that two older trusts created by the decedent even before the Act under which they were taxed was in force, were considered revocable and therefore taxable.

On April 14, 1930, in re: May vs. Heiner, the decedent in 1917 created a trust granting a life estate to her husband. She reserved a right to herself should she survive him. She died in 1920. Although the Treasury Department included the trust in taxing her estate as a gift intended to take effect in possession or enjoyment at or after death; the Supreme Court said "no interest in the property held under the trust passed from her to the living; title thereto had been definitely fixed by the trust deed. The interest therein which she possessed immediately prior to her death, was obliterated by the event." Whether she survived her husband or not was not of special importance.

June 5, 1930, the United States Circuit Court of Appeals, 7th Circuit, applied these decisions in the case of Commissioner vs. Northern Trust Company and held "that property conveyed by an irrevocable deed of trust through the income during the settlor's life be payable to settlor, does not pass at settlor's death, but at the date of the execution and delivery of the deed of trust. Property thus conveyed is therefore not subject to the tax provided for in the section above quoted."



Now these cases are not annuities, but if they are exempt from tax because they are not "property passing out of the control, possession or enjoyment of the decedent at his death," then annuities must be also so exempt. There are those who believe that the Supreme Court is zealous to see that a gift tax is not levied under the guise of an estate tax, "one may freely give his property to another by absolute gift without subjecting himself or his estate to a tax" says the Court (Reinecke vs. Northern Trust Co.). We know that the 1924 gift tax was repealed. Some even believe any gift tax to be unconstitutional where the gifts are absolute. Others believe the Federal Government desires to encourage the states to take over the field of death duties, and this leads to our next subject.

#### STATE ESTATE TAXATION OF ANNUITIES

In some of the states the chance of annuities being taxed under the Estate Tax Law is very much greater than in the case of the Federal Government. The earliest Inheritance Tax Statute in the United States—the Pennsylvania act of 1826—provided for taxation of transfers intended to take effect at death. The 1891 Amendment to the New York Transfer Law was the first to specifically tax transfers in contemplation of death. This law was copied by California in 1893 and Illinois in 1895. At the present time the State of California is endeavoring to collect a tax on annuities of the American Sunday School Union issued on the life of William Milhous and on that of his wife after his death, the reason for the tax being the claim that the annuities were purchased in contemplation of death. It appears to be the theory of the State Inheritance Tax Department that the sum to be taxed in this case is the amount paid by Mr. Milhous over and above the amounts received by him under the annuity agreements during his lifetime and the value of the life interest of his wife and also an exemption of \$500.00 which is allowed for gifts to foreign charitable corporations by the State of

California. The rate of tax is 5% on this sum. It will be seen that the amount of tax is not large in this case, the total amount of the tax on the two annuities which total \$2,000.00 is \$35.26. Some interesting points come out in this case because the American Baptist Publication Society and the American Baptist Home Mission Society also issued annuities to Mr. and Mrs. Milhou but they are held to be exempt because of the reciprocal agreement in the laws of the state in which they are incorporated exempting religious, educational and charitable groups from taxation "from legacy or succession taxes or death taxes of every character providing the said other state or territory allows a similar exemption." California has such a law and New York has such a law. Another point is the question whether the reciprocal agreements went into effect after the annuity was issued, the earlier date of the issuance of the annuity should exclude it from the law. If the tax is based on the value of the gift being ascertainable only at the time of death then this would seem to be the important date rather than the date of the issuance of the annuity. Furthermore, if the value of the wife's life interest is now ascertainable, why cannot the gift value be known in the same way when the annuity is purchased?

This matter is not yet settled but the American Bible Society is co-operating through its representative with the other parties mentioned and it is hoped that others will join in helping to secure a satisfactory termination of the case.

\* \* \* \*

Other cases could be given in other states. The volume of material on this subject is very large. There are many states which have claimed that an annuity is a gift in view of or in contemplation of death. There are also states where it is claimed that an annuity may be a transfer that takes effect in possession or enjoyment at or after death and as such is taxable.

## PROVISIONS IN WILLS TO PURCHASE ANNUITIES

It is becoming more and more a custom for individuals to provide in their Will for purchasing an annuity from religious, educational or charitable groups by their estate. This provision may be either for a fixed sum to be paid over or for a share of the residue. Of course, the purchase of such annuities does come under the Estate Tax Laws. Just because this is so it makes it important, however, that a sharp line of distinction should be drawn between annuities provided for in the Will and the annuities which the testator or testatrix may have purchased during his or her lifetime. The beneficiaries may be the same. The annuities purchased during the lifetime for the benefit of one or more relatives may be larger than the ones in the Will. Here we have a very definite problem, particularly if the beneficiaries may claim they do not receive under the Will their statutory share of the estate. It is easy to claim they do receive it if these annuities are included, but, of course, annuities purchased during the lifetime are not a part of the estate. Perhaps, however, they may be in a sense an irrevocable advancement. This is another large question that deserves most careful study.

A further question is also raised as to just how the amounts paid over for the annuities provided in the Will, are to be regarded. If the benefits granted are estimated under the Estate Tax Tables used by the different states or the Federal Government, then the amount paid for the annuity will be larger than the benefits granted. The difference appears to be a testamentary gift and as such it is less apt to be taxable than if the whole principal sum paid by the estate is regarded as the value of the annuity. We have already given a list of the Estate Tax Tables used by the different states so that it may be seen how many different standards are in use. Here again there appears to be a gift made from the estate as well as the purchase of an annuity.

It is most important to draw a sharp line between the annuities purchased by Will and annuities purchased during the lifetime of the testator. The attorneys who settle the estates are not always careful to draw this line. Sometimes the value of the estate is much enhanced by including them, or if the question is raised by the authorities as to an annuity purchased during the lifetime of the testator being taxable, they may agree to pay the tax if the amount is not large in order to settle the estate quickly. With them the principal at stake is not always of as much importance as the paying out of the sums called for in the Will to the beneficiaries. Let me conclude by referring to just such a case in New York State.

A gentleman of C——, New York, purchased an annuity for \$30,000.00 on October 3, 1924, payable first to himself and then to his wife, should she survive him. Upon the death of both, \$200.00 a year was to be paid to his wife's sister and \$1,200.00 per year to his adopted daughter, should they survive. By his Will, Mr. —— left the residue of his estate to his wife but upon her death the residue goes to the American Bible Society provided that a written agreement to pay the adopted daughter \$600.00 a year in quarterly payments is executed by the American Bible Society. His whole estate consisted of real estate worth about \$14,000.00 and furniture worth \$176.25. The State of New York naturally decided to collect a tax on the annuity provided in the Will to the adopted daughter, and this was paid by the estate before it was discovered that in figuring the amount, the payment called for under the annuity taken out in 1924 was also included. The state is now endeavoring to collect \$42.20 on account of the annuity to the sister who is not mentioned in the Will at all, plus interest at 10% from the date of Mr. ——'s death. It is interesting to note that the sister is now dead and has never received one cent under the annuity taken out during Mr. ——'s lifetime.

## CONCLUSION

1. It is evident that in these important matters there is need for co-operation from all those who are interested. No one group can keep in touch with what is going on in all the forty-eight states. What is needed is some one person or group of persons in each state who will keep themselves informed on this matter and give help to those who need it. While the problem is a difficult one, it is one that can be faced and conquered by united action. It will be found that in each state there are large Trust Companies which keep themselves informed on these matters as far as they affect their clients. These are only too glad to help, provided not too many individual groups approach them. There are also large insurance companies in the different states who are watching all legislation that affects them. There have been at least two cases when insurance policies have been made subject to taxation. This matter, of course, is vital to the life insurance companies and also to a less degree to those issuing annuities. There are also prominent lawyers who are interested in religious, educational and charitable work, who, if they can be properly approached, will be glad to help from time to time. When the laws are written and when the decisions are made is the time to discuss the facts fully and impartially. This cannot be done by any one individual but must be done by the united group. The writer therefore believes that this Conference should call upon or select some person or group in each of the forty-eight states to co-operate in this matter.

2. It will also be well to secure the judgment of this Conference as to the ruling of the Federal Income Tax Bureau I.T. 2397. To the writer this appears to be a fair, logical and just interpretation of facts. If, however, there are any who desire to appeal to the Board of Tax Appeals, now is their opportunity to state the reasons why they wish to do so, otherwise the separate states may soon follow the Federal Ruling in this matter in connection with their own state income tax laws.



3. A committee of the best legal ability obtainable should be appointed to prepare a short statement of the real facts about annuities. This statement would be forwarded to executors on the death of any annuitant. It may be that it will be decided to have more than one statement for use in particular states as conditions vary. This memorandum should cover first

- a. Whether an annuity is a gift in contemplation of death.

Any state may attempt to tax an annuity if the annuity was purchased within a limited time before the date of death. In Kansas the period of limitation is only ninety days, while in Arizona it is six years. Within this period the burden is on the estate to show that any payment of over \$500.00 in Arkansas or in West Virginia, or over three per cent. of the individual's net worth in North Carolina, should not be included in the estate. In the Federal Estate Tax regulations any amount over \$5,000.00 must be explained by giving full information.

If the gift was made before or outside the limited period then the burden is on the state to prove that the gift was in contemplation of death. Of course, annuities are apt to be over \$500.00 in amount and a sizeable part of the estate, but if the annuitants are in the habit of purchasing an annuity every year, this may be an important factor to have brought out. They may also be irrevocable gifts or advancements. Would it not be well then to make available to executors an explicit statement with authoritative court actions and decisions that an annuity is not a gift of principal in contemplation of death. It is not a revocable gift. Adequate consideration is given. The gift of the principal takes place immediately. There is no restriction as to the use of the principal in the agreement. If the annuity is split into the gift value and the market value of the annuity and if the gift value is considered to take effect immediately then it appears difficult to claim that the gift takes place at the date of death and not at



the date when the annuity was purchased. Of course, if certain precedents are followed, even if it is claimed that the gift part is taxable because occurring too near to the date of death, then a double exemption might be secured as under the New York rule the tax might be assessed on each separate transaction as though the other had no existence, a separate exemption being allowed in each case.

Re Hodges (1915), 215 N. Y. 447, 109 N. E. 559.

Re Kunhardt (1925) (N. Y. Surrogate's Court), N. Y. Law Journal, March 7, 1925.

It is true there are many states that do not follow this ruling, but even with them as the value of the gift is very much less than the amount paid for the annuity, it might remove the matter from the taxable class by reducing the size of the gift.

b. Gifts "Intended to take effect in possession or enjoyment at or after death."

The wording of the annuity agreement is most important in connection with this. If it contains a promise to keep the principal as security until the death of the annuitant then it may be regarded as a diminishing trust fund and not an annuity. In some states but not by the federal authorities a claim will be made that possession is only complete at death. In New Jersey if the sum annually called for by the annuity is paid out of the sum transferred by the annuitant or money earned on the sum transferred then the contract is taxable. If, however, the said sum payable for life "could be paid out of any fund," it is not taxable. New Jersey does not appear to follow the distinction made by the Supreme Court of the United States between "property passing out of the control, possession or enjoyment of the decedent at his death" and the income of the property so passing. Re Honeyman, 1925, 98 N. J. Equ. 638, 129 Atl. 393. Of course, if a religious or educational corporation purchases an annuity from a life insurance company, then the annual sum is paid out of funds not in the possession of the donee.

Even if, however, all annuities are placed with life insurance companies, the matter of taxation may still come up at some future date for there are two cases in which life insurance has been made taxable though this does not seem to be very probable now. These two cases are given, however, for what they are worth.

1. *Re Einstein* (1921), 114 Misc., 452, 186 N. Y. Supp. 931. In this case certain policies of insurance payable to the individual's estate were assigned to his son-in-law three days prior to his death. This was held to be in contemplation of death. The individual concerned had been in the constant care of a physician and nurse eighteen months prior to his death.

2. Similarly the United States District Court for the District of Maryland, 286 Fed. 692 (1920), held that an assignment of life insurance from the individual's estate to his children with the reservation of the right to change the beneficiary was a transfer intended to take effect at death. While these two decisions are not given much weight, they still show that even with life insurance, this same question may come up though by far the greater weight of evidence is against it.

Would it not be well, therefore, in this connection to establish that payments made to the annuitant are under a contract; that the principal parted with by the annuitant passes into the absolute possession of the party issuing the annuity and is not revocable; that the benefits granted may be even greater than the amount paid if the annuitant lives beyond his life expectancy; also that the sums paid to the annuitant are taken, at least in part, from other funds and might be taken from any fund in the possession of the party issuing the annuity? Is it not true that information of this kind is of value to executors who find among the securities of the deceased, one or more annuities either on his own life or with survivorship rights to others?

There is also the possibility that a further study of the recent Supreme Court Decisions, *Reinecke*, Collector

vs. Northern Trust Co., Executor of Bartlett, 1929 U. S. May vs. Heiner, April 14, 1930, and interpretations of the same by the United States Circuit Courts may also make trust agreements not subject to tax where the deed of trust is irrevocable, "though the income during the settlor's life be payable to settlor," for title "does not pass at settlor's death but at the date of the execution and delivery of the deed of trust." U. S. Circuit Court of Appeal, 7th Circuit, in re Commissioner vs. Northern Trust Co., June 5, 1930. This is of particular interest in cases where the remaining principal of an annuity becomes a permanent trust fund on the death of an annuitant or is to be used for a specifically designated purpose.

## LAWS RELATING TO ANNUITIES

ALABAMA—No law.

ARIZONA—American Experience, 5%. Northampton, 5%, may be used when use of American Experience table is impracticable.

ARKANSAS—Actuaries Combined Experience, 5%.

CALIFORNIA—Actuaries Combined Experience, 5%, with modifications as follows: If annuity is payable at end of year, add .5000; if payable semi-annually, add .2500; if payable quarterly, add .3750; if payable bi-monthly, add .4167; if payable monthly, add .4583.

COLORADO—American Experience, 5%.

CONNECTICUT—Actuaries Combined Experience, 4%.

DELAWARE—Rule 34, Orphans' Court.

FEDERAL—Actuaries Combined Experience, 4%. (See also Federal Regulations.)

GEORGIA—Carlisle, Northampton or Actuaries Combined Experience, 6%.

IDAHO—Actuaries Combined Experience, 5%.

ILLINOIS—Carlisle, 5%.

INDIANA—American Experience, 5%.

IOWA—Actuaries Combined Experience, 4%.

KANSAS—American Experience, 5%.

KENTUCKY—Dr. Wigglesworth's, 5%.

LOUISIANA—American Experience, 6%.

MAINE—Actuaries Combined Experience, 4%.

MARYLAND—Equity Rule No. 21, Supreme Bench of Baltimore City.

MASSACHUSETTS—American Experience, 4%.

- MICHIGAN—American Experience, 5%.  
MINNESOTA—American Experience, 5%.  
MISSISSIPPI—American Experience, 5%.  
MISSOURI—Actuaries Combined Experience, 5%.  
MONTANA—American Experience, 5%.  
NEBRASKA—Carlisle Table admissible in all courts. Rate usually between 5½% and 6½% as is considered fair by court and appraiser.  
NEVADA—None. No case has arisen in which use of table was needed. When such a case arises it will be a question for the courts.  
NEW HAMPSHIRE—Actuaries Combined Experience, 4%.  
NEW JERSEY—American Experience, 5%.  
NEW MEXICO—None.  
NEW YORK—American Experience, 5%.  
NORTH CAROLINA—Sections 1790 and 1791, Consolidated Statutes.  
NORTH DAKOTA—American Experience, 6%.  
OHIO—American Experience, 5%.  
OKLAHOMA—American Experience, 5%.  
OREGON—Actuaries Combined Experience, 4%.  
PENNSYLVANIA—Special table, 5%.  
RHODE ISLAND—American Experience, 5%.  
SOUTH CAROLINA—Actuaries Combined Experience, 4%.  
SOUTH DAKOTA—American Experience, 5%.  
TENNESSEE—Carlisle, 6%.  
TEXAS—Actuaries Combined Experience, 4%.  
UTAH—None officially designated.  
VERMONT—American Experience, 3½%.  
VIRGINIA—Carlisle, 6%. Section 5131, Code of Virginia.  
WASHINGTON—Actuaries Combined Experience, 4%.  
WEST VIRGINIA—Northampton, 4%.  
WISCONSIN—American Experience, 5%; Northampton may be used when more practicable.  
WYOMING—American Experience, 5%.

These tables were prepared by Albert Handy, LL.B. and copyrighted by Prentice Hall Inc.

LAWS RELATING TO TAXATION

| State         | Personal Income Tax Law          | Follow Federal Ruling                            | Taxable as Principal                                    | Rate of Tax |
|---------------|----------------------------------|--|---|-------------|
| ALABAMA       | No                               |  | Not taxable   |             |
| ARIZONA       | No                               |  | All property is taxable but intangibles not in practice |             |
| ARKANSAS      | No                               |  | All property taxable but not annuities in practice      |             |
| CALIFORNIA    | No                               | No   | Capital assets under head of personal property          |             |
| COLORADO      | No 1931?                         |  | Not taxable   |             |
| CONNECTICUT   | No                               |  | Exempt  |             |
| DELAWARE      | Yes                              | Exempt   | No  |             |
| DIST. OF COL. | No                               | No   | No, 1/3 of that assessed by U. S. Government            |             |
| FLORIDA       | No                               | Yes  | No  |             |
| GEORGIA       | Yes                              | No   | Personal property at present value                      | rate varies |
| IDAHO         | No                               |  | As Capital Asset  |             |
| ILLINOIS      | No                               |  |   |             |
| INDIANA       | No                               |  |   |             |
| IOWA          | No                               |  |   |             |
| KANSAS        | No                               |  |   |             |
| KENTUCKY      | No                               |  |   |             |
| LOUISIANA     | No                               |  |   |             |
| MAINE         | No                               |  | Not in practice   |             |
| MARYLAND      | No                               |  | No  |             |
| MASSACHUSETTS | Yes                              | No, See Item 22 Sched. C<br>Income Tax Ret. Blk. |   | 1 1/2 %     |
| MICHIGAN      | No                               | No   | No  |             |
| MINNESOTA     | No                               | No   | No  |             |
| MISSISSIPPI   | Yes, Principal must be recovered | No   | No not taxable as principal                             |             |
| MISSOURI      | Yes                              | Probably   | Personal property, but do not believe it would be taxed |             |

## LAWS RELATING TO TAXATION—Continued

| State          | Personal Income Tax Law         | Follow Federal Ruling   | Taxable as Principal   | Rate of Tax     |
|----------------|---------------------------------|-------------------------|--|-----------------|
| MONTANA        | No                              | No                      | No   | \$8 per \$1,000 |
| NEBRASKA       | No                              | No                      | Intangible   |                 |
| NEVADA         | No                              | No                      | Personal property  |                 |
| NEW HAMPSHIRE  | No                              | No                      | No   |                 |
| NEW JERSEY     | No                              | No                      | No   |                 |
| NEW MEXICO     | Yes                             | Yes                     | No   |                 |
| NEW YORK       | Yes                             | Yes                     | No   |                 |
| NORTH CAROLINA | Yes                             | Yes                     | No   |                 |
| NORTH DAKOTA   | Yes                             | No                      | No   | 2.62%           |
| OHIO           | No                              | No                      | Valued at the sum which person believes them worth in money at time of listing |                 |
| OREGON         | No                              | No                      | Personal property not enforced   | 4%              |
| PENNSYLVANIA   | No                              | No                      | Yes if \$200 annually over 4 mills per \$1,000                                 | 5% discount     |
| RHODE ISLAND   | No                              | No                      | No   |                 |
| SOUTH CAROLINA | Yes                             | Yes                     | No   |                 |
| SOUTH DAKOTA   | No                              | Yes                     | Money and credit if enforced   | 5%              |
| TENNESSEE      | Yes                             | Annuitants not included | No   |                 |
| TEXAS          | No                              |                         | As property unless capital of such annuity be taxed within the state           |                 |
| UTAH           | No, but one is being considered |                         | No   |                 |
| VERMONT        | No                              | Yes                     | No   |                 |
| VIRGINIA       | Yes                             | Yes                     | Property, 50c. per \$100 of its fair market value                              |                 |
| WASHINGTON     | No                              | No                      | No   |                 |
| WEST VIRGINIA  | No                              | Probably                | No   |                 |
| WISCONSIN      | Yes                             |                         | Intangible not enforced  |                 |
| WYOMING        | No                              |                         |  |                 |



CORRESPONDENCE SHOWING FEDERAL  
RULINGSCOPY 1.  
TREASURY DEPARTMENT  
WASHINGTONOffice of  
Commissioner of  
Internal Revenue

June 11, 1929

Refer to  
IT:E:RR  
NFAMr. John G. Touzeau,  
2889 San Pasqual Street,  
Pasadena, California.

Sir:

Reference is made to your letter of May 23, 1929, enclosures, and prior correspondence, in which you inquire whether or not the income you receive under certain annuity contracts with the Presbyterian Board of Foreign Missions, 156 Fifth Avenue, New York, New York, and the Los Angeles Bible Institute, Los Angeles, California, is subject to Federal Income Tax.

It appears from the copies of the contracts submitted that (1) on June 24, 1912, you gave \$6,000.00 to the Board of Foreign Missions of the Presbyterian Church in the United States of America on the condition that the sum be expended in the purchase of property at Medallin, Colombia, South America, and in return for its promise to pay you \$360.00 annually during your lifetime; (2) on February 3, 1918, you gave \$4,000.00 to the same organization on the same condition and in return for its promise to pay you \$240.00 annually during your lifetime; (3) on September 10, 1923, you gave \$750.00 to the Bible Institute of Los Angeles as consideration for its promise to pay you \$62.50 each year during the term of your natural life; and (4) on January 21, 1924, you gave the same organization \$350.00 in consideration of the payment to you of \$29.40 each year of your lifetime.

In reply you are advised that annuities paid by a religious corporation under an annuity contract are, in general, subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds the amount paid as consideration for the contract. For instance, in the case of your gift of \$6,000.00 in 1912 you were to receive an annuity payment of \$96.00 on October 1st of that year and \$90.00 each three months thereafter which, on April 1, 1929, would amount to \$6,036.00, or \$36.00 in excess of the amount paid for the contract: hence the sum of \$36.00, together with all subsequent payments on that annuity contract, is subject to income tax.

Respectfully,

C. B. ALLEN,  
Deputy Commissioner.  
By L. K. SUNDERLIN,  
Chief of Section.

COPY 2.

TREASURY DEPARTMENT  
WASHINGTONOffice of  
Commissioner of  
Internal Revenue

September 21, 1929

IT:E:RR  
NFAAmerican Bible Society,  
Bible House,  
Astor Place,  
New York, New York.  
Attention: G. Darlington, Treasurer.

Sirs:

Receipt is acknowledged of your letter of September 7, 1929, and enclosures, in which you inquire whether there has been any change in the policy expressed in I. T. 2397, C. B. VII-I, 90, and in the correspondence you have had with this office, symbolized IT:E:RR:CNW.

You enclose a copy of office letter of June 11, 1929 to Mr. John G. Touzeau, 2889 San Pasqual Street, Pasadena, California, an annuitant of your organization, which does not appear to be in complete harmony with the ruling contained in I. T. 2397.

In reply you are advised that the policy of this office has not changed since the correspondence referred to and that the inconsistency therewith of the office letter to Mr. Touzeau will be taken up directly with the taxpayer at an early date.

Respectfully,

DAVID BURNET,  
*Deputy Commissioner.*By L. K. SUNDERLIN,  
*Chief of Section.*

COPY 3.

TREASURY DEPARTMENT  
WASHINGTONT:E:RR  
CNW

December 21, 1928

Mr. Gilbert Darlington, Treasurer,  
American Bible Society,  
Bible House, Astor Place,  
New York, New York.

Sir:

Reference is made to your letter dated November 12, 1928, presenting certain further questions in addition to the one presented in your letter of October 13, 1928, which is under consideration as stated in office letter of November 9, 1928.

In your previous letter you referred to the ruling published as I. T. 2297 in Internal Revenue Bulletin Vol. VII, No. 5, Page 3, (C. B. VII-I, Page 90) in which it was held that a portion of the amount transferred to the educational corporation constituted a contribution or donation. In reply to your inquiry as to when or in what case the transfer of an amount to such educational, religious, or charitable corporations constitutes in part a contribution or donation and in part the purchase price of an annuity, you are advised that this occurs *when the amount so parted with by the annuitant is in excess of the cash value of the annuity at the time.*

The date of the contribution is of course, the date on which the amount is parted with and transferred to the corporation by the annuitant, and the amount thereof cannot be claimed as a deductible contribution by the donor or contributor for a later year. In the case of such donors or contributors who did not claim the proper allowable deduction for the year in which such contribution was made, an amended return with claim for refund may be filed at any time *within the period of limitation* for filing claims for refund for such year. For the year 1924 and prior years this is within four years from the time the tax for the particular year was paid. For the years 1925, 1926 and 1927 such claim is required to be filed within three years from the time the tax for the particular year was paid.

With reference to the time when such annuitants should begin to treat the annuity payments as income in rendering their income tax returns, you are advised that for the year 1925 and subsequent years it is the year in which the aggregate of the total annuity payments received first exceeds the cost of the annuity, and this should be determined from the books of account or other records of the particular annuitant.

Respectfully,

C. B. ALLEN,  
*Deputy Commissioner.*

By L. K. SUNDERLIN,  
*Chief of Section.*

COPY 4.

TREASURY DEPARTMENT  
WASHINGTON

January 5, 1929

Mr. Gilbert Darlington, Treasurer,  
American Bible Society,  
Bible House, Astor Place,  
New York, New York.

Sir:

Reference is made to your letter dated October 13, 1928, with which you enclose a form of contract issued by your organization whereby the holder on payment of a specified sum acquires the right to a stated annuity for life, along with a list of annuitants to whom such contracts have recently been issued, for consideration relative to the rate of per cent to be used in computing the cash value or present worth of the annuity at the time of issuing the contract.

In reply, you are advised that the cash value or present worth of annuities such as are mentioned in the list furnished with your letter, should be determined in accordance with Table A in Article 13, page 20, of Estate Tax Regulations 70, using the uniform rate of 4% therein employed.

Respectfully,

H. F. MIRES,  
*Acting Commissioner.*

COPY 5.

TREASURY DEPARTMENT  
WASHINGTON

January 12, 1929

Mr. Gilbert Darlington, Treasurer,  
American Bible Society,  
Bible House, Astor Place,  
New York, New York.

Sir:

Reference is made to your letter dated December 27, 1928, in which you refer to office letter of December 21, 1928, relative to the construction and application of the ruling published as I. T. 2397 in Cumulative Bulletin VII-I, Page 90.

In reply you are advised that your understanding of the explanation made by office letter of December 21, 1928 relative to the construction and application of the ruling in question appears to be correct. The theory on which the ruling is based is of course required to be applied consistently, and where the amount parted with by the annuitant was such as to constitute a part of it a deductible contribution, the whole amount parted with cannot be treated as having been applied to the purchase of the annuity, regardless of the fact that the allowable deduction may not have been claimed by the annuitant.

Respectfully,

C. B. ALLEN,  
*Deputy Commissioner.*

By L. K. SUNDERLIN,  
*Chief of Section.*

COPY 6.

TREASURY DEPARTMENT  
WASHINGTON

November 3, 1930

IT:E:RR  
NFA

American Bible Society,  
Bible House, Astor Place,  
New York, New York.  
Attention: G. Darlington, Treasurer.

Sirs:

Receipt is acknowledged of your letter of October 24, 1930, in which you request a ruling in connection with an annuity purchased from your organization by Mr. and Mrs. W. I. Deck, Womelsdorf, Pennsylvania.

On March 25, 1930, the taxpayers forwarded \$1,000.00 to you with the statement, "*Mrs. Deck andd I are pleased to send you our check for \$1,000 for another annuity.*" The annuity of \$60.00 annually is to be paid semi-annually on January 1 and July 1 to Mrs. Deck. The first payment on July 1, 1930, will be \$16.16, but each subsequent payment will be \$30.00. After the death of Mrs. Deck, the annuity is payable to Mr. Deck.

You inquire who is entitled to the deduction of that portion of the purchase price of the annuity regarded as a contribution to your organization; and, in the event that Mrs. Deck should die before one or two payments were made to her, whether or not Mr. Deck would be entitled to exemption from tax on the entire cash value of the annuity contract.

In reply you are advised that if the taxpayers file a joint return, a deduction may be claimed therein of that portion of the purchase price of the annuity regarded as a contribution to your organization. If they file separate returns, it would appear that the one who paid the \$1,000.00 for the annuity would be entitled to deduct that portion of it which is a contribution; or if the amount paid for the annuity belonged partly to each taxpayer, claim for the contribution might be apportioned between them.

In the event that Mrs. Deck should die in 1930 after the receipt of the first annuity payment, such payment represents tax-free income to her alone and could not possibly be regarded as income to her husband. Annuity payments received after her death would represent tax-free income to Mr. Deck in the year of receipt, until the aggregate of all payments made to Mrs. Deck and Mr. Deck equalled the cash value of the annuity.

Respectfully,

J. C. WILMER,  
*Deputy Commissioner.*

By L. K. SUNDERLIN,  
*Chief of Section.*



COPY 7.

TREASURY DEPARTMENT  
WASHINGTON

November 3, 1930

IT:E:RR  
NFA

American Bible Society,  
Bible House, Astor Place,  
New York, New York.  
Attention: G. Darlington, Treasurer.

Sirs:

Receipt is acknowledged of your letter of October 24, 1930, in which you request a ruling relative to an annuity purchased by the Rev. A. Edwin Keigwin.

On November 13, 1929, the taxpayer, who was born July 21, 1869, paid \$1,000.00 to your organization in return for an annuity of \$62.00 payable semi-annually on May 13 and November 13 to his servant, Martha Suggs, born October 11, 1865, and, in the event that he should survive her, to himself. It is your understanding that the cash value of the annuity is \$727.14, and that the taxpayer is entitled to deduct in his return for 1929, as a gift to a religious organization, the difference between such cash value of the annuity contract and the amount paid for it, or \$272.86; and that annuity payments to the amount of \$727.14, if paid to the servant, are not subject to Federal income tax.

You suggest that the servant may not be required to pay any income tax. In the event that she should die before she has received \$727.14, you inquire whether the taxpayer would be entitled to subsequent annuity payments free of tax, and suggest that he might be entitled to the entire cash value of the annuity free of tax.

On the assumption that the cash value of the annuity at the time of purchase has been properly computed as \$727.14, you are advised that until the aggregate of the annuity payments to the servant, or to the servant and master, amounts to \$727.14, such payments are not subject to income tax. Annuity payments in excess of that amount constitute taxable income to the recipient. The fact that the servant may not be in receipt of sufficient income to require her to pay a tax does not alter the fact that in the hands of the recipient, be it servant or master, any excess over \$727.14 is taxable income.

Respectfully,

J. C. WILMER,  
*Deputy Commissioner.*

By L. K. SUNDERLIN,  
*Chief of Section.*

COPY 8.

TREASURY DEPARTMENT  
WASHINGTONIT:E:RR  
NFAAmerican Bible Society,  
Bible House, Astor Place,  
New York, New York.  
Attention: G. Darlington, Treasurer.

November 3, 1930

Sirs:

Receipt is acknowledged of your letter of October 24, 1930, in which you make several inquiries in connection with annuities purchased by Mr. Lewis M. Dunton, Orangeburg, South Carolina, from your organization.

On January 2, 1925, the taxpayer paid your organization \$2,500.00 for an annuity of \$215.00 payable semi-annually on January 2 and July 2 to himself and to his wife, Mary E. Dunton, should she survive him. He was born September 22, 1848 and she was born May 19, 1849. You have computed the cash value of the annuity at \$1,457.49 and the contribution to your organization as \$1,042.51.

On March 28, 1925, the taxpayer paid your organization \$2,500.00 under the same provisions except that the annuity payments were to be made to his wife and, after her death, to himself as survivor and the payments were to be made on March 28 and September 28. You have computed the cash value of the annuity at \$1,424.16 and the contribution to your organization as \$1,075.84.

You inquire as follows:

"In such cases who would be entitled to claim the gift value of the annuity provided it were claimed at the proper time specified by the law? To whom would the exemption be given, on principal paid in and if the exemption is not all used up by either Mr. or Mrs. Dutton, does the survivor have a right to the unused part of the principal paid for the annuity as tax-free income under the Federal Income Tax Law?"

In reply you are advised that, depending upon the period of life expectancy of the annuitant or annuitants, the amount received by your organization for the annuity resolves itself into two parts—consideration paid for the annuity contract or value of the annuity at the time of purchase, and an outright contribution to the organization.

The contribution is an allowable deduction for the year in which it is made in the return of the one who makes the contribution. If part of it is made by the husband and part by the wife and they do not file a joint return, each may claim his or her proportionate part in their separate returns. No part of the annuity payments is taxable income to the recipient until the total of all annuity payments made under the annuity contract exceeds the value of the annuity at the time of purchase or the consideration paid. Any excess over that amount is taxable income to the recipient in the year in which it is received.

Respectfully,

J. C. WILMER,

*Deputy Commissioner.*

By L. K. SUNDERLIN,

*Chief of Section.*

COPY 9.

TREASURY DEPARTMENT  
WASHINGTON

November 30, 1930

American Bible Society,  
Bible House, Astor Place,  
New York, New York.  
Attention: G. Darlington, Treasurer.

Sirs:

Reference is made to your letter of October 24, 1930, in which you make inquiries as to the rights of certain of your annuitants, in connection with their Federal income tax.

On January 13, 1925, Mrs. Sarah D. Miller purchased for \$200.00 an annuity of \$9.00, payable first to her daughter, Mabel E. Miller, who was born July 7, 1884, and then to another daughter, Mary B. Miller, who was born October 12, 1886.

You inquire (1) whether Mrs. Miller is entitled to deduct any sum as a gift in her income tax return for 1925 in the event that her claim was made before the expiration of the period for filing an amended return; (2) whether the daughters are entitled to claim that their annuity is free of Federal income tax until they receive "the principal value of the annuity as figured on the Actuaries' or Combined Experience Tables"; and, if so, whether the exemption applies only to the first consecutive payments, or whether each daughter claims one-half or some other percentage of the exemption.

In reply you are advised that annuities paid by a religious corporation under an annuity contract are, in general, subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds the amount paid as consideration for the contract. Depending upon the period of life expectancy of the annuitant, the amount of the gift resolves itself into two parts—consideration paid for the annuity contract or value of the annuity at the time of purchase, and an outright contribution to the organization.

Inasmuch as the exact terms of the payment of the annuity and the period over which the payments are to be made are not stated, the consideration paid for the annuity contract or value of the annuity when purchased cannot be determined. If such value is in excess of the sum of \$200.00, there would be no gift to your organization and no deduction could be made for a gift in the return of the purchaser of the annuity. If the value of the annuity at the time of purchase is less than \$200.00, the difference between such value and \$200.00 is the amount of the gift to your organization and the amount which the purchaser is entitled to deduct as a gift in her return for the year in which the annuity is purchased.

The annuity paid by your organization to the daughters is subject to tax to the extent that the aggregate amount of the pay-

ments made to the annuitant or annuitants exceeds the amount paid as consideration for the contract. If the value of the annuity at the time of purchase is less than \$200.00, such value represents the consideration paid, but if the value of the annuity is more than \$200.00 the latter sum represents the consideration paid.

Consecutive payments to the amount of the consideration paid are exempt from tax, irrespective of which annuitant receives them.

Respectfully,

J. C. WILMER,  
*Deputy Commissioner.*

By L. K. SUNDERLIN,  
*Chief of Section.*

## ADMINISTRATION AND INVESTMENT OF ANNUITY FUNDS

WILLIAM T. BOULT

*Treasurer, National Council of Congregational Churches  
in U. S. A.*

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The representatives of religious, educational and charitable organizations, present here today, are undoubtedly fully aware of the definite responsibility laid upon all corporations entering into agreements to pay annuities to maintain with the utmost care reserves to insure the fulfilment of annuity agreements.

It would indeed be a serious defection, if such organizations should fail to administer and invest funds committed to their care in any but the most prudent and effective way.

Lists of investments held against annuity agreements should therefore be so sound that leading financiers and business men would commend them. State Insurance Commissioners, who may possibly call upon us to submit lists of securities, will also be favorably impressed. The confidence of benefactors, large and small, is vital. Nothing will foster this confidence more than evidences of able business management of annuity funds. Moreover, as responsible administrators, we should hold ourselves to the strictest account in the handling of monies which are entrusted to us.

Other corporations, organized for profit, may be justified in adopting an investment policy which looks more largely to the appreciation of principal or an abnormally high interest return. Such procedure is in the nature of speculation. In the case of corporations like ours, "not for profit," and involving us in guarantees of regular payments to annuitants, there should be no taint of speculation. Profits on investments will occur, but are incidental to the main business of keeping the principal of reserve funds intact and maintaining a stable income.



## SAFETY OF PRINCIPAL AND INCOME IS PARAMOUNT

A security yielding higher than the normal rate of interest on the current market is to be suspected. The higher yield indicates, generally, that the financially wise are avoiding this investment. Abnormal yield usually means a greater risk of principal.

Life insurance companies are legally bound to limit their investments, as indicated by the following letter from the treasurer of one of the largest companies:

"Life Insurance Companies of New York State may invest on Bond and Mortgage to the extent of two-thirds of the value of the property mortgaged; in United States Government, State, County and Municipal bonds; in Railroads, Public Utilities and Industrials secured by mortgage and in debentures of the same Companies, providing the issuing Corporation has for five years, previous to the investment, earned four per cent. on all its outstanding capital stock. They may also invest in preferred stocks with the same restrictions, to the extent of not more than ten per cent. of any one outstanding preferred stock and not more than two per cent. of the assets of the Life Insurance Company in any one preferred stock.

"Companies doing a business in foreign countries, may invest in those countries in the same class of security as is legal in New York State.

"They may also make loans on the security of their own policies, and may invest in Real Estate convenient for the accommodation of their business."

There can be no question but that we are morally bound, and may some day be legally bound in a similar way.

## PRACTICES TO BE AVOIDED

It is clear, since we are under obligation to maintain reserves, that the principal of the annuity fund should be judiciously invested. Cases have been brought to our attention where the principal has been put into current work, and even used for expenses. In another instance a one thousand dollar gift was used by an organization to pay a bank note which fell due. These are deplorable uses of annuity funds, because they leave no reserve to back the payment of annuities.



Certain classes of investments should be scrupulously avoided. A letter from the Insurance Commissioner of one of our largest states declares:

"We have uniformly objected, when an institution wished to use its own real property as the fund required by law. It has been our feeling that the reserve fund guaranteeing the fulfilment of the contracts issued should be invested in some standard interest-bearing securities."

It is clear from this that insurance commissioners are likely to frown on the use of a corporation's own real estate as the reserve fund against annuity agreements. The acceptance of real estate as the basis of an annuity agreement is also to be deprecated. Some time ago an agency accepted unimproved farm lands in lieu of cash. The farmer who made the gift had been unsuccessful in making his acres profitable. This institution accepted real estate which produced no net income, after carrying charges, from which an annuity could properly be paid, and held as its reserve, against an agreement good for the duration of the life of the donor, and continuing to his widow during her life, property that not only produced no net income, but could not be liquidated for cash in any amount commensurate with the basis on which it was accepted as a Conditional Gift. This is obviously an exceptional case of poor management.

Not only is accepting real estate, particularly non-income producing real estate, as the basis of an annuity agreement to be discouraged, but real estate investments of reserves is also to be avoided.

The tendency of real estate to become a "frozen asset," its rapid depreciation and its uncertain income-producing nature, to say nothing of the problem of management involved, make real property an unsatisfactory means of guaranteeing annuity payments which are predicated on regular receipt of income and maintenance of principal.

### ACCEPTING SECURITIES AS THE BASIS OF ANNUITIES

There are instances where the donors ask us to accept real estate mortgages, bonds, stocks, or other securities as the basis of an annuity agreement. Where investigation proves the merit of these securities, they should be accepted, but the value with which the donor is credited should be determined by their actual market worth at the time they are received, or the liquidated value if the securities are immediately sold. Accepting securities at their par or face value when their market value is less than par is not good management.

### FIRST STEP IN AN INVESTMENT POLICY

Having cautioned against either the use of a corporation's own real estate or the investment in real estate as a reserve against annuity agreements, and indicated on what basis securities should be accepted from a donor, we may now proceed to some of the elementary and fundamental considerations in the administration and investment of annuity funds.

The first step in a wise investment policy is the choice of a competent investment committee, preferably consisting of three men whose standing and experience in the banking, insurance or business world qualifies them. Such men are available when the magnitude of the job and the businesslike administrative policies of the organizations appeal to them. Lesser men may readily be had, whose judgment is neither experienced nor disinterested. Inexperienced investing, even though done by people of the finest devotion and intention, is unsafe.

### DIVERSIFICATION OF RISK

The kind of investment committee we recommend will adopt a well-conceived investment plan, providing for diversification of its holdings as to maturity, locality and type.

### A. *Maturity.*

Diversification as to maturity is an excellent principle to follow. Recently the statistical department of a large brokerage concern examined the holdings of a religious organization and discovered that there was an exceptionally large percentage of the securities maturing within three to five years. Where such a large percentage of one's investments matures at approximately the same time, the investment committee is called upon to reinvest when conditions may be most unfavorable for reinvestment, either through bond prices being at or near their peak, or prime real estate mortgages difficult to secure. Maturities should be "staggered."

### B. *Locality*

There are corporations which have invested their funds mainly in and near the city where their principal offices are located. This is not good policy. Any organization which has a national constituency commends itself throughout the entire country by making its investments on a nation-wide scale.

This places a corporation in a position, when a donor asks whether or not any of the funds have been invested in his locality, to show, for instance, that by holding bonds of public utility companies which serve his community, or railroads that traverse his state; monies that have been given by people in his area have, in some measure, been reinvested there, with consequent benefit.

Fully as important as diversification of investments as to locality because of the favorable impression it makes upon the donors, is the investing on a nation-wide scale for the sake of distributing business risk. For example, there is an investment committee which limits its holdings in the region of a city which within the last twenty-five years suffered from a great catastrophe. There is reason to believe that there may be a recurrence of this catastrophe and complete loss of investments in the vicinity.

Another investment committee will not permit its holdings to be excessive, for example, in public utilities of companies serving a certain city, because they regard it as a one-industry city. Should some new invention or some calamity specifically affect this industry unfavorably, the entire city would be affected. This may be extremely conservative, but to say the least it is far-sighted.

An even larger consideration in favor of diversification of investments as to locality is the fact that all sections of our country do not suffer equally through depression. While certain areas are passing through a serious business decline which reduces income and causes default of interest on securities, there is likely to be at the same time, large areas where business is more nearly normal and the return on sound investments in these districts is unaffected. Even during the present business depression, statistical research agencies indicate that some areas are suffering more acutely than others, and, conversely, some less acutely than others.

### C. *Type*

1. *Government Bonds*.—Of course, the issues of the United States represent the acme of security, though the very low yield at the present time is a discouraging feature to investors.

State and municipal bonds are regarded as next in security. Purchasers of these bonds, however, pay for the tax-exemption privilege. Religious, educational and charitable institutions find no inducement in this tax-exemption feature, and therefore such bonds are not attractive purchases, especially on account of the low interest return.

Next in order of preference are bonds of Great Britain and Canada. Others have been willing to include in their list of government bonds, issues of France, Belgium, Holland, Denmark, Norway, Sweden and Switzerland. There may be something to be said in

favor of this inclusion. In general, we think other foreign government bonds should be avoided:

(a) The instability of South American governments seems ample reason for making no purchases of their bonds.

(b) Hesitancy to recommend bonds of European countries in general at the present time, is due to the uncertainty of the political trend, particularly in central and southern Europe. How far radical movements may go is a matter of conjecture, though there appears to be no immediate reason for undue pessimism. To the far-seeing there is still a possibility of Europe again becoming embroiled in war, which would be, as usual, destructive to security values.

A very small percentage of the total holdings will be in the United States, British or Canadian bonds, because of the low yield. United States government bonds of early maturity, however, are particularly desirable for short term investments, where the least possible fluctuation is desired.

2. *Railroad Bonds.*—While government bonds of the countries recommended are regarded as prime investments, a good diversification of securities will undoubtedly include a large proportion of first mortgage railroad bonds, junior issues of the strongest companies, and equipment trust certificates.

These give a widely diversified investment geographically and are protected by the fundamental economic need of transportation. They are less affected in times of depression than industrials. Under government regulation the railroads are permitted to earn a reasonable return on their investment.

Equipment trust certificates represent the highest type of security in the railroad field. The first mortgage or prior lien is valuable for obvious reasons. Railroad bonds of this type are so highly regarded that certain specified issues are designated as legal investments for savings banks in the State of New York. In order to be eligible, however, for the list of bonds legal for savings banks, a company must have earned its fixed charges for five or six years preceding the admittance of the bond to the legal list, not less than one and one-half times. Of course, investments will only be made



when the capital structure, management, dividend record for a period of five to ten years, earnings and condition of the properties are favorable.

3. *Public Utility Bonds.*—Close to the railroad bonds in desirability are public utilities, with the possible exception of tractions, because the latter are subject to violent municipal agitations, and they are having such keen competition from busses and automobiles that their history in recent years is one of decreasing income, and loss of both principal and interest to many stock and bond holders.

Water and natural gas bonds are, in our judgment, less desirable than issues of light and power companies. Light and power companies represent a fundamental industry, usually protected by long term franchises, with State Public Utility Commissions favoring a fair return on investments. They are less affected in times of depression because of their classification among the absolute necessities of life. In recent years certain public utility bonds have been added to the legal list in New York, Massachusetts and Connecticut.

Operating company bonds are preferable in general to holding company bonds, because, in the main, holding company bonds are issues of companies which derive their income from the common stock of their subsidiaries. There are exceptions, of course, where the strength of the holding company is outstanding, as in the case of American Telephone and Telegraph Company. Holding company securities should be considered on the basis of consolidated reports covering their subsidiaries and their own operations.

4. *Industrial Bonds.*—Investments in industrial bonds should be limited to the largest companies of fundamental industries, such as steel, food, etc., where the management, condition of the property, capital structure, dividend record and earnings over a period of years are favorable. In this type of investment, however, the essential nature of the industry, its standing as to good will, its prospects for the future and its rela-



tive position in the industry are important considerations. The percentage of funded debt should be lower and interest charges should be covered a greater number of times than in railroad and public utility bonds.

5. *Guaranteed Real Estate Mortgages.*—Farm mortgages are generally to be avoided. The irregularity of crops makes income on such mortgages uncertain. In case of foreclosure a corporation is obliged to take over the kind of property which it can hardly hope to operate profitably.

Furthermore, it is our opinion that unguaranteed mortgages should not be taken. The treasury staff of religious, educational and charitable institutions is usually so small that there cannot easily be the regular inspection of properties, periodical check-up on the payment of taxes and assessments, and the expiration of fire insurance policies.

For these reasons, we recommend guaranteed first mortgages on improved real estate, provided the guarantee is that of a financially strong and well managed corporation. The expertness of a guaranty company's staff can largely be depended upon to choose good risks. The diversification geographically of their mortgages is an element of strength.

Furthermore, for the payment of one-half of one per cent. of the principal per annum, the guaranty company insures the payment of the principal and interest, and title. In connection with its guarantee, a strong company gives efficient service in the checking of tax payments, insurance premiums, and also carries the burden of securing prompt collection of principal and interest, when due.

Not the least important consideration is the fact that, if foreclosure becomes necessary, the guaranteeing company becomes the owner, and the corporation guaranteed is freed from the care and problems incident to ownership through foreclosure.

The basis of acceptance of a guaranteed mortgage, however, should not merely be the fact that it is guar-

anted. A personal inspection of the premises should be made by a representative of the corporation which is considering making the loan, and an independent appraisal of the guaranteeing company, is desirable, which will show the loan to be generally not more than sixty per cent. of the appraisal, and in no instance, not more than sixty-six and two-thirds per cent.

At the present time, higher yields are possible from investments in guaranteed mortgages on improved real estate, as these are netting us in the City of New York, five and one-half per cent. per annum.

If an organization is disposed to take unguaranteed mortgages, exceptional care should be given, in the inspection of the premises, to checking up of all the data as to rents, etc., given in the application for the loan; the credit standing of the bondsman, and the uses to which the property is put. Otherwise, in the case of foreclosure, a religious, educational or charitable organization might find itself the owner of premises wholly or in part given over to illegal or immoral uses.

6. *Preferred Stocks.*—Preferred stocks should represent a very small percentage, if any, of the entire investments. There are exceptional preferred stocks, with a record for the payment of dividends for many years, which may be considered as eligible for the investment of annuity funds. Preference, however, should be given to companies representing the greatest financial strength and able management, where there are no bonds outstanding ahead of the preferred stock, or where the bonded indebtedness is conservative.

7. *Common Stocks.*—In general, investments in common stocks should be shunned. Slightly more than a year ago this sort of investment was strongly encouraged by some financial experts. The experience of common stock holders, however, in the last year, very plainly shows the wide fluctuation to which this form of investment is subjected. The first class of security to be hurt in any business depression is common stocks. Depreciation in market values of stocks of fifty per

cent. and more, has occurred within the last fourteen months. Dividends have been widely cut or omitted.

It would seem sound policy, therefore, to buy no securities where the principal and the income are both subject to drastic fluctuation. This class of security, though in selected cases suitable for ordinary investments, is not stable enough for annuity reserves, on which a fixed rate of interest has been guaranteed to an annuitant.

Since a very large proportion of the membership of the churches, and supporters of our educational and charitable institutions regard dealing in the stock market as in the nature of speculation unworthy of either religious or educational organizations, some consideration should be given to this sentiment. Inquiry which was limited to the following missionary boards revealed that none of them were or are purchasers of common stocks:

1. AMERICAN BAPTIST CHURCHES,  
Home Mission Society;
2. METHODIST EPISCOPAL CHURCH,  
Board of Home Missions and Church Extension;
3. PRESBYTERIAN CHURCH IN U. S. A.,  
Board of Foreign Missions;  
Board of National Missions;  
Except a very small percentage. In the case of Board  
of Foreign Missions, less than two per cent.
4. PROTESTANT EPISCOPAL CHURCH,  
Church Pension Fund;  
Domestic and Foreign Missionary Society;
5. REFORMED CHURCH IN AMERICA,  
Board of Domestic Missions;
6. UNITED LUTHERAN CHURCH,  
Board of American Missions;
7. CONGREGATIONAL CHURCHES,  
Home Boards.

Securities of this class which they hold have been acquired either by gift or legacy.

A further objection raised to the holding of stocks, particularly by religious and educational organizations is the position taken that such institutions, which become partners through stock-holding in an industry,

expose themselves to the charge of prejudice in favor of the industry.

If an organization insists on investments in common stocks, at least it should exercise care that the services or product of that corporation is not incompatible with its own principles or purposes.

While there is reason to believe that the best common stocks are, or soon will be in a purchasing area, and will likely in a short term of years show large appreciations from present market values, I repeat that our kind of organizations, organized "not for profit," it is better to remain creditors of the large corporations through bond holdings than partners through stock.

To recapitulate, the investment policy as to common stock should be governed by the purpose of the fund. The purpose of annuity funds is not to make profits by speculation, but to conserve the principal and insure income to meet annuity obligations. Will our corporations commend themselves more, either to our annuitants or the general public, by a conservative or by a speculative policy. The fact that savings banks and national banks in New York State, and life insurance companies in most of our states are not permitted to buy common stocks, is significant. It indicates that institutions which hold and administer other people's funds are required to avoid speculation with them. Since annuity funds are held and administered for other people, if the states were ever to legislate as to the investment of our annuity funds, it may be safely presumed that we would be prohibited by law to invest in common stocks.

#### LISTED AND UNLISTED SECURITIES

Having indicated the various classes of securities, the question may well arise as to the purchase of unlisted securities. It is true that there are many substantial corporations whose stock is comparatively closely held, that have not applied for the listing of their securities on the New York Stock Exchange or the New York Curb Exchange, or any local exchanges.

We particularly favor investments in listed securities and discourage the purchase of unlisted securities. Listed securities are quickly marketable, and financial reports from companies whose bonds or stocks are listed, are readily available. Each day, except in the inactive bonds or stocks, the market price of a listed security can be found in the local newspapers.

The constituency of our missionary enterprises, colleges, schools, and charitable institutions are impressed by lists of investments which are generally recognized to be high-grade and with which they are familiar through the stock exchange quotations.

On the other hand, unlisted bonds are usually of companies which are not well known, and therefore their place in a high-grade list of investments is questioned. Furthermore, the unlisted securities are not quickly saleable; then, there are wide variations between the bid and asked quotations. The following will illustrate:

Some years ago, when there was less care given to annuity investments, a missionary organization accepted the bond of a suburban water company at its face value, as the basis for an annuity agreement. It was an unlisted bond. The treasurer of this organization happened to know the bank in the local community served by the water company and was able to sell it for a hundred. The treasurer of another organization who received a similar bond, when he applied to a broker for a bid, got a quotation of eighty-six.

Rapidly changing conditions in our individual and economic life make it highly desirable that securities be quickly marketable. For the most part, unlisted securities lack this feature.

#### SUGGESTED PERCENTAGES FOR DIVERSIFICATION

|   |       |
|---|-------|
| Government bonds .....                            | 10%   |
| Railroad bonds .....                              | 25%   |
| Public utility bonds.....                         | 25%   |
| Industrial bonds .....                            | 5%    |
| Guaranteed mortgages on improved real estate..... | 30%   |
| Preferred stocks .....                            | 5%    |
|   | <hr/> |
|   | 100%  |



These percentages of diversification, however, may and probably should be altered, depending on economic conditions and general market trends. At the present time, when it is apparent that market prices for higher grade bonds show a comparatively low return, it is, in our judgment, advantageous to purchase some short term bonds, or to increase the percentage of guaranteed mortgages, which will mature in three years.

The investment cycle usually operates in the following fashion:

When commodity prices are declining, business is depressed, and money is cheap, fixed interest-bearing securities such as bonds and preferred stocks are in demand, but when commodity prices turn upward and business improves, bonds are liquidated as a result of the increasing demand for money and rising rates of interest.

As common stocks begin to reflect the improvement in business, a large number of investors sell out their bonds and place their money in common stocks in order to share in the increased profits of business.

Money which is invested in short term bonds or real estate mortgages is thus made available for the purchase of bonds when the decline in bond values makes them attractive purchases again.

#### EXAMINATION OF INVESTMENT LISTS

In addition to the careful investment of annuity funds with the utmost concern for the safety of principal and the certainty of income, and after due attention to the diversification of investments as to maturity, locality and type, which will be the policy of any efficient investment committee, constant attention needs to be given to the securities held. Frequent examination of the investment lists should be made.

It is our custom to submit our lists periodically to the investment advisory department connected with one of the largest trust companies in New York, with particular attention to such developments as make advisable the sale of any securities for the following reasons:



1. *Securities not considered attractive to hold.*—Changes in economic conditions, or changes in certain industries or localities may cause some securities which, when purchased were of high order, to decline in favor. Declining earnings and other unfavorable factors may develop which are likely to result in the defaulting of interest, and even the default of the principal of the bond. Researches made by statistical departments of banks, trust companies or brokers often foresee these declining tendencies in these securities, and should therefore advise their sale.

2. *Securities which should be sold because of odd lots.*—When a fund has accumulated into the millions, it becomes good policy to hold only large blocks of securities. It is as easy to watch a fifty thousand dollar block of bonds as a five thousand dollar block. It is easier to care for a list which includes one hundred securities in fifty thousand dollar blocks than to handle a list which includes five hundred securities in ten thousand dollar blocks. Odd lots of bonds or stocks acquired by gift or legacy should ordinarily be disposed of.

The advice to hold securities of fewer companies in larger blocks is of course predicted on holding the best bonds. It is obviously easier to pick twenty-five excellent bonds than a hundred and twenty-five.

3. *Securities which should be sold because of call feature.*—A periodical examination of the list of investments will undoubtedly bring to attention bonds or preferred stock which are at or near their call price. The sale of these is advised because it is obvious that there can be very little appreciation of the principal above the call price. Moreover, a security which is at its call price may be called. If it is sold before actually called, it is sometimes possible to get a point or two more than the call price. Waiting until the call data arrives often means that you will need to reinvest the money at a lower yield, because the issuing company has called this security on the assumption that it can refinance at a lower interest basis.

4. *Securities which should be sold because of low yield.*—An illustration of this may be given. One of our large denominational pension funds recently had its list of investments examined, to compare the present market value with the book or cost value, and show the current yield at present market prices. Out of a fund of five million dollars, it was clear that approximately five hundred thousand dollars worth of securities were on a market basis so that they yielded four and one-tenth per cent. Believing that it was an advantageous time to sell these investments, taking the profits and re-investing the proceeds, the investment committee so voted. The proceeds from these sales were reinvested in guaranteed first mortgages netting five and one-half per cent., making an increased return on all its securities on the average of better than one and one-quarter per cent.

#### THE PROFIT RESERVE ACCOUNT

In order to maintain annuity accounts without reduction through loss, it is recommended that a Profit Reserve be set up, to which should be credited all profits taken on securities sold, and against which should be debited all losses. This Profit Reserve is a highly desirable back-log of protection.

Furthermore, this may be an opportune time to mention that in a pension fund of approximately five million dollars, which has been invested within the last ten years, where the policies here recommended, except that no preferred or common stocks were held, have been followed; profits of two hundred five thousand, seven hundred thirty-four dollars have already been taken and set up in a Profit Reserve. The market value of these investments as of December 31, 1929, was three hundred ninety-nine thousand, seven hundred forty-nine dollars more than the cost or book value.

The investment committee responsible for this exceptional showing, of course, received most of this money for investment at a favorable time in the bond market, but its good judgment is attested by the fact

that purchases of low rate coupon bonds, three and one-half, four, and four and one-half per cent. at a discount were made, so that leaving out of consideration any profits made by the cyclical fluctuations of the bond market, a profit is assured if these bonds are held to maturity. For instance, the four per cent. bought at eighty-five in 1925 and paid off at maturity in 1955 at a hundred would, of course, show an appreciation in principal of fifteen points.

#### AMORTIZATION OF PREMIUM BONDS

When bonds are purchased at a premium, or in an amount above their face value, it is considered a conservative policy to charge the premium immediately against the profit reserve account and carry the bonds on the books at their par value.

In cases where bonds are bought at a discount, or at a price below their par value, it is also conservative accounting to carry the bonds on the books at their cost value, taking no account of the accrual through appreciation in market value, until the bonds have been sold, or mature.

The large life insurance companies have a more scientific way of amortizing premium bonds, and accounting for accruals on discount bonds.

#### NEW VERSUS SEASONED ISSUES

This committee, previously referred to, which was composed entirely of New York City bankers, favored seasoned issues. New issues that were presented by houses participating in syndicates were scrutinized with the utmost care. High-pressure salesmanship which accompanies the distribution of new issues was ineffective. The incentive on the part of brokerage houses and salesmen to press new issues is explained by the fact that new issues generally carry larger commissions. New issues are therefore thrust upon the attention with more enthusiasm than seasoned issues. The committee felt that new issues needed to be more carefully studied,

and unless they were issues of companies that already had the highest grade standing, it was usually preferable to purchase only when the security had been seasoned. There are times, of course, when new issues should be purchased, but this should be conditioned upon analysis of the values represented.

#### INVESTIGATION OF SECURITIES OFFERED

In making investments, the financial officer who takes the initiative in submitting offerings to the investment committee, will naturally secure all available information which will serve to help him analyze the values presented. Whatever his own judgment may be after a personal study of the security, he will seek to get the opinions of high grade investment houses and banks to check his own opinions and judgments. Supplementing the opinions and judgments of reputable banks and investment houses, the ratings of the security by Moody, Standard Statistics, Fitch, Babson and others will naturally be consulted. All these factors being favorable, the offering will be submitted for the approval of the investment committee, which, in turn, is likely to have additional information which will lead either to the rejection or acceptance of the security.

#### CUSTODIANSHIP OF INVESTMENTS

The administration of annuity funds involves, of course, not only the problem of investing safely, but of safeguarding of the securities after they have been purchased.

It has been found convenient by many organizations like our own, to place all its securities in custody of a strong and reputable trust company, or trust department of a bank.

For a nominal cost, usually two per cent. of the income per annum in the case of sizeable funds, a trust company or trust department will agree to hold securities in custody, cut and collect coupons from bonds, make collections of interest due on mortgages, or divi-

dends on preferred stock. This obviates the necessity of the treasury department handling these details. It also serves as a protection against loss of securities through theft, hold-up, or in any other way.

The practice is usually for the corporation which has a custody account in a trust company, when purchasing, to order the broker to deliver the securities directly to the trust company against payment. The trust company is ordered to accept delivery and make payment, charging the account. In the case of sales, the trust company is directed in writing to deliver certain securities to the broker against receipt or payment. The handling of the actual securities purchased or sold is therefore made the joint responsibility of the broker and trust company.

A formal receipt from the trust company is sent when it receives and pays for securities for an account. When an audit of securities is desired, the trust company or trust department promptly furnishes a certified copy of the list of investments which they hold in custody for your account. It is, of course, understood that auditors may have access to the securities held in custody at any time.

This custodian account is not to be confused with other arrangements with a trust company or trust department, which make them not only responsible for handling and safekeeping of the securities, but give them the additional responsibility of actually investing the funds. This larger service of trust departments or trust companies is, of course, much more costly than custodian service. In instances where a religious, educational or charitable institution has a competent investment committee and treasury department there is no need of putting the full responsibility for investing and reinvesting outside.

#### OTHER SAFEGUARDS

Other means of safeguarding investments, involve bonding of all employees who handle the funds in any way, the insistence that all checks be signed by two



persons, and the securing of safe-burglary, messenger, and office robbery insurance.

An exceedingly important item is the periodical auditing of the accounts. Instances have recently appeared in the newspapers where an audit apparently was not made for commercial companies until defalcations were suspected. There are some large investment funds for which a monthly or bi-monthly audit is provided. Every corporation, however, should insist on the irreducible minimum of a thorough-going audit at the end of each fiscal year.

It is quite possible that the suggestions which have been made in this paper will be regarded by many as very conservative. We think that this charge is justified. However, we do not see how treasurers or investment committees, who are expected in a very real sense to be conservators, can be true to their trusts without being conservative. The policies which have been here recommended have proven sound by long term operation in the treasury departments of several large missionary organizations and pension funds. In every instance, each of these organizations is able to show a very substantial Profit Reserve. Not only that, but should they liquidate the conservative securities they hold today at the market, their profit reserves would be materially increased. Their lists of securities have been commended widely. They would welcome an examination of their holdings by any life insurance commissioner. Their constituencies, as far as they are familiar with the lists of investments, are grateful to the investment committees for their wise and conservative policies and their businesslike administration.

Furthermore, these corporations have been writing annuity agreements in some instances for a term of fifty-six years. Payments to the annuitants have been promptly made. They have, as they deserve, the complete confidence of the people whose funds they are administering. The increasing number of annuity agreements which are being made with them from year to year, indicates the wide favor given to these methods of administering and investing annuity funds.



## UNFINISHED TASKS AND FUTURE ACTIVITIES OF THE COMMITTEE

ERNEST F. HALL

*Chairman, Sub-Committee on Annuities.*

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That there is much yet to be learned and acted upon in connection with annuities is evident from this conference. A growing interest in the subject, the increasing amount of annuity gifts, the importance of conducting the annuity business according to legal requirements, and the problems which have emerged, as shown by inquiries which have come to the Committee on Annuities, made it advisable to hold a conference at this time.

The committee decided that the papers presented should give as full information as possible on the various topics treated. Only a few of the most pressing problems were to be considered. That they have been well presented all who have listened to the papers and discussions will agree. Answers to the survey questionnaire sent out by the committee reveal the fact that much needs to be done to make sure that all organizations which use the annuity plan of securing gifts conform to state laws. Unless they do so, unpleasant, legal consequences may ensue and further unfavorable legislation be enacted.

That the committee has work to do in seeing that the annuity business is properly conducted by the several organizations is manifest from the actions which this conference has taken, requesting the committee to study certain phases of annuities still further and to report at a conference to be held next March. The committee will cheerfully do all in its power to carry out the wishes of the conference thus expressed. The committee wishes to be of the greatest service possible and will gladly devote time to directing the consideration of annuity matters and in giving to organizations from

time to time such information and suggestions as may seem necessary.

The conference has requested the committee to study the subject of annuity rates and to recommend a schedule of uniform maximum rates. The schedule of rates recommended at the 1927 conference on annuities has apparently received thoughtful consideration. It may be found wise to suggest a schedule somewhat different from that one. Steps should be taken to see that the suggested schedule is brought to the attention of all organizations making use of the annuity plan, with a view to having it adopted. This is no small task. It requires a study of rates now in force by many organizations, which vary considerably, the residuum of the original gift desired, and the service of actuaries.

The important question of taxation of annuities and legislation regulating the annuity business lays on the committee the responsibility of endeavoring to secure all possible information concerning annuity legislation in the several states, and the co-operation of a capable lawyer in each state to keep the committee advised of new laws and proposed changes in legislation. The committee appreciates the co-operation of those who in answering the questionnaire gave the names of persons who can be of assistance along this line. Those who did not suggest names and are willing to do so may send them to Mr. Gilbert Darlington, in care of the American Bible Society, Astor Place, New York City. Mr. Darlington is the member of the committee who has been made responsible for matters connected with taxation and legislation.

Requests have come from several organizations for a form of annuity agreement. The committee finds that some organizations are using a very simple form, while others are using a very elaborate form, some even going to the extent of issuing their agreements in the form of coupon bonds. In view of the suggestions which have been made against the use of the word "bond" this seems to be unnecessary. However, each

organization must use such a form as it deems best. The committee assumes no authority in regard to this matter because legal agreements can be framed very differently. The committee will act on the suggestion of this conference and be prepared to present at the March conference a suggested form covering the main points and embodying things which the committee finds to be essential.

This conference has asked the committee to study and report on "the method of establishing reserves for annuities together with accounting therefor" and to report at the conference in March. The survey showed that a good many organizations are not familiar with the laws even of their own state governing reserves and the method by which those reserves must be determined. The committee has at hand information on this subject and is pursuing the matter still further in order that whatever information is necessary may be in the hands of the committee and available for organizations desiring it. One of the dangers to be avoided in connection with annuities lies right at this point. The committee has been informed that certain small colleges, for example, which had a small number of annuities have been unable to meet annuity payments. Such disasters should be avoided, both for the standing of the institution and the security of the annuitants. Religious, charitable and educational organizations should conduct their business in such a way as to gain and hold the good will of their constituents.

Some embarrassment has been occasioned in the settlement of estates because of the lack of information by executors concerning annuities which have been provided for in wills. The practice of providing for annuities in wills is increasing. It seems necessary, therefore, to have a statement prepared which can be placed in the hands of executors of estates in order that provisions in wills for the purchase of annuities may be properly carried out. The committee will take this matter into consideration and, with the assistance of lawyers, will endeavor to see that this need is met, so that

any organization wishing to make use of such a statement will find it available.

It is well that we remind ourselves of the basic principles on which the annuity business should be conducted. We should not lose sight of the fact that the plan was devised as a method by which people who wish to make a gift to an organization can do so while living and still have a needed income from their capital funds. The commercial idea is not a part of the plan. The organizations coming within the scope of our discussions are not commercial organizations and should not endeavor to present opportunities for investment. The emphasis should be placed on the opportunity to make a gift. If this is observed then it will naturally follow that methods of promotion and terminology should be made to conform to it.





