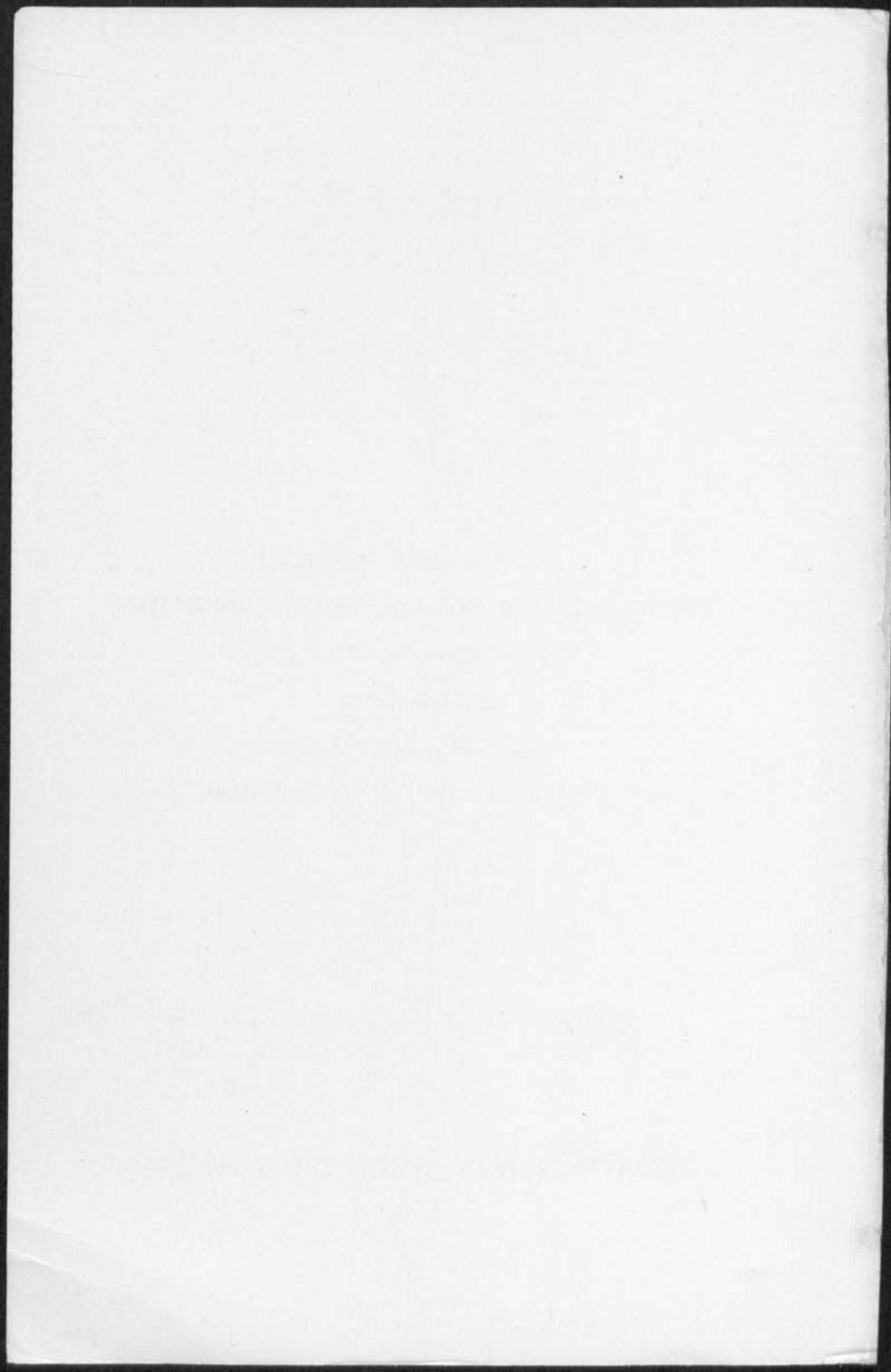


**EIGHTEENTH
CONFERENCE
ON
GIFT ANNUITIES**



WISE PUBLIC GIVING SERIES, NO. 57

1983



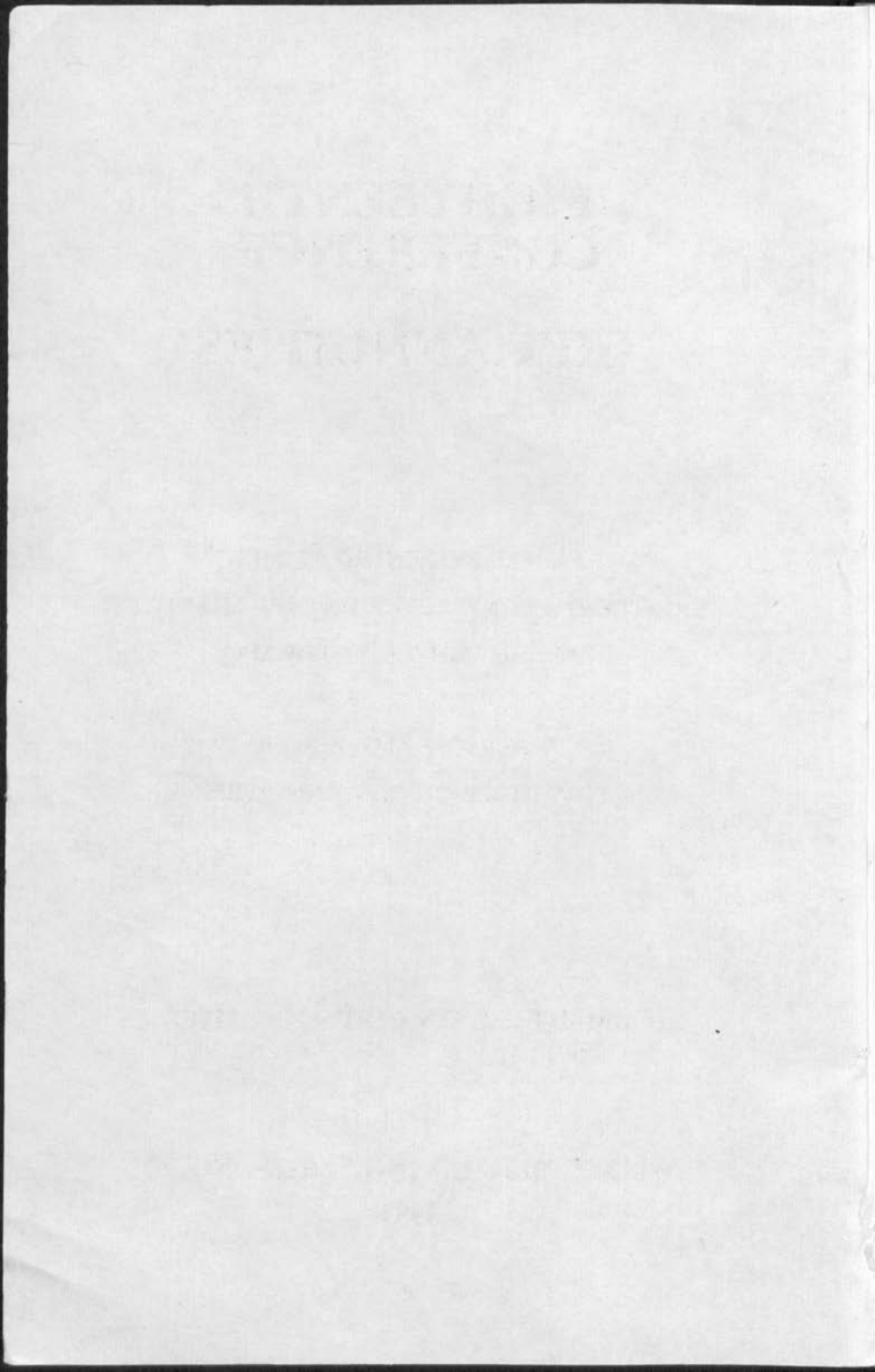
**EIGHTEENTH
CONFERENCE
ON
GIFT ANNUITIES**

PAPERS PRESENTED AT THE
EIGHTEENTH CONFERENCE ON GIFT ANNUITIES
HELD IN DENVER, COLORADO
MAY 3-5, 1983
UNDER THE AUSPICES OF
COMMITTEE ON GIFT ANNUITIES

COMMITTEE ON GIFT ANNUITIES
1865 Broadway New York, NY 10023

WISE PUBLIC GIVING SERIES, NO. 57

1983



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OPENING REMARKS

Dr. Charles W. Baas

Chairman, Committee on Gift Annuities

WELCOME TO THE EIGHTEENTH CONFERENCE on Gift Annuities. A comparison of several past Conference programs with the one in your folder will bring you to the conclusion that very little in these programs stays the same for long. Part of the reason is, of course, the messages that come from you, the Conference Sponsors. For example, there are now fewer plenary sessions and there has been a considerable change in the character of the workshops. Your Committee is influenced by outside changes as well. Would you believe in the early years the first Conferences contained little reference to the Federal Tax consequences of a deferred gift? It took even longer before major references to State control surfaced. I suppose you could say the Conferences have been reactionary in that the current problems seem to take the larger share of program time. However, there is one thing that has remained a constant headliner from the very beginning — the setting of maximum permissible gift annuity rates. Actually, that was what originally called for the creation of the Committee on Gift Annuities in 1927. Apparently, the gift annuity vehicle became popular in the early twenties when each issuing organization set its own rates. Imagine the total actuarial cost if we each did it individually today! In the 1920's, competition created a situation where the issuers were continually upping gift annuity rates until they even exceeded commercial rates and I'm sure the point was reached where organizations were actually making a gift to the annuitant instead of the opposite. It was in this climate a universal realization occurred that competition in terms of dollars could not be continued and that the competition had to be limited to the cause represented by the issuing organization. Thus, each Conference from the first, has considered the level of maximum acceptable gift annuity rates. This Conference will be no exception. What is different about the Committee's recommendation which will be presented to you today is that it represents the largest increase over previous rates ever proposed. So it behooves you to pay close attention to the first two presentations this morning. We will follow our usual practice of deferring

any action on the recommended gift annuity rates until tomorrow morning. This pause is intended to give you time to discuss the issue, to ask questions and to make your wishes known. Don't think rate confirmation is automatic. I can remember a Conference when the Committee's proposal was rejected, and with the benefit of hindsight, rightly so. Gift annuity rates are not the only important subject, yet, I want to stress the point that what you are getting as a proposal from your Committee is a bit unusual. What I've been talking about is perhaps the main reason for having eighteen Conferences in 56 years. Yet, don't overlook subjects which have only come to prominence in recent Conference proceedings like: the increasingly complicated tax structure — federal, state, local and lately Canadian; or the variety of deferred gift vehicles other than the gift annuity.

Let's change gears for a minute and comment on the question: "What are you supposed to get out of this Conference?" The answer to the question must be tempered by another question: "How much are you going to put in?" For example, there will be many opportunities to compare organizational practices. We encourage information sharing. In many respects this is a do-it-yourself Conference. You have to participate to get the most out of it. Speakers, particularly workshop leaders, are expecting your comments and questions. There is ample time allowed for this. You also have opportunities to find out what your Committee has been doing. Committee people are intended to be easy to find. Light blue name tags will distinguish them for you. Incidentally, the leaders of the majority of the Conference sessions will be Committee members. Your Committee members are volunteers. By that, I mean they have the opportunity to do quite a bit of work without getting paid for it.

There are some papers in your folder which you should examine. For example, there have been some amendments to the Committee's Constitution & By-Laws since the last Conference. Believe it or not, the changes deal mainly with procedures for getting members off the Committee. While on the subject of these Committee people, there are some who had more to do with this Eighteenth Conference than others. Two I'd specifically like to mention: The Chairman of the Program Committee — Bob Gronlund, and the Chairman of the Arrangements Commit-

tee — Tal Roberts. Without these two and their helpers, there would be no Eighteenth Conference. So special thanks to them is in order.

You probably have noticed that there is an exhibit area near the registration desk. I suggest you take a look at what the exhibitors have brought, if you have not already done so. The privilege of being an exhibitor was open only to Conference registrants. What is being offered has not been reviewed by your Committee so there is no Committee on Gift Annuities' endorsement involved. However, that statement is not intended to mean that what is in the exhibit area could not be useful to you. That, you must decide.

You might be interested in knowing who the 1,174 organizations are, that currently sponsor these Conferences on Gift Annuities. At the 17th Conference I reported 1,104 sponsors — so the total is still growing but at a slower rate.

A quick run thru of the major categories shows:

	<u>1983</u>	<u>1973</u>
Religious		
Organizations	26% of the total	30% (were)
Educational	36%	46%
Foundations	11%	3%
Medical	14%	11%

Even though there is a percentage decline in the religious and educational categories, the actual numbers of religious and educational sponsors have increased during the last 10 years. The 1,174 sponsors today compares with 846 in 1973.

These trends are watched closely as there is a definite attempt to keep representation on the Committee related to the composition of the total Sponsorship.

Now the final item before this Conference gets rolling. The practice of using a Resolutions Committee to propose Conference actions has proved very helpful in the past. So a continuation of that practice is recommended. The following persons are being suggested to serve as members of the Resolutions Committee:

Chairman: MR. CHARLES W. SPICER, JR., CLU, Vice
President, Development, OMS International, Inc.
MR. JOHN M. DESCHERE, Comptroller, Bard College
MR. PETER LAFFERTY, Director of Deferred Giving,
University of Miami
DR. DAROLD H. MORGAN, President, Annuity Board,
Southern Baptist Convention
MR. MICHAEL MUDRY, Actuary, Senior Vice President
& Secretary, Hay/Huggins
MR. ED SAVAGE, Planned Giving Director, Sacred Heart
League
MS. CLAIRE M. TEDESCO, Director, Lutheran Church
in America Foundation
And your Chairman as an Ex-Officio member.

The Conference voted to accept the nominations as presented.

ECONOMIC AND FINANCIAL OUTLOOK

Dr. Lacy H. Hunt

Executive Vice President & Chief Economist, CM&M Group, Inc.

It is a privilege to be with you today and to speak to the economic outlook as it may impinge on future interest rates, so that you can better assess the direction you may wish to go in determining maximum suggested gift annuity rates for the next 3 years.

Now if you will turn to Schedule A of the material which I have prepared, I think it is wise that I give you at least one precautionary note: that the views that you are about to hear are only one person's views; that what I am going to try to do for you is to outline some of the basic fundamentals and the momentum that I see developing in them. And hopefully, they will provide you with some understanding of the future prospects developing in them.

I believe that the U.S. economy is in the midst of a very significant recovery and that we're going to see substantial economic progress on several fronts for the balance of this year. One of the many reasons that I have this view is shown here on Schedule A of the material you have before you.

The basic money supply measures have grown pretty rapidly and there is an extremely bad monetary thrust now being supplied to our economy. Now this can be seen if you examine column (1) which shows the rate of growth in the basic M1 money supply over the last 13 years. You will notice in examining column (1), that in the twelve months ending this past March, the money supply is up by nearly 11%. By examining column (1), you will see there is no twelve month period since 1970, in fact, no twelve month period in the entire history of the U.S. economic experience where their monetary growth has been faster. In other words, the money supply is increasing at an unprecedented rate. And history suggests that this will once again lead to faster economic growth. Unfortunately, it has some implications with regard to inflation.

Now to understand the final thrust of monetary growth on economic activity, we have to make certain adjustments. In column (2) on Schedule A, we show the rate of change in prices as shown by the Consumption Deflator which, for my money, is a better measure of inflation than the Consumer Price Index. You will notice in the last twelve months that prices have risen by 4.6%, which means that when you look at column (3) the money supply after inflation in real terms has risen by 6.3%. If you will examine column (3), you will notice that in real terms, money has also grown by record rates not only in the last 13 years but also for the entire period of U.S. recorded history.

Now I believe that the record indicates that the M1 measure is the best possible guide to future economic activity. Let's look at the record. For example: if you examine column (3) and go back to the years 1974 and 1975, you will notice that we had two sharp declines of 5.1% one year and 2.9% the next year. Those sharp declines corresponded with and led the very sharp recession we had in 1974 and 1975. After those sharp declines, the monetary growth turned positive for the three years 1976 through 1978. Then, however, as inflation flared up and money growth was coming down, there were three serious declines in monetary growth: 1979, 1980, and 1981 — with a very steep decline of 4% in 1980. None of the other money averages shows this pronounced trend of accelerating before the economy turns up and decelerating before the economy turns down.

For example: if you turn to column (4) and examine the real M2 money stock, which is favored by some people, and you examine the period in 1974, we find there is only one decline which is hardly suggestive of the severe recession we experienced in the mid 1970's. And then in 1979 and 1980, we only have two declines in the M2 money stock. The M2 money stock turned up prematurely in 1981 and suggested a recovery of economic activity which did not really materialize until the end of last year. If you will examine the record here, you will find the M2 money stock in the last 12 months is up about 8½%. That too is close to a record which is exceeded by the 8.9% increase in 1972.

The M3 money stock, which is also favored by others, indicates a somewhat different picture, but its record is not nearly as good. For example: it had only one decline, hardly a measurable

decline of only 4/10's of one percent in 1974; and then there was no decline in 1979 and 1981; and only a modest drop of 1.2% in 1980.

Now one of the reasons I expect the recovery this year to be quite good is what is happening in the housing sector, which is found on Schedule B. According to my calculations, we're going to have the best housing year since 1978, some five years ago. You will notice in examining column (1), we project new housing starts to be nearly 1.8 million units in 1983. You have to go all the way back to 1978 to find a year where housing starts were better than what they are expected to be this year.

Now the housing recovery is quite important. When people buy new homes they have to fill them with washers, dryers, garden equipment and a whole host of other furnishings and fixtures.

The recovery in housing has some other implications. Six months ago, if someone wanted to buy a house or sell a house, it was decidedly a buyer's market. Today, it is now a seller's market. A strong revival of the housing market is already resulting in a substantial amount of new inflation in the housing sector. Let's examine column (3).

You will notice in 1982 that housing prices on average rose only 6/10's of one percent or some \$400 to an average of \$69,300 from 1981. However, if you will move to the last line on Schedule B and examine the figures in columns (2) and (3), you will notice as of the first quarter of 1983 the average home prices are up some 10% to \$74,000. You will notice that in the last year they are up almost 10% and I believe when 1983 is completed, they will be up almost 15% from a year earlier.

Another reason why I am optimistic for a recovery this year can be seen on Schedule C which contains several important indicators of consumer well-being. In column (1), you are examining the Wilshire 5,000 Equity Index. I like this particular index because it is a dollar value index of all the stocks on the New York, American and major over the counter exchanges. If you look at the second quarter of 1982, you will see that the average of all stock prices on that index was about 1.1 trillion dollars. By the first quarter of 1983, the average of all the prices of stock on these exchanges had risen to 1.5 trillion dollars. At the close of the

market yesterday, the average of all stock prices had risen to 1.7 trillion dollars. Even if just a small percentage of this increase in business and consumer and personal value is converted into an increase in expenditures, economic activity will rise very substantially over the balance of the year.

Now another reason for being optimistic about the consumer sector is shown here in column (2), labeled Real Disposable Income. This is family income from all sources, wages, salaries, interest income, with everything adjusted for inflation and taxes paid to federal, state and local governments.

Now there is something that is very clear cut about Real Family Income when we have a recession such as the one we had in 1981 and 1982. One would expect the Real Family Income to go down based on historical experience. After all, joblessness went up, the work week went down, and the total number of people employed also declined. But a funny thing happened in the recession of 1981 and 1982. Real Family Income did not go down. In fact, if you examine column (2), you will find that there was an increase of 1.2% in 1982. It was not a large increase, not as much as in 1981 or the much larger increases of 1978 and 1979. But the fact remains that families did build up a savings reservoir. In fact, if you examine the quarterly experience since the beginning of 1982, there were four consecutive quarterly gains in Real Family Income.

Now what was it that allowed consumers to become better off in terms of disposable dollars? The reason can be found if you examine columns (3) and (4). Column (3) is the rate of increase in wages and column (4) is the increase in prices. As you will notice, the picture here has changed very dramatically. In 1979, wages went up 8% and prices went up 9%. That pinched the typical family for they had less money to spend. In 1980, the typical family was pinched even more with wages of 9% and prices of 10.3%. But then things changed in 1981, with wages of 9.1% and prices up 8.6%. Last year, with wages up about 7% and prices up about 6%, and in the first quarter of this year, wages rose about 5% and prices only a bit more than 2%. The typical American family has accumulated a discretionary buying power as a result of the slowdown in inflation.

Now another reason I am optimistic about a recovery this year is the inventory situation which is shown on Schedule D. The recession that we went through in 1981 and 1982 was quite unique when compared with other recessions of the post-war era, in that one of the burdens fell on the business community and there was a massive liquidation of inventory. Now this had very important implications.

But first, let's look at the last line on Schedule D. We see that in two of the three quarters prior to the recovery, there was a liquidation of inventory of 4.4% and 20.3 billion dollars. There are two things that jump out if you examine the table on this page. First of all, if you view the first quarter of the recovery which corresponds to the first quarter of 1983, we see that inventory was reduced by 12.4 billion dollars. There is no other similar first quarter recovery period where inventory continued to decline at such massive rates except for the 1974-1975 recession where the inventories for the first quarter of the recovery period declined about 11.3 billion dollars. And if we look at the Four Quarter Total column on the right, we find that the inventory shrinkage for this recession far outstrips any similar post-war recessionary period.

The reason that this is significant is that when inventories are at extremely depressed levels, all you have to do to give the economy a lift is to have the inventory investment go back to an even figure just to maintain inventories at their present level. In fact, even if we just maintained inventories at their present level, the resulting increase in economic activity would cause the economy to grow at a rate of about 3½% in the current quarter.

Another reason for the belief that the recovery is going to be a good one is found on Schedule E. It is no secret that capital spending has been one of the weakest sectors of the American economy. We have a woefully inadequate investment in capital expenditures to replace plant and equipment in recent years. Until we do this, we are not going to have the capability of producing jobs and growth and productivity for our people in the years to come.

You know, if you read the views of all the major economists of all persuasions, they all agree that to have a higher standard

of living, you have to have an increased investment in the future. It is very simple: if you do not make capital expenditures in new plants and equipment, you cannot get a rising standard of living over the years.

If you look at the last line on Schedule E and compare it to the average of the preceding business expansion periods, we find that investment in durable equipment in the last quarter of 1982 and the first quarter of 1983 is higher, as is the investment in business structures as shown in the second column. The total of the non-residential investment of 2.8 billion dollars is higher than the average of the seven early business expansion periods, which collectively averaged a decline of 1.5 billion dollars.

If we evaluate the entire scope of U.S. economic problems, the main stumbling block, in my opinion, of continued economic prosperity is captured here on Schedule F.

The principal difficulty as I see it, is the problem of the federal financial situation, which is desperate in my opinion. Now there are some who will tell you that the large federal deficits of today are a temporary matter. Or that when the recovery comes about, federal receipts will go up and the deficits will come down, solving this problem. Don't you believe them. We have, in my opinion, a serious structural federal budget problem that is going to be increasingly difficult for the financial markets of this country to finance.

You can see why I call it a "structural budget problem" by looking at columns (5) and (6) on Schedule F. In column (5) we have simply the difference of the Federal Treasury income and outgo. In column (6) we have the increasing interest costs on the National Debt which must be paid each year as part of the Treasury expenditures.

If you look at columns (5) and (6) together, you will see that, since 1978 the Treasury deficit has been approximately the same amount as the interest expense on the National Debt. In 1982, for example, the interest expense was 117 billion dollars while the total deficit was 110 billion dollars.

Because we did not take care of our past problems, we ran deficits in good times and bad times, today we have a National Debt of 1.1 trillion dollars. If we assume that the interest on this

debt will average about 10% a year, and in 1983 and 1984 the federal deficits will continue in the 200 billion dollar range, we will be adding at least 20 billion a year in annual interest expense to the federal budget. Such increases make it increasingly unlikely that we will ever have a stable federal financial situation.

The basic problem is found in column (1). It has to do with federal spending. Federal spending is racing out of control and is growing faster than anything else in the rest of our economy. And that is the problem.

For example, if you look at column (1) in 1976, the federal government spent 369 billion dollars. That was an 8.3% increase over what we spent in 1975. In 1980 federal expenditures had risen to 580 billion dollars, which was a 17.4% increase over the same expenditures in 1979. In other words, in only four short years, the federal government doubled the rate of increase at which it was spending money, from 8% to 17%.

Now, in my opinion, the main failure of the current administration is that they have been unable to deliver on their promise to effectively slow the rate of government spending. The column of percentage increases in column (1) show, that while the increases have reduced slightly from 17% in 1980 to 11% in 1982 and 1983, there is still no other sector of our economy that is growing at this rate.

If you look at column (3), which is the federal government expenditures as a percentage of the Gross National Product, you will see a steady increase from 1976 through 1982 and continuing on with estimated figures in 1983 and 1984. In other words, as the federal government expenditures grow, the private sector growth is hampered.

The other problem I have is our ability to finance the federal budget deficits in the years to come. This can be seen on the exhibits on Schedule G. In column (1), you are looking at total Personal Savings. Column (2) shows total Government Borrowing and column (3) is the Ratio of Savings to Borrowings.

At the top of column (3), in the year 1970, as a nation, we saved 4.73 for each one dollar of government borrowing. By 1978 government borrowing had increased to a point where we saved only \$1.16 for every dollar of government borrowing. In

1982 this had shrunk to our saving only 3¢ more than each dollar the government borrowed. Our estimates for 1984 show that we will have saved less than 50¢ for every dollar the government borrows. How are we going to be able to finance the needs of American industry when the government takes such a large percentage of the total savings of the American people?

Looking at column (1), we can see the problem. While we estimate 135.8 billion dollars in savings for 1983, the first quarter of this year, the annual rate was at 132 billion. This means we will have to increase our rate of savings in the next three quarters to hit the target figure. If we look at 1971, our savings was 60.7 billion dollars in that recession year. In 1972, the recovery year savings dropped to 52.6 billion. Again, in 1975 the recession year savings was 94.3%, while the 1976 recovery year savings dropped to 82.5 billion dollars.

As people become more confident in a recovery period, they spend more which results in declining savings. As savings decrease and borrowing increases, there will be a clash in the financial markets between the needs of funding the private sector and the needs of funding the federal budget.

The next thing I would like to discuss are the credit demands on our economy which are found on Schedule H. In column (1) we find the business credit situation which peaked in September of 1982 at about 218 billion dollars, declining to 214 billion in December. While the figures for 1983 are preliminary, you can see that business loans are beginning to increase in the early months of the new year.

In addition to bank loans, we must look at column (2) which shows the sale of commercial paper which are I.O.U.'s which companies issue in the market place as another means of borrowing funds. The commercial paper peaked at about 59 billion dollars in May, dropping to a low of 46.4 billion dollars in February, so that when we view column (3), which is the total of columns (1) and (2), we find that the peak of 273 billion was reached in September with the low of 263.3 coming in February.

While the commercial borrowing is not excessively strong, the changes in consumer borrowing is showing increased movement as found in column (4). The low watermark of consumer borrowing was in the months of August, September and Octo-

ber, with the low point in October. In that month, consumers actually paid back 131 million dollars in consumer borrowing. Since that time, the consumer installment loans have been going upward and I suspect that in the next few days, we will find that the March figures will show a substantial increase, perhaps the largest since the end of the recessionary period.

The mortgage sector is even far more significant as found in columns (5) and (6). Column (5) shows the new mortgage commitments, while column (6) shows the total commitments. In column (5) we find in January of 1982 that Savings and Loans had committed 3.2 billion dollars toward new mortgages. By September this had doubled to 6.2 billion dollars. Since then, it has steadily risen until it has doubled again by March of this year. The 13.4 billion dollars in new commitments is an all-time high. This is a leading indicator of new building permits and housing starts which show every indication of making new records later this year.

Let us look at the effect of energy prices on producer and consumer prices as found on Schedule I. We have been very fortunate that the recession of 1981 and 1982 produced a very significant decline in inflation.

If you review the top line, you will see that the Producer Price Index has remained virtually unchanged over the last four months. The same is true of the Consumer Price Index in the next to the last line of this chart. Now I would hope that this trend would continue and that prices would stay down. But I don't think that is going to happen. I'm afraid that inflation is going to start to move up.

Moving to the two final pages, we see the April 28 run of my Econometric Model. The first page is history from the first quarter of 1981 through the first quarter of 1982 with annual figures to the right in columns headed "1980" through "1982." The second page shows the forecast from the first quarter of 1983 through the first quarter of 1985, with annual figures for 1982 through 1984 shown on the right. Each of the lines are numbered from 1-37.

Moving to the forecast (the last page) on line 1 for the Gross National Product, we find this element growing at the rate of 6.9% for the second quarter of this year and continuing strong

through the fourth quarter. However, I believe the economic recovery as time moves on will become pivotal.

As we move into 1984, the growth prospects begin to deteriorate and you will notice that as we head toward the fourth quarter of 1984 and the first quarter of 1985, the economy begins to head toward stagnation.

The real problem, in my view, that will undermine the growth rate, is found in lines 10, 11 and 12 which show that inflation begins to increase during the same period. On line 10 we see the Consumer Price Index doubling between the second quarter of 1983 and the first quarter of 1985. This indicates that there is considerable inflation just below the surface which could affect the growth of the economy as we move further along.

Let's look at the prospects of the labor market which has caused great concern. Line 20 shows that we expect to end the year at about 9.6% with the same period in 1984 ending at about 9.1%.

Finally, if we move on to interest rates, which I know is your primary concern as you look toward setting gift annuity rates for the future, we could not really look at that subject until we had a firmer grasp on the underlying factors which affect them.

I believe that interest rates are now as low as they're going. And while they will not rise appreciably, the various factors including the recovery of economic activity, and the imbalance in government borrowing all suggest that interest rates will begin to creep upward.

Before I go further, I should explain that an Econometric Model is a complex grouping of data and formula, with this one using 325 variables and 147 statistical formula. To make the model go, one must make certain assumptions.

One of those critical assumptions is what the Federal Reserve will do to monetary growth. Monetary growth is very critical to the forecasts in any Econometric Model. For instance, if you wish to use a different set of monetary growth assumptions, I would tell you to come by our offices and I could rerun this entire model using your assumptions and many, if not most of the numbers would change. So, monetary growth is very important to the way that we develop and work out our forecasts.

If you will look at line 15, you will see that our assumptions of monetary growth stay very close to 10% all the way across through the fourth quarter of 1984, only dipping down below 10% in the first quarter of 1985. This would be an unprecedented rate of high monetary growth.

In spite of that, if you will turn to line 28, the Federal Funds Rate, we have an 8.65% rate this quarter moving up about 9½% in the fourth quarter and then on up to about 10½% at the end of next year.

This concludes my presentation.

**Comparison of the Growth Rate in Real and
Nominal M1, M2 & M3 Money Stock Since 1970**

	(1)	(2)	(3)	(4)	(5)
	M1 Money Stock	Consumption Deflator	Real M1 Money Stock (Column 1 Minus Column 2)	Real M2 Money Stock	Real M3 Money Stock
	(% chg.)	(% chg.)			
1970	3.8	4.6	-0.8	-0.4	0
1971	6.8	4.3	2.5	7.8	10.6
1972	7.1	3.6	3.5	8.9	9.9
1973	7.3	5.7	1.6	4.2	7.5
1974	5.0	10.1	-5.1	-4.0	-0.4
1975	4.7	7.6	-2.9	1.7	0.6
1976	5.7	5.2	0.5	7.7	5.3
1977	7.6	5.9	1.7	6.8	6.2
1978	8.2	7.0	1.2	1.5	4.5
1979	7.7	9.0	-1.3	-0.7	1.2
1980	6.2	10.3	-4.1	-2.2	-1.2
1981	7.2	8.6	-1.4	0.9	3.0
1982	6.5	5.9	0.6	3.5	4.6
12 months ended Mar. 1983	10.9	4.6	6.3	8.4	5.9

Sources: Board of Governors of the Federal Reserve System, Bureau of Economic Analysis, and CM&M Group, Inc.

Schedule A

Changes In Major Housing Indicators

Year	(1) Housing Starts (millions of units annual rate)	(2) Home Prices (dollars)	(3) Home Prices (% change)
1975	1.16	39,300.	9.5
1976	1.54	44,200.	12.5
1977	1.99	48,800.	10.4
1978	2.02	55,700.	12.4
1979	1.72	62,900.	12.9
1980	1.30	64,600.	2.7
1981	1.10	68,900.	6.7
1982	1.06	69,300.	0.6
1983e	1.79	79,700.	15.0
1984e	1.71	85,700.	7.5
			Percent change vs. year ago
1983.I	1.69	74,000.	9.8

Sources: Department of Commerce, Bureau of Census and CM&M Group, Inc.

Schedule B

Indicators of Consumer Well-Being

Annual	(1)	(2)	(3)	(4)
	Wilshire 5,000 Equity Index (Trillions of \$)	Real Disposable Income (% Change)	Hourly Wage Index (% Change)	Consumption Deflator (% Change)
1978	0.878	4.9	8.2	7.0
1979	0.989	2.7	8.0	9.0
1980	1.179	0.2	9.0	10.3
1981	1.339	2.5	9.1	8.6
1982	1.239	1.2	6.9	5.9
1982.1	1.191	-1.9	6.5	5.0
1982.2	1.159	3.1	6.4	3.5
1982.3	1.185	1.2	6.6	7.6
1982.4	1.421	0.3	4.4	4.6
1983.1	1.557	1.8	4.8	2.2

Sources: Wilshire Associates; Bureau of Economic Analysis; Bureau of Labor Statistics; CM&M Group, Inc.

Schedule C

Inventory Investment in Early Post-War Business Expansions (1972 dollars)

	Quarters Prior to Full Recovery			First Qtr. Recovery	Four Quarter Total
	(-3 Qtr.)	(-2 Qtr.)	(-1 Qtr.)		
1948 II-1949 I	5.6	6.9	5.3	- 0.3	17.5
1953 IV-1954 III	- 5.0	- 3.4	- 4.1	- 2.7	-15.2
1957 IV-1958 III	- 3.0	- 6.8	- 6.2	0.3	-15.7
1960 III-1961 II	3.4	- 5.3	- 4.1	1.8	- 4.2
1970 II-1971 I	5.0	6.5	1.4	11.2	24.1
1974 III-1975 II	7.7	12.9	-14.3	-11.3	- 5.0
1980 I-1980 IV	- 2.6	- 2.5	- 8.5	- 6.2	-19.8
1982 II-1983 I	- 4.4	3.4	-20.3	-12.4	-33.7

Source: Department of Commerce, Bureau of Economic Analysis.

Schedule D

**Nonresidential Investment in Early Post-War
Business Expansions
(1972 dollars)**

	Producers' Durable Equipment (% chg.)	Nonresidential Structures (% chg.)	Total Nonresidential Investment
1948 IV-1949 I	- 23.3	- 8.1	- 18.0
1954 II-1954 III	16.4	0	9.1
1958 II-1958 III	- 6.1	- 10.0	- 7.9
1961 I-1961 II	19.8	- 6.4	6.9
1970 IV-1971 I	4.2	- 0.9	2.2
1975 I-1975 II	- 9.4	- 10.0	- 9.6
1980 III-1980 IV	7.8	3.4	6.5
Average	+ 1.3	- 4.6	- 1.5
1982 IV-1983 I	1.5	5.5	2.8

Source: Department of Commerce, Bureau of Economic Analysis.

Schedule E

Treasury Revenues and Expenditures Since 1976

Year	(1)*		(2)*		(3)	(4)	(5)	(6)*
	Treasury Expenditures (bil. \$)	(% chg.)	Treasury Receipts (bil. \$)	(% chg.)				
1976	369.2	8.3	309.3	9.8	21.78	18.53	- 59.9	37.1
1977	402.8	9.1	356.9	15.4	21.73	19.05	- 45.9	41.9
1978	450.9	12.0	401.2	12.4	21.31	19.22	- 49.8	48.7
1979	493.6	9.5	466.0	16.1	21.04	19.88	- 27.7	59.8
1980	579.7	17.4	520.1	11.6	22.84	20.26	- 59.7	74.9
1981	657.2	13.4	599.3	15.2	23.78	21.12	- 57.9	95.6
1982	729.6	11.0	619.0	3.3	24.16	19.91	- 110.7	117.4
1983e	816.5	11.9	612.9	- 1.0	24.85	19.06	- 203.6	124.5
1984e	901.0	10.4	680.6	11.1	25.42	18.94	- 220.4	150.0

*Fiscal year
e-estimate

Sources: Department of the Treasury and CM&M Group, Inc.

Schedule F

Personal Saving and U.S. Government Borrowing Since 1970
(Billions of Dollars)

<u>Year</u>	(1) <u>Personal Saving</u>	(2) <u>Government Borrowing</u>	(3) Ratio Savings to <u>Borrowings (1 ÷ 2)</u>
1970	55.8	11.8	4.73
1971	60.7	20.6	2.95
1972	52.6	21.7	2.42
1973	79.0	26.0	3.04
1974	85.2	21.8	3.91
1975	94.3	67.1	1.41
1976	82.5	88.9	0.93
1977	78.0	63.2	1.23
1978	89.3	77.1	1.16
1979	96.6	63.9	1.51
1980	106.2	89.3	1.19
1981	130.2	117.3	1.11
1982	142.7	138.4	1.03
1983e	135.8	214.5	0.63
1984e	119.6	244.7	0.49

Sources: Bureau of Labor Statistics, Department of the Treasury; Board of Governors of the Federal Reserve System; CM&M Group, Inc.

Schedule G

Major Indicators of Credit Demands, 1982-1983
(billions of \$)

	(1) Commercial & Industrial Loans at Large Reporting Commercial Banks	(2) Nonfinancial Commercial Paper (outstanding)	(3) Short-Term Nonfinancial Credit Demands (1 + 2)	(4) Change in Consumer Installment Loans, All Financial Institutions	(5) Insured Savings & Loan Assocs. New Mortgage Commitments	(6) Total Mortgage Commitments
1982						
Jan.	196.9	55.4	252.3	0.417	3.199	15.073
Feb.	200.5	55.5	256.0	0.167	3.896	15.338
Mar.	203.7	56.8	260.5	0.633	4.950	15.523
Apr.	205.3	57.4	262.9	1.623	5.078	16.304
May	210.4	59.1	269.5	1.844	5.167	16.549
June	213.2	57.4	270.6	2.023	5.549	16.753
July	213.4	57.0	270.4	0.839	4.850	15.865
Aug.	213.9	57.4	271.3	0.256	5.931	16.870
Sept.	217.7	55.8	273.5	1.256	6.236	17.176
Oct.	217.0	55.3	272.3	0.131	6.835	18.307
Nov.	215.3	51.1	266.4	2.015	7.571	19.563
Dec.	213.9	48.3	262.2	2.418	8.578	17.964
1983						
Jan.	216.9	46.8	263.7	2.930	7.665	19.343
Feb.	216.9	46.4	263.3	1.744	10.125	21.945
Mar.	217.4	46.5	263.9	n/a	13.384	24.965

Notes and Sources: Figures are for the end of the period, except for the last, which is for the week of March 30.

Column 1 is seasonally adjusted by the Federal Reserve Bank of St. Louis. Columns 2 and 4 are from the Board of Governors of the Federal Reserve System; Columns 5 and 6 from the Federal Home Loan Bank Board.

**Energy Price Impact on Recent Changes in
Producer and Consumer Prices**

	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>
PPI - Finished Goods	0.2	- 1.0	0.1	- 0.1
PPI - Finished Goods Less Energy	0.4	- 0.6	0.6	0.3
PPI - Finished Consumer Goods	0.1	- 1.4	0.1	- 0.3
PPI - Finished Consumer Goods Less Energy	0.3	- 0.8	0.7	0.2
CPI - All Items	- 0.3	0.2	- 0.2	0.1
CPI - All Items Less Energy	- 0.2	0.4	0.3	0.3

Source: Bureau of Labor Statistics

Schedule I

Carroll McEntee and McGinley
Econometric Model
Historical Table

April 28, 1983

Page 1 History

	1983											
	1981				1982				1983			
	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4
1. GNP, 1972 \$	7.9	-1.5	2.2	-5.3	-5.1	2.1	.7	-1.0	3.1	-4	1.9	-1.7
2. Final Sales 1972 \$	5.3	-4.0	1.0	-2.3	.2	-9	-1.4	5.5	.9	.5	1.0	-.5
3. Consumption, 1972 \$	4.4	-2.7	2.9	-3.4	2.5	2.4	.7	4.5	2.2	.3	1.8	1.0
4. Bus Fixed Invest 1972 \$	8.2	1.0	9.4	.5	-4.9	-11.8	-7.6	-6.0	2.7	-2.3	3.5	-3.6
5. Govt. Purch, 1972 \$	5.4	-4.2	3.8	6.9	-2.7	-5.4	8.3	12.1	-8.9	2.2	.9	1.5
6. Residential Inv. 1972 \$	1.2	-17.6	-32.0	-25.1	-10.5	12.8	-5.3	39.5	83.5	-20.1	-4.9	-10.3
7. Industrial Prod.	8.4	1.9	1.4	-16.5	-11.8	-6.6	-3.4	-8.1	8.2	-3.6	2.6	-8.1
8. Disp. Income 1972 \$	3.7	.6	4.8	1.2	-1.9	3.1	1.2	.3	1.8	-1	2.5	1.1
9. Corp. Profits A Tax	9.2	-33.0	13.5	-15.0	-60.5	5.3	10.7	-4.9	68.4	-4.4	-4.4	-22.4
10. CPI: All Urban	11.0	9.6	11.9	5.9	3.3	6.3	7.8	.8	-2	13.5	10.3	6.2
11. PPI: Finished Goods	11.6	9.6	3.1	4.8	4.0	1.2	5.0	4.3	-1.6	13.5	9.3	4.0
12. Consumption Deflator	8.2	7.3	8.1	7.0	5.0	3.5	7.6	4.6	2.2	10.3	8.6	5.9
13. Wage Rate 1977 = 100	9.3	8.5	8.5	7.3	6.5	6.4	6.6	4.4	4.8	9.0	9.1	6.9
14. Productivity	5.8	.0	1.2	-3.1	-.4	1.2	3.6	2.8	2.4	-.7	1.7	.3
15. M1	5.0	9.2	3.2	3.2	11.0	3.2	6.3	13.7	14.8	6.2	7.1	6.5
16. M2	7.0	10.3	10.4	10.0	8.9	7.2	11.3	9.6	21.2	8.0	9.5	9.4
17. Nonborr Res Dep Inst	11.1	-1.5	7.7	11.4	-.9	4.2	11.7	17.6	3.8	6.1	6.7	6.0
18. Monetary Base	5.1	6.4	4.1	3.8	8.3	6.8	6.9	8.9	9.5	8.4	6.7	6.4
19. C & I Loans + Nonfin Paper	13.4	13.5	25.4	11.7	7.0	15.2	8.8	-1.1	-1.7	15.0	14.1	11.6

Econometric Model
Historical Table

April 28, 1983

Page 2 History

	1981				1982				1983			
	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4
20. Unemployment Rate	7.4	7.4	7.4	8.3	8.8	9.4	10.0	10.7	10.4	7.2	7.6	9.7
21. Housing Starts	1.39	1.18	.96	.87	.90	.95	1.12	1.26	1.69	1.30	1.10	1.06
22. Auto Sales, Total	9.8	7.9	9.0	7.4	8.0	7.5	7.8	8.7	8.4	9.0	8.5	8.0
23. Auto Sales, Domestic	7.2	5.7	6.8	5.2	5.8	5.5	5.5	6.1	6.0	6.6	6.2	5.7
24. Invt Invest 1972 \$	2.5	12.1	16.5	4.8	-15.4	-4.4	3.4	-20.3	-12.4	-5.0	9.0	-9.2
25. Net Exports G & S 1972 \$	48.2	44.2	39.5	36.5	36.9	35.8	27.5	27.2	24.0	50.6	42.1	31.8
26. Govt Surplus/Def, Uni	-37.4	16.4	-9.1	-48.2	-23.7	-2.5	-36.2	-68.3	-61.0	-59.7	-57.9	-110.7*
27. Fed & Agency Dept. CH	158.2	80.4	99.3	153.4	137.3	99.6	196.2	226.8	292.5	89.3	117.4	137.9
Interest Rates												
28. Federal Funds Rate	16.57	17.78	17.58	13.59	14.23	14.51	11.01	9.29	8.65	13.36	16.38	12.26
29. Prime Comm. Bank Rate	19.21	18.93	20.32	17.01	16.27	16.50	14.72	11.96	10.88	15.27	18.87	14.86
30. Prim. 89 Day CD(NYCB)	15.88	16.96	17.51	13.27	14.30	14.24	11.46	8.97	8.47	13.16	15.91	12.24
31. 90 Day Comm Paper	15.13	16.23	16.85	12.80	13.76	13.70	10.96	8.57	8.25	12.63	15.25	11.75
32. 3 Mo Treasury Bill	14.37	14.83	15.09	12.02	12.89	12.36	9.71	7.93	8.08	11.61	14.08	10.72
33. AA Utility, New Issue	15.05	15.82	17.07	16.63	16.65	16.17	14.94	12.33	12.25	13.11	16.14	15.02
34. 5 Yr Govt Sec	13.20	14.19	15.43	14.13	14.39	14.06	13.11	10.47	10.12	11.48	14.24	13.01
35. 10 Yr Govt Sec	12.96	13.75	14.85	14.09	14.29	13.93	13.12	10.67	10.56	11.46	13.91	13.00
36. 30 Yr Govt Sec	12.54	13.25	14.14	13.83	13.99	13.51	12.80	10.75	10.71	11.30	13.44	12.76
37. Conventional Mortgage	14.97	15.69	16.83	17.41	16.93	16.77	16.31	14.38	13.21	13.63	16.23	16.10

*Indicates Value is for Fiscal Year

Carroll McEntee and McGinley
Econometric Model
Base Line Forecast

April 28, 1983

Page 1 Forecast

	1983				1984				1985					
	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	
1. GNP, 1972 \$	3.1	6.9	6.6	5.2	4.6	3.0	1.8	1.9	1.2	-1.7	3.2	4.2	3.2	4.2
2. Final Sales 1972 \$.9	3.9	5.4	5.2	4.3	3.5	1.9	1.8	1.5	-.5	2.7	4.0	2.7	4.0
3. Consumption, 1972 \$	2.2	3.9	5.7	6.4	3.8	3.5	1.3	2.2	2.8	1.0	3.5	4.1	3.5	4.1
4. Bus Fixed Invest 1972 \$	2.7	10.0	5.3	6.2	7.3	7.1	5.2	6.2	4.2	-3.6	.5	6.6	.5	6.6
5. Govt. Purch, 1972 \$	-8.9	-2.2	.8	-.7	1.7	1.2	.1	-1.4	-.3	1.5	.1	.4	1.5	.4
6. Residential Inv. 1972 \$	83.5	55.3	24.7	13.6	5.3	-1.0	-3.6	-2.7	-3.7	-10.3	39.8	8.4	-10.3	8.4
7. Industrial Prod.	8.2	6.9	6.8	5.8	6.4	2.3	1.1	.8	1.4	-8.1	2.0	4.5	-8.1	2.0
8. Disp. Income 1972 \$	1.8	5.1	10.3	2.7	2.7	2.1	2.1	.9	1.1	1.1	3.3	3.5	1.1	3.3
9. Corp. Profits A Tax	68.4	25.0	23.1	23.9	28.7	10.7	6.9	9.5	.7	-22.4	24.6	19.1	-22.4	24.6
10. GPI: All Urban	-.2	4.3	6.1	6.0	6.8	7.4	8.1	9.0	9.1	6.2	3.4	6.8	6.2	3.4
11. PPI: Finished Goods	-1.6	4.9	5.3	3.6	5.3	6.3	7.0	8.6	7.5	4.0	2.9	5.6	4.0	2.9
12. Consumption Deflator	2.2	4.6	4.9	4.9	5.6	6.1	6.6	7.3	7.5	5.9	4.3	5.7	5.9	4.3
13. Wage Rate 1977 = 100	4.8	4.5	6.4	6.0	6.4	7.0	7.1	7.5	7.6	6.9	5.2	6.5	6.9	5.2
14. Productivity	2.4	7.9	4.5	3.0	.6	.2	-.3	-.4	-.4	.3	3.9	1.7	.3	3.9
15. M1	14.8	10.6	10.8	10.0	9.9	9.9	9.7	9.9	8.8	6.5	11.2	10.1	6.5	11.2
16. M2	21.2	11.8	14.5	13.0	12.5	10.1	8.9	9.6	9.4	9.4	13.7	11.6	9.4	13.7
17. Nonborr Res Dep Inst	3.8	20.4	11.0	6.5	7.5	8.5	8.0	8.1	5.0	6.0	11.4	8.8	6.0	11.4
18. Monetary Base	9.5	9.2	6.6	6.6	6.7	6.9	6.6	6.4	6.3	6.4	8.3	6.8	6.4	8.3
19. C & I Loans + Nonfin Paper	-1.7	2.7	7.5	9.3	9.6	9.8	11.1	8.8	8.6	11.6	3.3	9.0	11.6	3.3

	1983				1984				1985				
	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	
20. Unemployment Rate	10.4	10.2	9.9	9.6	9.3	9.2	9.1	9.1	9.1	9.1	9.7	10.0	9.2
21. Housing Starts	1.69	1.77	1.85	1.83	1.78	1.71	1.66	1.59	1.55	1.06	1.79	1.68	1.68
22. Auto Sales, Total	8.4	8.6	9.3	9.0	9.1	9.0	8.9	8.9	9.0	8.0	8.8	9.0	9.0
23. Auto Sales, Domestic	6.0	6.3	6.7	6.4	6.5	6.5	6.3	6.4	6.4	5.7	6.4	6.4	6.4
24. Invt Invest 1972 \$	-12.4	-1.9	2.5	2.5	3.5	1.3	.8	1.2	.3	-9.2	-2.3	1.7	1.7
25. Net Exports G & S 1972 \$	24.0	19.6	18.5	16.8	17.7	17.7	19.6	18.8	15.6	31.8	19.7	18.4	18.4
26. Govt Surplus/Def, Uni	-61.0	-33.0	-41.4	-56.1	-62.3	-37.2	-64.8	-73.6	-73.6	-110.7	-203.6	-220.4*	-220.4*
27. Fed & Agency Dept. CH	292.5	253.0	200.7	240.3	276.0	251.4	309.0	329.1	272.5	137.9	233.9	261.3	261.3
Interest Rates													
28. Federal Funds Rate	8.65	8.65	8.95	9.33	9.70	10.21	10.57	10.52	10.25	12.26	8.90	10.25	10.25
29. Prime Comm. Bank Rate	10.88	10.49	11.01	11.51	11.99	12.48	12.76	12.97	12.63	14.86	10.97	12.55	12.55
30. Prim. 89 Day CD(NYCB)	8.47	9.07	9.32	10.06	10.38	10.89	11.21	11.31	10.84	12.24	9.28	10.95	10.95
31. 90 Day Comm Paper	8.25	9.02	9.47	10.01	10.34	10.86	11.18	11.32	10.90	11.75	9.19	10.93	10.93
32. 3 Mo Treasury Bill	8.08	8.24	8.64	9.19	9.36	9.84	9.98	10.24	10.32	10.72	8.54	9.86	9.86
33. AA Utility, New Issue	12.25	-12.20	12.60	12.68	12.98	13.02	13.41	13.81	14.11	15.02	12.43	13.31	13.31
34. 5 Yr Govt Sec	10.12	10.04	10.24	10.57	10.68	11.05	11.29	11.69	12.03	13.01	10.25	11.18	11.18
35. 10 Yr Govt Sec	10.56	10.34	10.78	11.12	11.28	11.60	11.83	12.17	12.46	13.00	10.75	11.72	11.72
36. 30 Yr Govt Sec	10.71	10.60	10.92	11.33	11.55	11.93	12.12	12.50	12.83	12.76	10.89	12.02	12.02
37. Conventional Mortgage	13.21	13.18	13.60	13.70	13.75	13.85	13.94	14.09	14.21	16.10	13.42	13.91	13.91

*Indicates Value is for Fiscal Year

ACTUARIAL BASIS FOR IMMEDIATE AND DEFERRED GIFT ANNUITY RATES

Mr. Michael Mudry

Senior Vice President & Secretary

Hay/Huggins (A Member of The Hay Group)

My remarks today will cover the following four areas:

First, a historical comparison of the maximum annual immediate gift annuity rates adopted by previous Conferences on Gift Annuities and the actuarial assumptions used in calculating these rates,

Second, a more detailed analysis of issues involved in arriving at the actuarial assumptions used for calculating the maximum immediate gift annuity rates being recommended to this Conference by the Committee on Gift Annuities,

Third, the presentation of the recommended rates, and

Fourth, some comments concerning deferred gift annuities.

Material relating to the first two of these areas can be found in Schedule 1 in the packet which was distributed to you at the time you registered for the Conference. At the top of this schedule is shown a historical comparison at sample ages of the maximum immediate single-life gift annuity rates adopted at each Conference on Gift Annuities since the first Conference in 1927.

To avoid possible confusion, I should mention that the word "rate" in the gift annuity field represents the percentage that is multiplied by the principal paid to the charitable organization in order to arrive at the annual annuity payable to the annuitant. For example, if the principal paid to the organization is \$100,000 and the rate table shows 7.1% at the annuitant's age, then the rate is 7.1% and the annuitant will receive 7.1% of the \$100,000 (or \$7,100) as an annual annuity. This meaning of the term "rate" is different from that used in insurance circles, where "rate" means the premium rate that is charged by the insurance company for a benefit. Of course, when I refer later in this paper to mortality rates or interest rates, the difference in usage of the word "rates" will be obvious.

It can be seen from Schedule 1 that, for most ages shown, the gift annuity rates in column A which were adopted by the 1927 Conference were higher than those of any subsequent year

until 1980. Depending on age, the lowest annuity rates were those adopted by the 1939 or 1955 Conference. Rates adopted subsequent to the 1955 Conference have gradually increased, with the 1980 rates being roughly the same as the original 1927 rates for ages up to age 60, less than the 1927 rates at ages 65 through 75 and exceeding the 1927 rates at ages 80 and over.

The bottom part of Schedule 1 contains a summary of the actuarial assumptions used to calculate the various rates adopted over the years. Basically these assumptions relate to:

- (1) the mortality rates in future years,
- (2) the investment yield rate to be earned in the future on the principal paid for the annuity,
- (3) the residuum available to the organization at the death of the last annuitant,
- (4) the loading needed for administrative expenses,
- (5) the frequency of the annuity payments and
- (6) adjustments in rates made at younger and older ages.

Some brief comments relating to these assumptions may be of interest.

The three columns under the heading of "Mortality Basis" identify the mortality rates assumed. The name of the basic mortality table used is shown in the first of these three columns. I won't delve further into this area at this time, but will make some remarks later concerning mortality tables when I cover the assumptions used for the proposed maximum gift annuity rates.

The second of the three columns pertaining to the mortality basis sets forth any age ratings included in the assumptions. An age rating is a device used by actuaries to adjust the mortality rates in a mortality table so as to bring them more closely in line with mortality rates assumed for the future. For example, if the age rating is minus two years, it means that a person of a given age will be assumed to die in accordance with the rates of mortality shown in the unadjusted mortality table for a person two years younger. A rating has the general effect of making provision for lower rates of mortality (and hence longer longevity) than are inherent in the unadjusted mortality table. Thus, ratings are used when it is anticipated that the unadjusted mortality table will not

accurately portray future mortality experience.

The third column in Schedule 1 under the heading "Mortality Basis" indicates the sex assumption used for purposes of calculating gift annuity rates. Except for the annuity rates adopted at the first Conference on Gift Annuities in 1927, all rates have been based on mortality assumptions related to female lives. Thus, in contrast to the usual practice among insurance companies of paying a different amount of annuity to a male than to a female of the same age for a given amount of premium, the maximum gift annuity rates provide the same amount of gift annuity per \$1 of principal at a given age regardless of the sex of the annuitant. This policy has been in effect in connection with the maximum annuity rates adopted at all Conferences ever held.

It may well be that this unisex approach used by the Conference for all these years will become a mandatory practice in connection with all annuities, whether under pension plans or from insurance companies. First of all, the U.S. Supreme Court has already heard arguments and is expected to issue shortly a decision in the Norris case, which relates to a situation where a female member of a pension plan was provided a smaller annuity from contributions made on her behalf than would have been paid to a male of the same age and with the same contribution history. She has sued to overturn this practice. Secondly, there are bills before Congress at this time which would prohibit insurance companies from charging different premiums for insurance for males than for females. If either the Supreme Court or Congress no longer permits the recognition of the sex of the annuitant in calculating annuity amounts, it would mean that the rest of the country would have to follow a practice used by the Conference for over 50 years in connection with maximum gift annuity rates.

The fourth column of actuarial assumptions during past years shows the investment yield rates assumed or, as referred to less accurately but more frequently, the interest rates. These rates have been increasing since the low point of 3% for 1939 to 1955. The 5½% rate adopted at the last Conference in 1980 is the highest ever assumed.

The fifth column of assumptions relates to the residuum built into the rates. From 1927 to 1939, the assumed residuum

was 70% of the original principal paid to provide the annuity. The present 50% assumption was adopted in 1939.

The residuum represents the portion of the original principal which would be made available to the charitable organization at the death of the annuitant or annuitants if (1) the total principal had been invested at the date of issue of the gift annuity, (2) the annuity and expenses were paid from such principal and (3) experience exactly equaled all assumptions made.

It is, of course, not required that the availability of the value of the residuum be deferred until the death of the annuitant. It is possible to insure the amount of annuity with an insurance company or the charitable organization can set aside adequate reserves to cover the payment of the annuity and make the payments itself, thus releasing a portion of the principal immediately. However, since the matter of how the original principal is handled is not the subject of my remarks, I won't delve into this area further.

Incidentally, I have used the word "principal" several times. This word is intended to represent the original amount paid for a gift annuity. For example, if \$10,000 is paid for a gift annuity, the \$10,000 is what I call the principal in this paper. Other people may refer to it as the gift or some other term, but in my remarks I refer to it as the principal.

The next assumption shown in Schedule 1 is that concerning expenses. There was no expense loading until the 1955 Conference, at which time the expense assumption that has continued in use since then was adopted. This assumption is that all future expenses will be able to be met from an amount equal to 5% of the principal. For example, if the principal paid for a gift annuity is \$10,000, then it is assumed that an amount of 5% of the \$10,000, or \$500, together with interest thereon, would be able to cover all expenses relating to the annuity, including those of promotion, writing of the agreement, record keeping and the issuance and mailing of all future annuity payments.

In my opinion, this area of expenses is one of the least studied of all the assumptions made and probably would produce a number of different opinions as to what the actual expenses are in connection with a gift annuity. On the one hand, a charitable organization that already has a staff whose responsibility it is to

obtain charitable gifts may consider that, by expanding the efforts of the staff into the field of gift annuities, it has not really added any expenses since the staff was already there. On the other hand, it could be argued that expenses should be allocated over all the gift giving endeavors entered into by the staff. Sometimes it is very difficult to determine the appropriate allocation of expenses. For example, expenses that have been allocated to gift annuities at the time the expenses were incurred may not have resulted in a gift annuity agreement, but may have (at that time or a later date) produced a bequest in a will to a charitable organization.

Once again, though, since it is not the purpose of my comments to discuss expenses in depth, I will move on to the next assumption, which concerns the ages at which the calculated tabular rates are modified. Since 1934, the rates resulting from the application of the various assumptions have been reduced somewhat at the younger ages in recognition of the fact that annuities that commence at those ages are likely to be paid for many years in the future (during which substantial changes in interest rates can occur), so that it would be advisable to be a bit conservative in setting rates at such ages. Similarly, due primarily to a paucity of data relating to mortality experience at older ages, it has been usual in the insured annuity field to not increase the amount of annuity payable to individuals whose annuities begin above some cut-off age such as 85 or 90. This same practice is followed in connection with gift annuities.

Finally, it is indicated at the very bottom of Schedule 1 that it is assumed that the annuities will be paid in semi-annual installments, with the first payment due six months after the issue date of the gift annuity agreement. If the payments are actually to be made at a different frequency, such as quarterly or annually, it would theoretically be necessary to modify the gift annuity rates somewhat. In practice, however, most organizations apparently use the rates as approved regardless of the frequency of payment, even though it may have some relatively small impact on the residuum.

Obviously, it is extremely unlikely that the assumptions used would be experienced exactly by any organization issuing gift annuities. Experience may be more favorable to the organi-

zation in connection with some assumptions, but less favorable for others. If an organization is fortunate enough to have its net experience be more favorable than assumed, it simply means that its residuum would exceed the 50% residuum assumed. If, though, actual net experience were less favorable than assumed, the organization would receive a smaller residuum than 50%. Since the primary purpose of gift annuities is for the organization to obtain a residuum for its use, the Committee on Gift Annuities leans toward being conservative when recommending gift annuity rates in order to reduce the possibility that charitable organizations will not receive appropriate residuums under their annuity agreements.

Now that I have reviewed the various assumptions that have been utilized in the past for the calculation of gift annuity rates, I will comment on the assumptions used for calculating the rates being recommended by the Committee on Gift Annuities to this Conference. As compared to the assumptions used in connection with the rates adopted in 1980, the only changes being recommended are in the mortality basis and the interest rate. Thus, there are no changes in the assumptions concerning a 50% residuum, a 5% expense loading, rate modifications at the younger and older ages, and semi-annual payments at the end of each six months.

A bit of detail concerning the revised assumptions in the two areas where changes are being recommended would seem to be advisable. Let us first consider the mortality basis. The Society of Actuaries has recently published a new mortality table (called the 1983 Table a) which was developed from experience among annuitants receiving individual annuities from insurance companies as the result of purchases of annuities or the conversion of death benefits or matured contracts into annuities. The experience does not include that of annuitants receiving benefits under group insurance contracts.

The annuitants reflected in the mortality study which resulted in the 1983 Table a represented a mixture of various types of individuals, including those who themselves had made elections to receive annuities and those where the contractholder who died had imposed the requirement that an annuity be paid to the beneficiary. Furthermore, some annuitants had elected annuities

under which there were no guarantees (i.e., there is no continuation after the death of the annuitant), while others elected some form of guarantee under which a beneficiary would receive either continued payments for a guarantee period (such as under a ten-year certain and life annuity) or a refund amount in a lump sum if the annuitant were to die during the early years of the annuity. Therefore, the combined experience of the following four categories of annuitants was used in the development of the 1983 Table a:

- (1) Those receiving annuities with no guarantees and who elected the annuities themselves.
- (2) Those receiving annuities with some guarantees and who elected the annuities themselves.
- (3) Those beneficiaries receiving annuities with no guarantees and who did not elect the annuities themselves.
- (4) Those beneficiaries receiving annuities with some guarantees and who did not elect the annuities themselves.

It was basically found that, if a separate mortality table had been developed for each of the above four categories of annuitants, mortality would have been lightest among annuitants in the first category (i.e., those who had made their own elections to receive annuities on a non-guaranteed basis). This is not unexpected, since an individual will tend to anti-select against the payer of an annuity if given a choice. A person in very good health would be inclined to elect a non-guaranteed annuity if given a choice, since that provides a larger amount of annuity than one under which a guarantee is provided. If the person's health is poorer, he or she would be more apt to elect an annuity with some form of guarantee in order to increase the chances that the initial value of the annuity will be returned either to him or her or to his or her beneficiary. Of course, if the individual were in very poor health, he or she would usually elect not to purchase an annuity or would take an alternative lump-sum payment if permitted to do so. Under those circumstances the individual would obviously never have entered the mortality study. If the individual had no choice, though, it would mean that such individuals would include some who were in very poor health and who would not have elected to receive annuities if they had had

a choice. Thus, their mortality rates would tend to be the highest of all annuitants.

Since the annuitants in the first category (who had elected their own annuities on a non-guaranteed basis) had the lowest rates of mortality among the above four categories of annuitants, it is obvious that, by combining all four categories for the purpose of developing the 1983 Table a, the resulting mortality rates in the table would be higher than those of such first category of annuitants. In addition, it would seem logical to assume that the individuals who receive annuities under gift annuity agreements are analogous to those in this first category, since they generally make their own elections to receive annuities and the annuities are payable without any guaranteed payments after the death of the last annuitant originally covered under the gift annuity agreement. Accordingly, it would appear appropriate to assume that the 1983 Table a would reflect higher rates of mortality than would be expected among annuitants entering into gift annuity agreements. Partly for this reason, I have recommended to the Committee on Gift Annuities that the mortality basis adopted in calculating the maximum gift annuity rates to be recommended to the Conference be in accordance with the 1983 Table a for female lives, but with ages rated as one year younger. As indicated earlier, the age rating would serve to make provision for somewhat lighter mortality among annuitants than under the unadjusted 1983 Table a.

It could be argued that it is inappropriate to use the one year age rating because gift annuity annuitants do not have the same motives as annuitants who purchase or elect annuities with no guarantees from insurance companies, and therefore do not have as low mortality rates as such insured annuitants. In addition to receiving an annuity, an annuitant who enters into a gift annuity agreement is also donating funds to a charitable organization for which the annuitant receives a tax deduction. Although it is difficult to rebut this argument directly because no actual study has been made at this time of mortality among annuitants receiving gift annuities, I can say that the last mortality study made for such annuitants was for the years of 1970 through 1975, so centered around December 31, 1972. This date is near the 1971 year

that was the base year for the 1971 Individual Annuity Mortality Table, which was also constructed under the same basic philosophy as was the 1983 Table a (i.e., by combining mortality experience among the four categories of annuitants mentioned in connection with my previous remarks relating to the 1983 Table a). If mortality among annuitants receiving gift annuities were not subject to the same anti-selection that exists among insured annuitants who themselves elect annuities without guarantees, then the mortality rates in the 1970 to 1975 study of gift annuity annuitants would have been the same as or higher than those under the 1971 Individual Annuity Mortality Table. The results of that study showed that it was necessary to use a one year age rating in conjunction with the 1971 table in order to reflect the actual low mortality of gift annuity annuitants. Thus, it would appear appropriate at this time to also use a one year age rating in connection with the proposed basis of the 1983 Table a.

There is also another reason why a one year age rating seems advisable. This is somewhat technical and you have probably had enough explanations concerning the proposed mortality basis, but I will still discuss it, although relatively briefly. The mortality rates in the mortality table normally represent the rates experienced as of a given point in time at all ages. Therefore, the 1983 Table a indicates the mortality rate *for 1983* of individuals from age 5 to 115 in 1983. The mortality rate at a given age in 1983 represents the probability that a person of that age will die within one year. For example, the probability under the 1983 Table a with a one year age rating that a 65-year old female in 1983 will die within one year is .66% (in other words, about $\frac{2}{3}$ of 1%), while the probability that an 80-year old female in 1983 will die in one year is 3.23%, or roughly $3\frac{1}{4}$ %. However, is it appropriate to assume that, when women who are age 65 in 1983 reach age 80 in 1998, their rate of mortality in 1998 at age 80 will be the same 3.23% that 80 year old women are experiencing today? If the past is any guide, such an assumption would not be appropriate, since mortality rates at almost any given age have gradually been decreasing over the years. Thus, 80-year olds in 1983 have a lower rate of mortality than 80-year olds had fifteen years ago, and it is likely that individuals who reach age 80 fifteen

years from now will have a lower rate of mortality than is being experienced today by 80-year olds. Such reductions in mortality rates have occurred for a number of reasons such as better medical care and improved living standards.

Another indication of reducing mortality rates can be obtained from a study of life expectancies. The following are the remaining years of life expectancy of a 65-year old female under the mortality basis used for calculating gift annuity rates adopted by the Conferences of various sample years in the past and under the basis being recommended to this Conference:

<u>Year</u>	<u>Life Expectancy</u>
1934	15.2 years
1955	18.2 years
1971	19.6 years
1983	22.8 years

Thus, the remaining years of life expectancy of a 65-year old female under the assumptions used to calculate gift annuity rates have increased by more than 7 years in a period of 49 years from 1934 to 1983. These increases in life expectancy reflect reductions in mortality rates over past years. Because further reductions in mortality rates are likely in the future, it is essential to recognize that a mortality table which has been prepared to show the mortality rates as they exist at one point in time cannot be used without modification to calculate annuity rates, because that would understate the expected payments to be made to annuitants in future years as mortality rates decrease.

Actuaries tend to make provision for decreasing mortality rates in several ways. One such way is to introduce an age rating into the mortality table being used. This is another justification for using the 1983 Table a with an age rating of one year. Actually, since the use of a one-year age rating has already been justified because of the earlier point made that the gift annuity annuitants have the light mortality applicable in connection with annuitants who voluntarily enter into annuity agreements under which no guaranteed payment is made after death, then a good argument can be made for the use of a two-year age rating of the 1983 Table a. However, the table already contains a mortality

loading, so the one-year rating seems more appropriate.

I'm sure that by now you have had more information about mortality rates than you really wanted, so I'll simply make the final comment that the proposed mortality basis would, without any other change in assumptions, reduce gift annuity rates. Having made that statement, I would now like to move on to the other assumption that is being changed, which is the interest assumption. The assumed interest rate adopted for calculating gift annuity rates by the 1980 Conference was $5\frac{1}{2}\%$. After being quite high much of the time since 1980, interest rates have decreased somewhat in recent months.

In setting the interest rate to be recommended for use in calculating gift annuity rates, the Committee on Gift Annuities takes into account several conflicting factors. For example, if the assumed interest rate is too low, it would produce relatively low gift annuity rates which might discourage donors from using the gift annuity vehicle. On the other hand, if the interest rate assumed and the resulting gift annuity rates are too high, it defeats the primary purpose of gift annuities of obtaining funds for use by charitable organizations issuing gift annuity agreements. The Committee also recognizes that Conferences are only held every third year and, although it is theoretically possible to revise gift annuity rates between Conferences, it has never been done in the past. Therefore, the rates adopted are extremely likely to be in place for three years, during which time substantial changes in the climate relating to new investments can occur. For example, the rate of inflation has declined significantly in recent months. If this situation continues, then the real rates of return should drop to historical levels, which would also decrease the nominal rates of return. Federal Reserve Board Chairman Paul Volcker is predicting that interest rates will decline further. On the other hand, you've just heard Mr. Hunt predict that interest rates will increase somewhat. Another point taken into account was the fact that interest rates currently available for new fixed income investments are significantly higher than the $5\frac{1}{2}\%$ assumption presently in force. Weighing these and other factors, the Committee is recommending that the annual interest rate to be assumed in calculating maximum gift annuity rates be increased from the present $5\frac{1}{2}\%$ to a rate of $6\frac{1}{2}\%$. This

represents an increase of one percentage point in the assumed interest rate, which is the largest increase ever made, since the highest previous increase adopted was one-half percentage point.

In summary, the assumptions recommended to this Conference by the Committee on Gift Annuities for the purpose of calculating the maximum gift annuity rates are as follows:

Mortality Basis:	1983 Table a, females lives, with ages rated as one year younger.
Interest Rate:	6½% per annum, compounded annually.
Residuum:	50% of the principal.
Expense Loading:	5% of the principal.
Payment Frequency:	Semi-annual installments at the end of each six months.
Adjustments:	Made at younger and older ages.

Once the assumption basis is known, it simply becomes a purely mechanical matter to calculate the maximum gift annuity rates at the various ages involved. I will explain the process briefly. If anyone wishes to obtain more detailed information about the procedures used, he or she can refer to my paper to the 1980 Conference which is printed in the booklet issued by the Committee relating to that Conference. Basically, from each \$100 of principal, there are subtracted (a) 5% of such principal to cover future expenses and (b) the single premium needed to provide a residuum of 50% of the principal at the death of the annuitant or annuitants. The portion of the principal remaining after those subtractions is the amount available to provide the gift annuity. When this remainder is divided by the single premium for an annuity of \$1 per year payable in semi-annual installments at the end of each six months, the result is the amount of annual gift annuity that can be provided per \$100 of principal. This dollar amount of annuity, when expressed as a percentage, also represents the gift annuity rate. For example, from each \$100 of principal, \$5 is deducted for expenses, leaving \$95. If we assume for a given age that the single premium to provide a residuum of \$50

is \$24.90 and subtract the \$24.90 from the \$95, we have \$70.10 left of the original \$100 to fund the gift annuity. If the single premium for \$1 of annual annuity is \$7.48, then the \$70.10 remainder can provide \$9.37 of annual annuity which, when rounded, results in a gift annuity rate of 9.4%.

Probably by now most of you feel that you've been given more background than you really wanted, so let us turn to the topic of most interest to you — the proposed maximum annual gift annuity rates. The proposed single life rates are set forth in Schedule 2 of your packet of material, while sample rates for two lives are shown in Schedule 3. Also set forth in both schedules are the present rates at the ages shown and the extent of increase between the present and proposed rates.

Let us first consider the single life rates in Schedule 2. It can be seen that the proposed rates increase by varying degrees at all ages except ages 88 and over. The increase amounts to one percentage point at the young ages, while at the ages where most gift annuities are issued the increases are generally six-tenths to eight-tenths of a percentage point. These results indicate that the liberalization in the interest assumption, which serves to increase rates, has for the most part had much more impact than the adoption of the more conservative mortality assumption, especially at the younger ages.

Although I have referred to some of the increases as being in the range of six-tenths to eight-tenths of a percentage point, which sounds relatively small, it should be recognized that this represents a fairly meaningful percentage increase in the amount of benefit actually payable. For example, at age 65, the rate increases from 6.6% to 7.3%. This increase in benefit of seven-tenths of a percentage point amounts to an increase in benefit of 10.6%. Of course, if the amount of benefit is increased, the amount of charitable contribution deductible for Federal Income Tax purposes is reduced. However, this reduction in charitable deduction is counterbalanced by the fact that the investment in the contract for the annuity is increased, which serves to increase the amount of annuity that is tax-free.

As was the case with the present rates, the proposed rates were modified at the younger and older ages. The bottom of

Schedule 2 indicates that the ages at which modifications were made were those below 45 and above 88.

Comments similar to those made in connection with the single life rates are also applicable to the two life rates which are shown in Schedule 3. The increases also range from one percentage point at the youngest ages to zero at the oldest ages. For two lives, each of whom is age 65, the proposed rate of 6.8% represents an increase of eight-tenths of a percentage point over the present 6.0% rate and an increase of 13.3% in the amount of benefit payable.

The proposed rates in Schedules 2 and 3 relate to immediate gift annuities where the first payment is due at the end of the regular installment period. However, since such rates also are used in connection with deferred gift annuities, the proposed increase in rates will serve to increase deferred gift annuity amounts by comparable percentages. Although there is much less activity in the area of deferred gift annuities than there is in connection with immediate gift annuities, I do want to make a few comments concerning deferred gift annuities. The amount of deferred gift annuity is determined by multiplying an interest factor, which depends on the length of the period for which the annuity is deferred, by the immediate gift annuity rate applicable at the age at the end of the deferred period. The first component of this multiplication (i.e., the interest factor) is set forth for each period of deferral up to 40 years in Schedule 14 of the Committee on Gift Annuities' booklet entitled "Deferred Gift Annuities." These interest factors reflect an interest assumption of 4% during the first ten years of the deferred period, 3½% during the second ten years, 3% during the third ten years and 2½% thereafter. Some comments have been made to the effect that the interest factors are much too conservative in today's investment climate and should reflect higher interest assumptions.

It is important to recognize that the interest factors cannot be considered independently of the gift annuity rates by which they are multiplied. Let me illustrate that statement by considering a situation where a female age 55 enters into a deferred gift annuity under which there is a ten-year deferral before the annuity becomes payable. During the deferral period, it is assumed that the principal contributed increases annually at a 4% rate of

interest. However (and this is the critical point to remember), at the end of the deferred period, an annuity begins under which a 6½% interest assumption will be used for the period of the annuitant's life expectancy if the proposed gift annuity rates are adopted. We had earlier stated that this life expectancy would be 22.8 years for a person age 65 under the proposed mortality basis. Thus, there would be a 4% interest assumption being used for the ten-year deferred period, but a 6½% assumption for about the following 23 years for those who reach age 65. There should be some hesitation in being willing to assume that a 6½% yield can be earned for the 23 year period starting ten years from now, especially recognizing the degree of volatility of interest rates in recent years. Because deferred annuities increase the period during which the principal paid for the annuity must be invested, thus increasing the investment risk, it is essential that the effective interest rate for the entire period of a deferred annuity agreement be less than it is for immediate annuities, where the average length of the period that the principal is invested is less. This could have been accomplished by the more logical approach of assuming a 6½% interest rate for the earlier years of the deferred annuity agreement and a lower rate during the later years during which the greatest degree of uncertainty arises as to the yield rates that will be available. However, this approach would complicate the required calculations of annuity rates, so the approach presently in effect has been deemed more appropriate. Although the net effect of assuming the lower interest rate initially and the higher rate for the later years is somewhat different than if the reverse were to apply, it can be seen that either approach tends to produce an effective overall interest rate that averages somewhere between the high and low rates assumed. If there is a short deferral period, the 4% assumption used during such period would not have much impact, so the average effective interest rate during the entire period of the agreement would be close to the 6½% interest rate assumed while the annuity is being paid. As the period of deferral lengthens, the lower interest rates applicable during such period become more heavily weighted and the effective average interest rate during the entire period of the agreement becomes reduced. However, isn't this appropriate? If the period of deferral and the total period of the

deferred annuity agreement are increased, then the period of uncertainty as to future interest rates is also increased, so the effective average interest rate that a charitable organization should be guaranteeing should be reduced to compensate for the increased risk.

When considering the interest factors used in connection with the deferred period under deferred gift annuities, the Committee on Gift Annuities came to the conclusion that it is appropriate for the interest factors to continue to reflect interest assumptions that would produce average effective interest rates less than the 6½% rate recommended for immediate gift annuities. However, it was also deemed appropriate to raise each interest assumption on which interest factors are based by ½ percentage point. Thus, the interest assumptions being recommended by the Committee on Gift Annuities for use in calculating the interest factors to be used during the deferred period would become 4½% per year for each of the first ten years of the deferred period, 4% during each of the second ten years, 3½% during each of the third ten years, and 3% thereafter.

A comparison of some sample interest factors under the present and proposed assumptions would be as follows:

Period of Deferral as Set Forth in Schedule 14 of the Booklet "Deferred Gift Annuities"	Interest Factor		
	Present	Proposed	Percentage Increase
At least 5 years, but less than 6 years	1.217	1.246	2.4%
At least 10 years, but less than 11 years	1.480	1.553	4.9
At least 15 years, but less than 16 years	1.758	1.889	7.5
At least 20 years, but less than 21 years	2.088	2.299	10.1

Thus, the impact of the proposed change in interest factors increases more as the period of deferral increases. When these increases in the interest factors are taken in conjunction with the higher recommended immediate gift annuity rates to which they will be applied, you will find that the resulting total deferred gift annuity rates can be significantly higher than those produced presently.

In conclusion I would like to restate the recommendations of the Committee on Gift Annuities which are scheduled to be discussed further and acted upon tomorrow morning. The Com-

mittee recommends that the Conference adopt maximum annual immediate gift annuity rates based on the following assumptions:

Rate of mortality:	1983 Table a, female lives, with ages rated as one year younger
Rate of interest:	6½ % per annum compounded annually
Residuum:	50% of the principal
Expense loading:	5% of the principal
Payment frequency:	Semi-annual installments at the end of each six months

The Committee further recommends that (1) the single life rates should be modified at the younger and older ages so as to produce a minimum rate of 6.0% at ages 35 and under and a maximum rate of 14.0% at ages 90 and over, (2) a rate for two lives should be at least two-tenths of a percentage point less than the single life rate for the younger of the two lives and (3) no rate at any age should be less than that adopted for that age by the 1980 Conference.

The Committee also recommends that the interest factors that are multiplied by the immediate gift annuity rates to produce the deferred gift annuity rates be based on an interest assumption of 4½ % per year, compounded annually, for each of the first ten complete years of the deferred period, 4% during each of the second ten years, 3½ % during each of the third ten years, and 3% thereafter.

**HISTORICAL COMPARISON OF MAXIMUM ANNUAL
IMMEDIATE GIFT ANNUITY RATES ADOPTED BY THE
CONFERENCE ON GIFT ANNUITIES**

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>	<u>F</u>	<u>G</u>	<u>H</u>	<u>I</u>	<u>J</u>
	<u>Date of Conference Action</u>									
<u>Age</u>	<u>4/29/27</u>	<u>3/17/31</u>	<u>11/20/34</u>	<u>10/5/39</u>	<u>10/4/55</u>	<u>4/7/65</u>	<u>4/15/71</u>	<u>5/2/74</u>	<u>5/4/77</u>	<u>5/8/80</u>
35	5.1%	4.9%	3.0%	2.5%	3.0%	3.0%	4.0%	4.0%	4.5%	5.0%
40	5.2	5.0	3.5	3.0	3.5	3.5	4.0	4.3	4.8	5.3
45	5.4	5.2	4.0	3.5	3.7	4.0	4.4	4.5	5.0	5.5
50	5.6	5.3	4.5	4.0	3.9	4.2	4.6	4.7	5.2	5.7
55	5.8	5.5	5.0	4.5	4.2	4.4	4.9	5.1	5.6	5.9
60	6.2	5.8	5.3	4.7	4.5	4.7	5.2	5.5	5.8	6.2
65	6.8	6.2	5.7	5.1	5.0	5.2	5.6	6.0	6.2	6.6
70	7.6	6.7	6.2	5.5	5.5	5.7	6.2	6.6	6.8	7.1
75	8.7	7.3	7.0	6.2	6.3	6.5	7.0	7.4	7.7	7.9
80	9.0	8.0	8.0	7.0	7.4	7.6	8.2	8.5	9.0	9.2
85	9.0	8.0	8.0	7.0	7.4	8.0	9.7	10.0	10.5	11.2
90	9.0	8.0	8.0	7.0	7.4	8.0	10.0	10.0	12.0	14.0

ACTUARIAL ASSUMPTIONS

Column Above	Mortality Basis			Annual Interest Rate	Residuum as a Percent of Principal	Expense Loading on Total Principal	Ages at Which Tabular Rates are Modified
	Table*	Age Rating	Sex of Lives				
A	McC	0	Male	4½%	70%	0	Older
B	AA	"	Female	"	"	"	"
C	CA	"	"	4%	"	"	Younger & Older
D	"	-2	"	3%	50%	"	"
E	SA	-1	"	3½%	"	5%	"
F	1955 AA	0	"	"	"	"	"
G	"	"	"	4%	"	"	"
H	"	"	"	4½%	"	"	"
I	IAM	-1	"	5%	"	"	"
J	"	-2	"	5½%	"	"	"

- *McC - McClintock Table of Mortality
- AA - American Annuitants Table
- CA - Combined Annuity Table
- SA - 1937 Standard Annuity Table
- 1955 AA - 1955 American Annuity Table
- IAM - 1971 Individual Annuity Mortality Table

In all cases it has been assumed that the annuity is payable in semi-annual installments at the end of each six months.

SCHEDULE 1

**MAXIMUM ANNUAL IMMEDIATE GIFT ANNUITY
RATES-SINGLE LIFE**

Age	Present	Proposed	Increase	Age	Present	Proposed	Increase
35 and under	5.0%	6.0%	1.0%	65	6.6%	7.3%	.7%
36	5.1	6.1	1.0	66	6.6	7.4	.8
37	5.2	6.1	.9	67	6.7	7.5	.8
38	5.2	6.1	.9	68	6.8	7.6	.8
39	5.3	6.2	.9	69	7.0	7.7	.7
40	5.3	6.2	.9	70	7.1	7.8	.7
41	5.3	6.2	.9	71	7.2	7.9	.7
42	5.4	6.3	.9	72	7.4	8.0	.6
43	5.4	6.3	.9	73	7.5	8.2	.7
44	5.4	6.3	.9	74	7.7	8.3	.6
45	5.5	6.4	.9	75	7.9	8.5	.6
46	5.5	6.4	.9	76	8.1	8.7	.6
47	5.6	6.5	.9	77	8.3	8.9	.6
48	5.6	6.5	.9	78	8.6	9.1	.5
49	5.7	6.5	.8	79	8.9	9.4	.5
50	5.7	6.5	.8	80	9.2	9.6	.4
51	5.8	6.6	.8	81	9.5	9.9	.4
52	5.8	6.6	.8	82	9.9	10.2	.3
53	5.9	6.6	.7	83	10.3	10.6	.3
54	5.9	6.7	.8	84	10.7	10.9	.2
55	5.9	6.7	.8	85	11.2	11.4	.2
56	6.0	6.8	.8	86	11.7	11.8	.1
57	6.0	6.8	.8	87	12.2	12.3	.1
58	6.1	6.9	.8	88	12.8	12.8	0
59	6.1	6.9	.8	89	13.4	13.4	0
60	6.2	7.0	.8	90 and over	14.0	14.0	0
61	6.3	7.0	.7				
62	6.3	7.1	.8				
63	6.4	7.1	.7				
64	6.5	7.2	.7				

ACTUARIAL ASSUMPTIONS

All rates provide for a residuum of 50% of principal, an expense loading of 5% of principal and annuity payments in semi-annual installments at the end of each six months.

The mortality and interest assumptions are as follows:

Present Rates: 1971 Individual Annuity Mortality Table, female lives with ages rated as two years younger; interest at the rate of 5 ½ %; tabular rates modified at ages under 49 and over 86.

Proposed Rates: 1983 Table a, female lives with ages rated as one year younger; interest at the rate of 6 ½ %; tabular rates modified at ages under 45 and over 88.

SCHEDULE 2

ILLUSTRATIONS OF MAXIMUM ANNUAL IMMEDIATE GIFT ANNUITY RATES — TWO LIVES — JOINT AND SURVIVOR

Age of Older Life	Present			Proposed			Increase		
	Present	Proposed	Increase	Present	Proposed	Increase	Present	Proposed	Increase
Age of Younger Life									
	35 and under			40			45		
35	4.8%	5.8%	1.0%						
40	4.8	5.8	1.0	5.1%	6.0%	.9%			
45	4.8	5.8	1.0	5.1	6.0	.9	5.3%	6.2%	.9%
50	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
55	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
60	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
65	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
70	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
75	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
80	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
85	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
90	4.8	5.8	1.0	5.1	6.0	.9	5.3	6.2	.9
	50			55			60		
50	5.5%	6.3%	.8%						
55	5.5	6.3	.8	5.6%	6.4%	.8%			
60	5.5	6.3	.8	5.7	6.5	.8	5.8	6.6	.8%
65	5.5	6.3	.8	5.7	6.5	.8	5.9	6.7	.8
70	5.5	6.3	.8	5.7	6.5	.8	6.0	6.7	.7
75	5.5	6.3	.8	5.7	6.5	.8	6.0	6.8	.8
80	5.5	6.3	.8	5.7	6.5	.8	6.0	6.8	.8
85	5.5	6.3	.8	5.7	6.5	.8	6.0	6.8	.8
90	5.5	6.3	.8	5.7	6.5	.8	6.0	6.8	.8
	65			70			75		
65	6.0%	6.8%	.8%						
70	6.2	6.9	.7	6.4%	7.1%	.7%			
75	6.3	7.0	.7	6.6	7.3	.7	6.9%	7.6%	.7%
80	6.4	7.1	.7	6.8	7.5	.7	7.3	7.9	.6
85	6.4	7.1	.7	6.9	7.6	.7	7.5	8.1	.6
90	6.4	7.1	.7	6.9	7.6	.7	7.7	8.3	.6
	80			85			90		
80	7.8%	8.3%	.5%						
85	8.3	8.7	.4	9.1%	9.4%	.3%			
90	8.6	9.0	.4	9.8	10.0	.2	11.1%	11.1%	0%

ACTUARIAL ASSUMPTIONS

All rates provide for a residuum of 50% of principal, an expense loading of 5% of principal and annuity payments in semi-annual installments at the end of each six months.

The mortality and interest assumptions are as follows:

Present Rates: 1971 Individual Annuity Mortality Table; female lives with ages rated as two years younger; interest at the rate of 5½%; tabular rates modified at younger and older ages.

Proposed Rates: 1983 Table a, female lives with ages rated as one year younger; interest at the rate of 6½%; tabular rates modified at younger and older ages.

SCHEDULE 3

REPORT ON STATE REGULATIONS

Dr. Roland C. Matthies
*Vice President and Treasurer Emeritus
of Wittenberg University*

Hearty greetings to all of you! And a special welcome to the many "First Timers" who are here to learn, to experience, to gain. From my perspective of twenty-eight years as a member of the Committee on Gift Annuities, these conferences are packed with needed information, never "old hat." They provide an excellent forum to showcase the role of the professional as a volunteer in serving his peers.

Now we tackle a subject and a problem — "State Regulations of Charitable Gift Annuities and Pooled Life Income Contracts." You have read in the proceedings of our previous Conferences that the subject is very much alive, and the problem becomes a bit more complex. Questions such as: Is a Charitable Gift Annuity a security? Is there Federal preemptive legislation on this matter? Is a Pooled Fund essentially a Trust? Does Blue Sky legislation in a state require compliance? Why is there so little case law on the subject? How does the Securities and Exchange Commission get involved?

Some six years ago, the Committee on Gift Annuities created a Subcommittee to give attention to this subject. We were cautioned to always remember that we are a volunteer body not having a professional staff. Our approach has been along the line of a recent article entitled, "Caught in the Middle," by Professor Jim W. Corder of Texas Christian University where he states:*

"When I was young, alone, say in the house with my family gone, and trees or something mysterious scratched against the roof and a settling in the house made steps creak; or alone, say walking home in the dark after seeing 'The Mummy Walks,' I thought that if I would go ahead and name the ghosts that are out there, my situation would somehow be better and I could breathe again. I expect I still feel that way. If we acknowledge and name the anxieties, fears, angers, and problems that are out there waiting for us, they don't go away, to be sure, but they're not so scary or discomfiting. It's easier to deal with the ghost behind the next tree if you know what it is, or even if you just think you do."

*With permission, Association of American Colleges

Each member of the Subcommittee has assumed responsibility for a section of the country, and we have established a network of cooperative monitors. We trust that we are thus able to be aware of those "ghosts behind the next tree." As you seek information concerning regulatory attempts in the states in which your program is operating, you may wish to direct inquiries for the following indicated regional areas:

Mr. David Johnson, Vice President, St. Olaf College, Northfield, Minnesota 55507, covering Iowa, Kansas, Minnesota, Nebraska, North Dakota, South Dakota, and Wisconsin.

Dr. Chester A. Myrom, 211 Kilburn Road, Garden City, New York 11530, covering Connecticut, Delaware, District of Columbia, Florida, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Vermont, and Virginia.

Dr. Roland C. Matthies, 1205 Vester Avenue, Springfield, Ohio 45503, covering Illinois, Indiana, Kentucky, Michigan, Ohio, Tennessee, and West Virginia.

Richard James, Esq., Secretary of the Corporation, Loma Linda University, Loma Linda, California 92354, covering Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, and Wyoming.

Mr. Tal Roberts, Vice President and Trust Counsel, Baptist Foundation of Texas, P.O. Box 1409, Dallas, Texas 75221, covering Alabama, Arkansas, Georgia, Louisiana, Mississippi, Missouri, New Mexico, Oklahoma, and Texas.

Please mail all inquiries to the New York office. We will do our best to be of help.

In line with our report to the Conference of three years ago, we continue to note tremendous growth in the area of deferred giving. Turnover in personnel has lessened with our downgraded economy. There is a real growth in professionalism here. The Council for the Advancement and Support of Education, known as "CASE," has been a leader. We remain convinced that unrealistic offerings, extreme advertising, and poor investment practices are pretty well behind us. We are creditable! AND YET — more regulatory efforts are on the scene.

First, the usual DISCLAIMERS:

1. State and municipal efforts to regulate charitable *SOLICITATIONS* are not within our scope of activity. That is an area thoroughly covered by reports from the American Association of Fund-Raising Counsel. Their issue of December 15, 1982, in their publication entitled "Fund Raising Review," gives a complete compilation of state laws regulating charitable *solicitations*. Copies may be obtained by contacting the AAFRC at 25 West Forty-Third Street, New York City, New York 10036, or by telephoning 212-354-5799. Copies are available at \$1 each.

2. The Committee on Gift Annuities, and this Subcommittee, made up of volunteers and without professional staff, is unable and unwilling to "police" our area of concern.

Now, for a few basics:

Basic Number 1. A Charitable Gift Annuity is a contract acknowledging a gift and agreeing to lifetime payment to one or, at most, two beneficiaries. The assets of the charitable institution back up the agreement.

Some states consider this a form of insurance and so seek to regulate. Other states designate the Charitable Gift Annuity as a security. Some states have specific legislative enactments covering Charitable Gift Annuities. Others rely upon staff interpretation. A majority of the states continue to ignore the matter.

To the best of our knowledge, and based upon what we believe to be accurate information, the following states are attempting to regulate the issuance of Charitable Gift Annuities:

Arizona, Arkansas, California*, Delaware*, Florida*, Illinois, Iowa*, Maine*, Maryland*, Michigan, Minnesota, Nevada, New Jersey*, New York*, Ohio, Oklahoma*, Oregon*, South Carolina*, Utah, Washington*, Wisconsin*.

We refer you to Section 961, Prentice-Hall's work on Charitable Giving for a very recent report by Charles Horn and John Herbitter. They provide a survey of state statutes covering Charitable Gift Annuities (thirteen of the above states as indicated by the asterisks).

Note well that several of the states listed in that article limit, by statute, the liability of the *state* institutions to the assets given, thus effectively constricting the undergirding of Charitable Gift Annuities issued by such *state* institutions. Accordingly, one of the prime advantages of a Charitable Gift Annuity, the backing of the *entire assets* of the charity, is denied.

Also, see Section 3037, Prentice-Hall's work on Tax Exempt Organizations for a comprehensive 1977 report by Robert L. Toms and Edwin C. Summers, which report continues unrevised in the 1983 edition.

Basic Number 2. A Pooled Life Income Fund is essentially a *Trust*, far different from a Charitable Gift Annuity. At the national level, the Securities and Exchange Commission has issued its well-publicized "No action" letter. In other words, as long as the SEC believes we are acting in good faith and giving proper information to our prospects, there will not be a Federal registration required.

But what about our fifty states?

We refer you to a thorough presentation to the Sixteenth Conference by Attorney Julius P. Fouts, from which the following is a direct quote:

"Tax exempt organizations have been reluctant to recognize the applicability of Federal and State securities laws to certain of their fund-raising activities, including, notably, their Pooled Income Funds. The uncertainty as to whether such funds are within the ambit of securities regulation and the concern of incurring the expense and administrative burden that might result from complying with such laws have combined to produce what some have called the 'Ostrich Syndrome.' It has been feared that if one or more major charities complied with such laws, other charities might be compelled to follow suit. It has also been hoped that a national legislative solution would render 'Blue Sky' registration unnecessary. And, implicitly, it has been felt that Pooled Income Funds organized and managed by nationally prestigious institutions simply should not have to be regulated in the same manner as profit-oriented public corporations.

"As most of you will know, the Blue Sky laws apply to a given transaction only if a 'security' is involved....

"Registration provisions of Blue Sky laws are elaborate and

often compliance is costly. Two forms of registration exist: registration of securities and registration of the organization as well as the individuals involved in effecting securities transactions....

"In view of the controls to which Pooled Income Funds are already subjected under tax and securities laws, few state authorities believe that any genuine public interest is served by regulating such funds. As each state has its own particular scheme or regulation, the burden on charities to conform to state Blue Sky laws, particularly as to disclosure, creates administrative costs that may outweigh the benefits expected to be obtained from this form of fund raising for all but the most well-established national charities...."

On the other hand, a large bank, acting as trustee over a Pooled Fund, takes the position that since a Trust is involved, control is in the SEC and no state registration is required.

Basic Number 3. Assuming that everything is going well with regard to your Charitable Gift Annuity and/or Pooled Income Fund activities in your *home* state, what about the necessity for registration in the other states where you have been soliciting or intend to solicit such gifts?

Is an occasional mailing to a select list of friends, or an ad in your national periodical, or an agreement signed in your home office, or regular visits by staff to interested possible benefactors, or having a non-paid volunteer representative call on prospects enough to require registration in those states?

There are no "pat" answers.

By now you may be so discouraged that you will want to adopt the "Ostrich Syndrome." But have heart! Turn to your legal counsel, but be sure that office has had experience in this field. When your board of trustees has acted upon that legal advice, then:

1. Make certain that proper motions have been adopted and minutes recorded covering authorization for your deferred giving program and such registration compliance as is being authorized.
2. Be sure that there is a written statement "in-house" as to registration procedures, if any, to be followed.

3. Keep records. Keep records. Keep records!

The members of this Subcommittee are in agreement that our long-standing commentary should be stated once more: "Don't muddy the waters in your state by inquiring of state officials as to what regulations need to be met."

**ROSTER
COMMITTEE ON GIFT ANNUITIES
MONITORS FOR STATE REGULATION
1983**

JAMES

ALASKA

Eugene B. Starr (905-279-2455)
718 Barrow Street
Anchorage AK 99501

ARIZONA

C. J. Owens, Director
Trust Service Department
P. O. Box 5317
Phoenix AZ 85010

HAWAII

CALIFORNIA

R. A. James, Esq.
Office of Legal Counsel
Loma Linda University
Loma Linda CA 92350

COLORADO

Elder I. B. Burton
2520 South Downing Street
Denver CO 80210

IDAHO

Leon Cornforth, Director
Trust Services
7777 Fairview
Boise ID 83704

MONTANA

Fred M. Beavon
P. O. Box 743
Bozeman MT 59715

NEVADA *and* UTAH

Elder Max Torkelsen
P. O. Box 10730
Reno NV 89510

ROSTER
COMMITTEE ON GIFT ANNUITIES
MONITORS FOR STATE REGULATION
1983, *continued*

OREGON	James K. Hopps, Esq. P. O. Box 16677 Portland OR 97216
WASHINGTON	David R. Duncan, Esq. P. O. Box 906 Bothell WA 98011
WYOMING	E. L. Eder P. O. Box 620 Casper WY 82602
ROBERTS	
ALABAMA	U. A. McManus Baptist Foundation of Alabama P. O. Box 11870 Montgomery AL 36111
ARKANSAS	Harry D. Trulove Arkansas Baptist Foundation P. O. Box 552 Little Rock AR 72203
LOUISIANA	Dickie Patterson Pittman, Matheny, Lewis & Moody P. O. Box 1598 Hammond LA 70404
MISSISSIPPI	Harold T. Kitchings Mississippi Baptist Foundation P. O. Box 530 Jackson MS 39205
MISSOURI	Frank Denton Missouri Baptist Foundation Baptist Building Jefferson City MO 65101
NEW MEXICO	Lee Black New Mexico Baptist Foundation P. O. Box 485 Albuquerque NM 87103

OKLAHOMA

C. Fred Williams
Baptist Foundation of Oklahoma
1141 North Robinson
Oklahoma City OK 73103

GEORGIA

Donald L. Folsom
Georgia Baptist Foundation, Inc.
Baptist Center, Flowers Road, S.
Atlanta GA 30341

MYROM

CONNECTICUT

R. Christian Hansen
Director of Development
Lutheran Service Association
of New England, Inc.
74 Sherman Street
Hartford CT 06105

NEW JERSEY

George A. Fenwick
Assistant to the President
Upsala College
East Orange NJ 07019

PENNSYLVANIA

Harold W. Anderson
750 Kelly Drive
P. O. Box 1344
York PA 17405

Richard E. Walker
Assistant Director of
Development for Estate Planning
Gettysburg College
Gettysburg PA 17325

DISTRICT OF
COLUMBIA

Gilbert C. Askew, Director
Development and Public Relations
National Lutheran Home
9701 Veirs Avenue
Rockville MD 20850

MASSACHUSETTS

John Bowen
Director of Development
Endicott College
Beverly MA 01915

VIRGINIA

Benjamin Case
Director of Planned Giving
Roanoke College
Salem VA 24153

ROSTER
COMMITTEE ON GIFT ANNUITIES
MONITORS FOR STATE REGULATION
1983, *continued*

- | | |
|----------------|---|
| NORTH CAROLINA | Clarence L. Pugh
Vice President for Development
Lenoir-Rhyne College
Hickory NC 28601 |
| SOUTH CAROLINA | Richard S. Cope
Vice President for Research and
Development
Newberry College
Newberry SC 29108

The Reverend Curtis E. Derrick, Jr.
Director for Development
Lutheran Theological Southern
Seminary, Columbia SC 29203 |
| JOHNSON | |
| IOWA | Alfred L. Disrud
Vice President for Development
Wartburg College
Waverly IA 50677 |
| KANSAS | Kenneth Sjogren
Director of Development
Bethany College
Lindsborg KS 67456 |
| MINNESOTA | David E. Johnson
Vice President
St. Olaf College
Northfield MN 55057 |
| NEBRASKA | Eugene L. Meyer
Executive Director of College
Relations
Dana College
Blair NB 68008 |
| NORTH DAKOTA | Tom Gunderson
Assistant to the President
Jamestown College
Jamestown ND 58401 |
| SOUTH DAKOTA | Robert Evenson
Vice President for Development
Augustana College
Sioux Falls SD 57197 |

WISCONSIN

Stephen A. Hirby
Manager of Planned Giving
Lawrence University
Appleton WI 54912

MATTHIES
ILLINOIS

William Z. Cline
Director of Trust, Annuity and
Bequest Programs
American Bar Association
77 South Wacker
Chicago IL 60606

INDIANA

William O. Powell, Jr.
Vice President for Financial
Development
Butler University
Indianapolis IN 46208

KENTUCKY

C. Dennis Riggs
Vice President
Bellarmine College
Newburg Road
Louisville KY 40205

MICHIGAN

Robert E. Debrodt
Associate Director
Development Council
University of Michigan
Ann Arbor MI 48109

OHIO

The Reverend Raymond F. Wolf
University Relations
Capital University
Columbus OH 43209

TENNESSEE

Michael F. Hitchcox
Director of Estate Planning
University of Tennessee
Knoxville TN 37916

WEST VIRGINIA

Herbert L. Sharp
Director of Deferred Giving
West Virginia Wesleyan College
Buckhannon WV 26201

CANADIAN TAXATION

Rev. Robert M. Bartlett

Director of Annuities, The United Church of Canada

Deduction of Charitable Donations

The legal authority for the deduction of charitable donations in calculating taxable income under Canada's income tax law is Section 110 (1)(a) of the Income Tax Act (Canada). That section provides for the deduction of gifts to registered charities, registered Canadian amateur athletic associations, housing corporations resident in Canada and exempt from tax, Canadian Municipalities, the United Nations, and certain universities and charities outside Canada, provided that the aggregate of such deductions in any taxation year cannot exceed 20 per cent of the taxpayer's income for the year.

Prior to the April 19, 1983 Budget, any excess over this 20 percent limit could be carried forward one year only. When the budget presented to Parliament on April 19, 1983 by the Honourable Marc Lalonde is formally adopted, as is expected shortly, the carry-forward period will be extended to five years. Perhaps even more significant for charities this new budget will eliminate the automatic standard deduction of \$100.00 for charitable gifts and henceforth require official receipts before any deduction is permitted. While there will be general acclaim by charities to this legislation it will nevertheless be widely regretted a proposed tax credit incentive was not implemented at this time.

What Is A Charity?

"Registered Charity" is defined in the Income Tax Act to mean a foundation with exclusively charitable purposes or an organization with exclusively charitable activities. However, as there is no definition of "charitable activities" or "charitable purposes" in the Act, recourse must be had to the common law for guidance as to their meaning.

Historically for an entity to be considered charitable its work had to be directed to one of the following:

- (1) the relief of poverty,
- (2) the advancement of religion,
- (3) the advancement of education, or

- (4) the advancement of other purposes of a charitable nature beneficial to the community.

This is still the test applied by Revenue Canada.

Gifts To Charities

Gifts to charities can take a form other than money. Interpretation Bulletin IT 297 defines "gift" as a voluntary and gratuitous transfer of real or personal property. Gifts of tangible capital property, gifts of life insurance policies and gifts of partnership interests and residual interests are all now recognized as legitimate forms of gifts. However donations of services do not qualify as charitable gifts.

Generally for a transfer of real or personal property to qualify as a gift, it must not entitle the donor to any right, privilege, material benefit or advantage. Revenue Canada has recognized, however, that certain transactions with charities from which the donor obtains a benefit may include a gift component. Tickets to functions the cost of which not only covers admission to the function but includes a gift amount, and the purchase of annuities, fall into this category and are covered by Interpretation Bulletins.

Annuities

In the case of annuity contracts the amount by which the purchase price paid for the annuity contract exceeds the total amount expected to be received as annuity payments under the contract because of life expectancy is treated as a charitable donation qualifying for a charitable receipt.

In Interpretation Bulletin IT-111 Revenue Canada has prescribed the method for calculating the charitable gift resulting from the purchase of an annuity contract from a charity. The annual payments to the annuitant are multiplied by the number of yearly installments expected, based on the age of the annuitant at the time of making the arrangement, the product being the total amount expected to be received by the annuitant under the contract. For the purpose of these calculations the annuitant's age is determined by subtracting the calendar year of the annuitant's birth from the calendar year in which the arrangement is made. The effect of this provision is that it is the age of the annuitant at December 31 in the year in which the contract is made that is

used to calculate the number of yearly installments expected, and therefore the charitable gift involved irrespective of when in the year the arrangement was made.

The table contained in IT-111 cannot now be used directly as the Income Tax Regulation requires when the annual payments under the annuity commence after 1971 the annuitant's age, determined as above described, must be reduced by two years.

Tangible Capital Property

In the case of gifts of tangible capital property section 110(2.2) requires that for the gift to qualify as a charitable gift, the property must be property that could, at that time, reasonably be regarded as being suitable for use by the donee directly in the course of carrying on its charitable activities.

Registration of Charities

1976 was the year of major revisions to the provisions of the Income Tax Act applicable to charities. Prior to that year any organization or corporation whose objects fell within the common law definition of charitable purposes, and which qualified as either a charitable organization, non-profit corporation or charitable trust was exempt from tax. Registration was only required if the charity wished to be able to issue receipts for gifts which would entitle the donor to a charitable deduction for income tax purposes. At the same time the only effect of revocation of a charity's registration was that it could no longer issue tax receipts. Revocation did not affect its tax exempt status.

Since 1976 registration is required for both tax exempt status and the power to issue tax receipts, and revocation of registration has draconian effects.

Classes of Charities

The 1976 amendments also ushered in a new classification of charities. Charitable organizations, public foundations and private foundations are the classes into which charities are divided, and each class is subject to its own set of detailed rules.

What distinguishes a charitable organization from a foundation is the proportion of its income expended on its own charitable activities as opposed to on grants to other charities. Generally if more than 50% of a charity's income for the year is donated to

others, the charity is a foundation. Otherwise it is a charitable organization. I qualified this statement by saying "generally" because grants to other charities which are considered "related charities" by Revenue Canada do not count as grants to others.

Public foundations are distinguished from private foundations in that in the case of the former more than 50% of the directors or trustees deal with each other at arm's length, and not more than 75 per cent of the capital contributed to the foundation has been paid in by persons who do not deal with each other at arm's length.

Code of Conduct

Any charitable organization or public foundation may have its registration revoked if it carries on an unrelated business, or if it fails to expend in any year an amount equal to at least 80 per cent of the amount of donations for which it issued receipts in the previous year. This 80 per cent expenditure test is subject to a number of ameliorating rules which permit with Minister's approval accumulations for particular purposes, and the carry forward of any excess expenditures over receipted donations in order to cover any shortfall in the succeeding three years. The application of this 80 per cent expenditure test to public foundations differs from its application to charitable organizations in that the former need not include in receipted donations, receipted gifts which are subject to a direction that they be held for 10 years or more.

Public foundations are subject to an additional expenditure test, by which they are required to disburse at least 90 per cent of their current year's net income. For the purpose of this requirement income again excludes gifts which the foundation is required to hold for 10 years, and also excludes certain other gifts. Public foundations are also prohibited from incurring any debts, except debts for current operating expenses.

The requirements on private foundations are most stringent of all. They are not permitted to carry on any business at all, and as to disbursement quotas, these foundations are subject to the 90 per cent of net income tests applicable to public foundations with a significant twist. If a private foundation holds investment properties entitled "capital properties", which include loans to individuals and companies which do not deal with the foundation

at arm's length and shares in such companies, and 90 per cent of the income derived from those properties does not amount to 5 per cent of the fair market value of those properties, then in addition to 90 per cent of the income derived from the other assets of the foundation, it will have to expend an amount equal to at least 5 per cent of the value of such "capital properties". The effect is that private foundations are required annually to obtain valuation of such capital properties.

Revocation of Registration

Failure by a registered charity to comply with the rules applicable to it can, in the discretion of the Minister, result in revocation of registration. In the new scheme of things the consequences of such revocation are severe. A registered charity whose registration is revoked has one year within which to pay its bona fide debts and reasonable expenses, and then to dispose of the balance of its assets to other registered charities. Any assets not so disposed of are subject to a 100 per cent punitive tax.

FORMULA FOR CALCULATING TAXABLE INCOME WITH RESPECT TO ANNUITY GIFT AGREEMENTS

1. Determine the life expectancy of the annuitant(s) as from age at date of gift in accordance with the tables set forth on pages 382, 386 and 387 (or comparable tables in subsequent editions) of Mercer's Canadian Handbook of Pension and Welfare Plans (1959) and with ages reduced by two years;
2. Multiply the life expectancy by the rate of annuity payable in order to arrive at the capital return over the span of life expectancy;
3. Divide the rate of annuity by the amount of the capital return to arrive at the non-taxable amount;
4. Subtract the non-taxable amount from the rate of annuity in order to determine the taxable portion per \$100.00.

TAXABLE INCOME — MALES

(adjusted as per Interpretation Bulletin IT-111)

Age at Date of Gift	Life Expectancy	Rate of Annuity	Taxable Portion per \$100 of Gift	Tax-Free Portion
60	18.9	9.8%	\$4.51	\$ 5.29- 54.0%
61	18.2	9.9	4.41	5.49- 55.5
62	17.6	10.0	4.32	5.68- 56.8
63	16.9	10.1	4.18	5.92- 58.6
64	16.2	10.2	4.03	6.17- 60.5
65	15.6	10.3	3.89	6.41- 62.2
66	15.0	10.4	3.73	6.67- 64.1
67	14.4	10.5	3.56	6.94- 66.1
68	13.8	10.6	3.35	7.25- 68.4
69	13.2	10.7	3.12	7.58- 70.8
70	12.7	10.9	3.03	7.87- 72.2
71	12.1	11.0	2.74	8.26- 75.1
72	11.6	11.2	2.58	8.62- 77.0
73	11.1	11.4	2.39	9.01- 79.0
74	10.6	11.6	2.17	9.43- 81.3
75	10.1	11.8	1.90	9.90- 83.9
76	9.6	12.0	1.58	10.42- 86.8
77	9.2	12.3	1.43	10.87- 88.4
78	8.7	12.5	1.01	11.49- 91.9
79	8.3	12.8	.75	12.05- 94.1
80	7.9	13.2	.54	12.66- 95.9
81	7.5	13.5	.17	13.33- 98.7
82	7.1	13.9	.00	13.9 -100
83	6.7	14.3	.00	14.3 -100
84	6.4	14.7	.00	14.7 -100
85	6.0	15.0	.00	15.0 -100

(Charitable Receipts begin at age 82 years)

TAXABLE INCOME — FEMALES
(adjusted as per Interpretation Bulletin IT-111)

Age at Date of Gift	Life Expectancy	Rate of Annuity	Taxable Portion per \$100 of Gift	Tax-Free Portion
60	22.5	9.8%	\$5.36	\$ 4.44- 45.3%
61	21.8	9.9	5.31	4.59- 46.4
62	21.0	10.0	5.24	4.76- 47.6
63	20.3	10.1	5.17	4.93- 48.8
64	19.6	10.2	5.10	5.10- 50.0
65	18.9	10.3	5.01	5.29- 51.4
66	18.2	10.4	4.91	5.49- 52.8
67	17.6	10.5	4.82	5.68- 54.1
68	16.9	10.6	4.68	5.92- 55.8
69	16.2	10.7	4.53	6.17- 57.7
70	15.6	10.9	4.49	6.41- 58.8
71	15.0	11.0	4.33	6.67- 60.6
72	14.4	11.2	4.26	6.94- 62.0
73	13.8	11.4	4.15	7.25- 63.6
74	13.2	11.6	4.02	7.58- 65.3
75	12.7	11.8	3.93	7.87- 66.7
76	12.1	12.0	3.74	8.26- 68.8
77	11.6	12.3	3.68	8.62- 70.1
78	11.1	12.5	3.49	9.01- 72.1
79	10.6	12.8	3.37	9.43- 73.7
80	10.1	13.2	3.30	9.90- 75.0
81	9.6	13.5	3.08	10.42- 77.2
82	9.2	13.9	3.03	10.87- 78.2
83	8.7	14.3	2.81	11.49- 80.3
84	8.3	14.7	2.65	12.05- 82.0
85	7.9	15.0	2.34	12.66- 84.4
86	7.5	15.0	1.67	13.33- 88.9
87	7.1	15.0	.92	14.08- 93.9
88	6.7	15.0	.07	14.93- 99.5
89	6.4	15.0	.00	15.00-100.

(Charitable Receipts begin at age 89 years)

NOTE: Taxable Income in connection with Joint Survivor Annuity Gifts to be calculated on an individual basis.

DESIGNING AN INCOME STREAM PROGRAM TO MEET DONOR'S FAMILY GOALS

John S. Ryan

*Director of Planned Giving
University of Minnesota Foundation*

I. INTRODUCTION

The charitable industry is in crisis, and the need for increased private support is making itself felt not only by the churches and educational institutions but by all the agencies represented here today. We all know that bequests represent one of the greatest potential sources for meeting these needs. In my opinion, bequest fundraising is also one of the easiest ways to raise money — as well as being one of the most comfortable places to start for certain donors. For this reason, I would like to put major emphasis today on the raising of large gifts through bequests and on working with the older donor.

Having spent 17 years in the Northeast calling on friends of Wheaton College and the last 6 years with the University of Minnesota, I speak from a background in both private and public, religious and secular fundraising. Furthermore, I have discovered that fundraising at a great university system like the University of Minnesota is representative of fundraising for almost the entire spectrum of charitable organizations, because within such a system there are examples of almost every type of charitable cause, with the possible exception of religion.

In exploring the possibilities inherent in bequest fundraising, I am going to make my main focus "what's left." People work their entire lives to accumulate resources. By deciding whom they will benefit with this "what's left," people are attempting to exercise some measure of control over this product of their life's work. Even those who claim there won't be anything left have to face the task of deciding what to do if, in fact, there is "something" left.

Fairly early in my career I noticed that some of the things I found happening with donors and prospects didn't dovetail very well with the orthodoxy being taught by the charitable industry. Because of a speaking engagement, I decided to write down

everything I was going to say, and this forced me to begin analyzing for the first time *why* the people I've worked with have given something away. The result of this exercise was a number of important surprises, surprises which I am going to share with you today.

First of all, I would like to dispell what I see as some common misconceptions about donors. Just what does a "real" donor look like? I sense that many in the charitable industry believe that the real donors will make a lot of money; they will be very "successful," will drive the "right" car and display all the accouterments of wealth—that they pile their money onto a Brinks truck and the Brinks truck delivers it to the bank. According to this logic, it should be fairly easy to figure out who the "donors" are.

Now, although I have obviously reduced this mindset to the level of absurdity in making my point, I have found that fund-raisers are often much more closed-minded than donors. For example, some time ago a professional fund-raiser I knew mentioned that he had visited a fairly wealthy man at his home. When I ran into this colleague at a local restaurant one day, he indicated that the individual was "not a prospect." I asked why, and my colleague explained that the man had a family. "Did you discuss that with him?" No, he said. Don't assume that a prospect's interest in an heir automatically excludes a charitable gift. This is a big mistake development people frequently make.

Some additional don't assumes: Don't assume that donors know what they want to do. Don't assume that they are happy with their present plans. Don't assume that they won't change their minds. Don't assume that their lives have been beautiful. Don't assume that they have someone to confide in.

II. *STAGES OF LIFE*

One of our major donors once made a very revealing comment regarding this issue. She said, "You focus on money until you have enough money that you don't have to worry about it, and then money becomes something you don't have to think about any more. Then you start thinking about values."

My experience has been that older donors usually have no desire to increase their estates. While most of us here are working

and accumulating resources, looking forward to the day that we'll have enough money to be able to retire or engage in something we're looking forward to, the typical older donor has already reached that point. The older donor usually has surplus or adequate income. (Many of the people I have worked with have more income coming in during their retirement years than they ever did during their working years! In fact, they sometimes have so much income that every six months they buy an additional certificate or treasury note.)

These people are at a time in life where they still have the physical energy and health to spend some of this money, but this period is really very limited. Usually there comes a time, particularly with couples, that there is a health breakdown, and they do not have the capacity to spend the money that is coming in. At this point, the surplus income often begins to compound and grow at a surprising rate.

Yet, paradoxically, many of these people have a tremendous concern — an almost paranoid concern — over having enough money to see them through. I remember a lady who had several million dollars telling me in all seriousness one day that her rent was going up from \$225 to \$250 per month, and that she didn't know how she was going to be able to pay the increase. It wasn't that she was lying; rather, it was her heart speaking, recalling the hard times of the Depression era. She "thought poor" even though she was quite wealthy. I have found this concern — will I have enough to see me through? — to be extremely widespread. We've got to remember this when we're dealing with older people.

Another important point about older donors is that they generally either have established heirs or they don't have any heirs at all. Moreover, those who have heirs rarely have any measurable idea of how much individual heirs will get under their present estate plan. One reason for this is the use of percentages. (I am not discouraging the use of percentages. I'm just saying that this does contribute to the complexity of determining how much someone is going to get.)

I remember visiting with a well-known, financially "comfortable" author about six months ago. I was having some difficulty explaining some of the above concepts, until I tried explain-

ing it this way. I asked, "Do you have any idea how much your three boys would get, if you and your husband were to be killed in a plane crash tomorrow?" She said, "Absolutely none." Try it some time when you're at a party and people are feeling sorry for you because you are a fundraiser. Try asking them that same question, and you will find you get some very strange, blank looks. People have no measurable idea how much their heirs will receive.

In addition, while donors are generally concerned with privacy, many don't have anyone with whom they can discuss their concerns and fears, and this is a real need for them. They are often concerned about shrinkage — the "monster" of probate and taxes (although, ironically, they usually have no measurable idea of how much that shrinkage will amount to). I don't find this a big element in the closing of charitable gifts, but this is certainly a factor in causing people to come to the surface and inquire.

Another common concern is that of "control." Older people find themselves losing hearing, vision, health, friends, and family. People offer to assist them, want to assist them with their finances, their checking accounts, etc. They sense themselves losing control, yet they are desperately trying to retain control. They would prefer not to let others make decisions concerning their money; yet, they are in a quandary.

I remember many years ago visiting a gentleman I will call Ed, who told me he was dissatisfied with the way his estate plan was drawn up. He had told me that his friend, Jack, was a local attorney and that he had a lot of confidence in him, so he did not lack counsel. I said, "Well, why don't you go down and see Jack — tell him what you're dissatisfied with and have him make the corrections, so that you feel good about where your money is going." He indicated that he couldn't do that. I said, "Excuse, me — I don't understand. You've worked for 50 years to accumulate your assets. You don't like who's going to get your money, you've got a good attorney, and you can't go down and change your will? Why?" "Because," Ed answered, "Jack will ask me what I want to do, and I don't know what I want to do."

This story has proved one of the most effective fundraising tools I've ever come across. Over the last 20 years I've beat that story to death, because I have found that when I share that story

with an older person, it is a rare individual who doesn't identify with Ed's problem. People usually do not have an estate plan they are happy with, and this story is a tremendous vehicle for helping them open up and share their confusion and frustrations.

I am convinced that the ability to help people out of their quandary is one of the most important "skills" a bequest fundraiser can acquire. However, I think that our typical reaction, when we find someone who doesn't know what he or she wants to do, is to say, "Perhaps by the time I get back here during my semi-annual trip you will have decided what you want to do, and we can sit down and discuss it...." Or, "I know you've told me of your strong interest in my charity. When you've decided what you want to do, get in touch with me — if I can provide any assistance, I will." Here are some more "don't assumes": Don't assume that it will get done, and don't assume that the donor knows what to do. The donor's quandary is a statement that he or she is out of control. Donors often feel they have lost control of their estates, their affairs, their money, and they don't like this feeling. In fact, they become extremely frustrated when this is brought out into the open. This is really a cry for help — but instead of helping donors out of this quandary, what we typically do is stop, wait and hope that something will happen. Generally, nothing ever does.

III. PROCEDURE FOR HELPING DONORS ESCAPE THE QUANDARY

I have discovered that one of the easiest ways to help a person out of this quandary is with a paper bag. I had been calling on Florence on a semi-annual basis for a couple of years and finally discovered she was in a quandary. I asked her if she would like me to give her some help making some decisions, and she said that, yes, she would. We were sitting in her kitchen at the time, so I picked up a paper bag and a pencil and wrote down two headings, one for *people* and one for *charities*.

Next, I wrote down numbers, from one to five, under each of the two column headings and told Florence that the first thing she needed to do was to decide to whom she was going to leave her money. I told her that in doing this, all she really needed was these two categories — "people" and "charities." Now, before you actually begin putting down names with a donor, you've got to

reassure the person you're dealing with what the priorities are. First, emphasize that the number one priority is to make sure he or she is protected: "It's what's good for you." Second, is to make sure that the plan takes care of the donor's heirs: "We don't want to do anything to remove assets from your heirs that you want your heirs to have." Finally come the donor's charitable interests: "After taking care of your desires for other charities, perhaps whatever's left can come to Wheaton College" (i.e., the charity you represent). Obviously, they wouldn't be talking to you and you wouldn't be there if they didn't have some interest in some of the things your charity stood for.

Getting the list filled in isn't that easy, though. The first thing I do is suggest that we simply list the names of the people the donor really cares about and wants to benefit. I tell the donor that we are not going to think about money at this point; we are just going to list the names. I will ask, "Who is the first person who comes to mind?" "Oh, I want to do something for Bill." So we'll put this down on that bag. Who is the second person that comes to mind that the donor would like to do something for? "Oh, I'd really like to do something for Mary, too." During the process of listing the names I will casually ask some question concerning the donor's reasons for being interested in a particular person.

After it seems we have completely exhausted the list of people the donor may be interested in benefiting, I will ask, "Now are you sure that there isn't anyone else that you want to do something for." If the donor answers that, no, there really isn't anyone else, I will say, "OK, but remember, this is just a beginning list — just something to help us in the process of getting some solutions. You may change this several times before we get through."

Next, I will move on to the "charities" column and ask some questions about their favorite charities.

Is there any other charity the donor would like to remember? I will frequently ask whether there isn't a church that donor may be interested in benefiting, and the donor will often say yes. (I once had a lady who said she did want to leave some money to her church. When I asked her whether she attended often, she answered that, no, she really never went — but that didn't keep

her from making a bequest to the church.)

Often the donor will begin to ask about the charitable organization I represent: "What about your charity, shouldn't we put that down too?" I will answer, "Well, I would prefer to put my organization down last, because the most important thing is you, your heirs, and the other charities. We can talk about my charity if there is anything left.

After we have listed all of the names under both the "people" and "charities" headings, the next step is to put down some numbers beside those names, some kind of measurements. This is a hard thing for people to do. In fact, the difficulty they have with this particular task is one of the main reasons that people are in a quandary. It is precisely because they have never been able to make this kind of decision, to quantify.

In helping people fill in the numbers, I have found it very useful to ask the following questions. First, "Is there an upper limit to the amount you want to give?" There may be, or there may not be. The donor might want to leave Bill everything. Nevertheless, I ask the donor to just think about the question of whether there is in fact an upper limit to the amount he or she wants to give a particular heir.

If there is an upper limit, I help the donor zero in on the right figure by asking, "Is \$5,000 enough...is \$30,000 too much?" And so on. For example, let's say we are still trying to decide how much we are going to put down for Bill. "Do you have any particular amount in mind for Bill?" "Gee, I really don't know." "Well, is \$10,000 enough?" "I don't know...I'm just not sure." "Is \$25,000 enough?" "I'm really not sure; I really don't think so." "Is \$70,000 enough?" "Oh, I think that's too much." "Well, how about \$60,000, is that too much?" "Yes, I think so." "Is \$50,000 enough?" "Yeah, I'm a little more comfortable with that." "It's not too much?" "No." "Well, then, why don't we just put \$50,000 down by Bill's name."

By asking these questions — Is there an upper limit? Is this figure too much? Is that figure too little? — you will eventually be able to fill in amounts by all of the individual names. Be sure not to move too quickly, though. You never want to give donors the feeling that you're rushing them, for it is extremely destructive to give someone in a quandary (or anyone you're cultivating) the

feeling that you're in a hurry.

Returning to the above example, let's assume that we have continued filling in amounts next to the name of each person and each charity listed *except* the charity I represent. Further, let's say the amounts listed on the paper bag come to \$67,000, and I know that the person's approximate net worth is \$200,000. (During a visit such as I have described, I have found that the donor will often volunteer their net worth or at least give a pretty good idea of what it is.) Again, up to this point I have not made reference to my own particular charity. All I've tried to do is help the donor to be definitive about heirs and about the other charities that were listed.

What are the implications of what has taken place in this example? If a net worth of about \$200,000, and the total of individual bequests comes to \$67,000, then by implication my charity has an opportunity to receive approximately \$133,000. This illustrates a very important principle, namely, that the most profitable place for you to end up is in the rest, residue and remainder section of the donor's estate.

Figure 1 is an overhead that was reproduced from an article published in *Fund Raising Management*. It tells in a little different way how helping people set measurable goals may ultimately result in surprise bequests for your charitable cause. Why? Because when donors set measurable goals for heirs, the largest share of the money will often end up in the rest, residue, and remainder of the estate. Remember, I have never set the goals, have never told the donor what to do. Instead, I have drawn out of the donor what he or she wants to do for the people and other organizations.

At this point I might say to the donor,

Well, it has taken us several hours to come up with this plan, and it's still far from perfect. But as imperfect as this paper bag is, if by some miracle we could affix your signature to it and get whatever witnesses are required, wouldn't it still be a lot better than your present plan?

The donor usually nods in agreement.

By going through this exercise with donors, what you're

really doing is giving them an opportunity to regain the control they had lost, control they perhaps didn't even consciously realize had been lost. They generally feel good about it. And one of the great surprises for the fundraiser is that some donors who never intended to give anything substantial to charity do so, once they have set upper limits for people. (See Figure 2 for a summary of the principles we have discussed so far.)

IV. *GIVING INCOME STREAMS TO HEIRS*

If this were the end of the story, I could write up a memorandum for the person, summarizing his or her objectives for estate distribution. I would then give the donor whatever assistance was necessary in setting up a meeting with an attorney, who would in turn draw up the legal documents to fulfill these intentions. The job completed, I could go on to see someone else, in the hopes that I could develop another bequest for the rest, remainder and residue of the estate.

Had I done this in the situation described above, however, I would have been committing a couple of grave errors. First of all, I would be missing a great opportunity. Second, I would not be acting like a true professional, would not be working in the best interest of this donor. We will see why this is true.

Instead of stopping with the paper bag, I wanted to make sure that Florence was at least aware of the option of leaving income streams to heirs. This is how I approached the situation. I told her,

Now, we have gone through this exercise and you have indicated that you want to give Bill \$50,000. But before I write up a draft copy of what we discussed today, I want to share one more possibility with you that others have appreciated knowing about. I find that people make mistakes because they base their decisions on inadequate information. This alternative may not appeal to you, but I feel responsible to make you aware of another way to take care of Bill.

Florence, there are two ways to give to Bill, although most people only think of one. Thus far we have been talking about what is called an "out-right gift" of capital to Bill. Some day, when you are gone, your executor will write out

a check for \$50,000 to Bill, and he will get it in his mailbox. Bill can do anything he wants to with your money, and that's what you want. Another way to take care of Bill would be to take the \$50,000, put it in an account, and let the income on the \$50,000 trickle out to Bill over a period of time. In other words, you could give him the same amount, \$50,000, but gradually, over a period of years.

I asked Florence how long it took her to save and accumulate her \$200,000 worth of capital. "Oh," she answered, "Some of it came from Mom and Dad, but you know I've really been saving and accumulating and investing for over 50...close to 60 years." I explained that if she were to decide to give Bill income rather than principal, what she'd be doing would be trickling the money out to Bill in the same way that she'd saved it over the years. "The difference," I explained,

...is that if you give income to Bill, then you would be retaining control over what will ultimately happen to the \$50,000. For, once Bill gets his \$50,000 in income and you've given him the exact amount you'd set, then that \$50,000 worth of capital could be directed anywhere you want it to go. If you so decide, you can let that capital revert to the charity I represent. I refer to this second way of giving as the "income stream," because your \$50,000 fund is just like a reservoir; and even as a stream flows out of a reservoir, the income on your \$50,000 will flow out of your capital and will go to Bill. Then, when the job of taking care of Bill was done, the fund could revert to our charity.

I explained that if she did decide to leave Bill an income stream from a fund of \$50,000, there were many different ways she could go. She could leave him \$5,000 a year for 10 years, \$2,500 for 20 years, etc. — either way, he would still have his \$50,000. Another option would be to give Bill income on the fund for the rest of his life. Then, if she so decided, the fund would ultimately revert back to the charity I represented.

In helping donors decide whether or not the income stream approach is "right" for them, I have found the following series of questions to be extremely useful: "Does the individual need the

money?" "Will they spend it?" "How will they spend it?" "Who would get the money after they are gone?" "Why do you want to benefit them?"

When I asked Florence whether Bill needed the money, she answered, "Well, no; Bill doesn't really need the money. He sold a successful hardware store some time ago, and financially he's just like me. He saves, invests...in fact, he gives me advice on my certificates." Will Bill spend the money, I asked her. "No, he lives very frugally...He stopped going to Florida years ago, when his wife died." Then who would get the money after Bill was gone? She replied that Bill's son, Jo, would get the money — "And Jo's been such a heartache to Bill. He's been bankrupt a couple of times, has been through several bad marriages, and has been in and out of treatment for chemical dependency. No, I wouldn't want Jo to get my money."

Scenarios of this sort (where donors have a concern over "bad marriages," chemical dependency, or apparent financial irresponsibility) are a very convincing argument for leaving heirs an income stream rather than principal. I explain that when you give capital outright to people, then control passes to heirs. Give income to people, then control over capital is retained by the donor. When the question is put to a donor — "Which would you prefer to do, leave Bill the capital and give him control of your money, or leave him income and keep control yourself?" — it is a rare person who doesn't choose the income stream approach. The key thing is to show people how this option will allow them to keep control without neglecting heirs.

V. CASE STUDIES

Here are three more brief case studies which illustrate how the income stream approach can be successfully applied to real-life donor situations.

First, the case of Sarah Jones: Sarah had come to my office interested in giving us some money — \$1,000. However, she indicated that she did need to receive some income from the gift. Her dream was to one day establish a \$10,000 scholarship, and while she could not give us the \$10,000 all at once, she thought that she could squeeze out \$1,000 a year to build her endowment fund. It was ultimately agreed that she would do this by investing

gradually in the pooled income fund. She also made a change in her will, so that if she didn't live for the 10 years necessary to accumulate the \$10,000, then her estate would make up the difference. This action provided her with a great deal of satisfaction.

Before accepting her \$1,000 gift, however, I told Sarah that I would have to clarify a few things:

Now, Sarah, are you sure you can afford the gift? Because we don't want to take anything that's going to deprive you of something that you need. Second, will you be depriving an heir of this capital if you make the gift? We don't want to take anything away from someone who deserves to inherit some of the money that you've accumulated.

Sarah indicated that she could in fact afford the gift, and that provisions had been made for her heirs... that there was no reason for me to be concerned on that account.

My next question flowed quite naturally out of my conversation with her: "What do you plan to do with the balance of your estate?" Sarah told me that she planned to leave the balance of her estate to her nieces and nephews. I inquired whether she had ever heard about the other way to take care of loved ones, and she indicated that, no, she had not. I described to her the differences between the outright capital gift and the income stream, using basically the same terms as in the Florence Dunton example, above. But what I had really done was to let the donor know I wasn't going to prematurely take control — instead of taking control, I handed control back to the donor so that she could take back the gift to which she had verbally committed herself. I probed for the quandary, and in the process I also discovered the net worth.

The Sarah Jones case continued to develop, and about six months after our meeting, Sarah called me back. She said, "I've been thinking about that income stream idea, John, and I really want to do it." Sarah ultimately changed her will, leaving income streams to her nieces and nephews and residue of her estate to her scholarship fund.

In this case study, then, we see a donor move from a gift of \$1,000, to a proposed gift of \$10,000, to a bequest anticipated to

come to in excess of \$150,000. Sarah ultimately made this decision because of values, not because of money. She continues to grow in her enthusiasm for her scholarship project, and has become what I call an enthusiastic "mini-philanthropist." While she may have only a modest estate of under \$200,000, my charitable cause is getting it all. So don't settle for a crust of bread when you can get a whole loaf.

The second case I'd like to discuss is Stella Wables, an elderly woman in her 80's. Stella called me on the telephone one day and indicated that she would like to discuss establishing a scholarship directly benefiting her grandnieces and grandnephews. I knew that this was virtually impossible, but I told her I'd be glad to get together with her to talk about it. I went out to her house and discovered that she really wanted to leave the money to her grandnieces and grandnephews, but she had some reservations. Her niece had married "beneath" her. Also, Stella was afraid that if she left part of her estate to her niece, the money would disappear and would not last long enough to help her grandnieces and grandnephews with necessary and supplemental educational expenses. (The niece and niece's husband were continually in hock with finance companies.)

I told Stella about the "other" way to give to heirs, and she decided to leave half of her estate to the niece in the form of a \$75,000 20-year term certain trust at 8%. This trust will spin out \$6,000 a year for 20 years, or a minimum of \$120,000, for that niece. The principal will ultimately revert to our charity. Stella decided that she would leave the other half of the estate to her nephew outright.

A year later she called me up, indicating that she wanted to discuss certain aspects of her estate plan a little further. When I went to see her, she told me that she wanted to do the same thing with regard to the nephew that she had done with the niece, i.e., to leave him income rather than principle. It is interesting to note that the real reason behind this decision was that she was not fond of her nephew's wife. She wanted to benefit her nephew, but did not want his wife to have access to a sizable portion of her estate. (This story is typical of dozens of other people I've encountered.) The will was eventually changed so that the charity I represented gets the whole estate after the term certain trusts have ended.

The third case study is that of "Edgar." One of our very gifted fundraisers had tracked Edgar and had invited me in to assist on the case. We worked with Edgar as a team, starting out with an emphasis on bequests. Edgar eventually committed himself to establish a chair in the College of Liberal Arts in his mother's memory; in order to accomplish this, he committed himself to making a sizable annual gift, until such time as the chair was fully endowed. He also put a clause in his will insuring that the commitment would be paid off as a debt against the estate, in the event he were to die before the chair had been funded.

Edgar had decided he also wanted to leave the University additional money, but it turned out he was in a quandary as to what he wanted to do for his heirs. I used the same "paper bag" method I had used with Florence, and we ultimately determined that there were three groups of individuals that he really wanted to take care of. First, there were two brothers, for whom he ultimately decided to set up a \$300,000 10-year term certain trust. Next, he decided to benefit his grandchildren with a 10-year term certain annuity trust; this required principal of \$650,000. Finally, he decided that he wanted his daughter to receive an income of \$30,000 a year for the rest of her life; a \$400,000 gift annuity agreement was drafted to provide this income for the daughter.

The University was to get the rest, residue, and remainder of his estate for the establishment of a center in fine arts. When I explained the income stream principle to Edgar, he was absolutely delighted. He told me, "John, this is great. My money will be doing double duty." By using the income stream method of taking care of heirs, he was able to direct an additional \$1,350,000 to his project. This was made possible only because the donor was given information about the "other" way of taking care of heirs.

Edgar's story illustrates another principle I have learned working with donors over the years: A lot of older people who have lived a challenging, productive life are frustrated and bored because their life no longer seems to have a noble purpose. One of the great thrills of being in this business is the opportunity to give donors such as Edgar a goal to work for — another "moun-

tain to climb"—and at the same time to serve great charitable causes.

VI. CONCLUSION

Before I encourage anyone to go out and apply the principals and techniques presented here, however, I must add an important note of caution. All of the ideas I have shared here today could easily backfire, if donors get the sense that all you are interested in is their money.

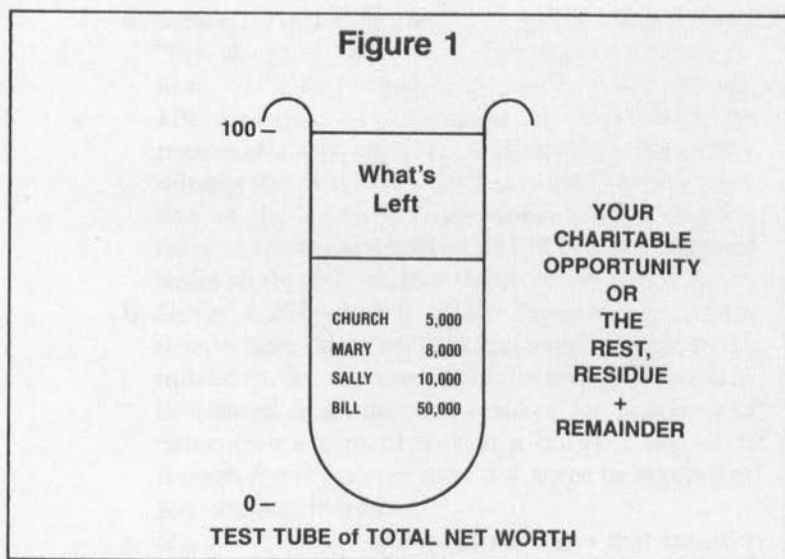
I tell people that I am not visiting them to talk about money, that I'm there to help them perpetuate their values. Admittedly, I often don't even know in advance what their values are. But I can probably help them articulate these values—which should pour out of their own hearts—and help make sure that the things that have been very important in their lives are passed on to another generation. I tell people that I'm not really clever enough to "talk them out of" their money. If they don't already have within themselves a desire to do something for a charitable cause, then I'm not smart enough to talk them into making such a gift.

You have got to care for people. You must be an "enabler," a giver, rather than a taker. If you have a taking, "gimme" attitude, the techniques outlined above will be relatively worthless. On the other hand, if you use your gifts and your skills to enable people to accomplish great purposes (this is the kind of fulfillment considered by Abraham Maslow to be part and parcel of the highest level of moral development), you will be successful.

The emphasis of the charitable industry is very much on the "head." I believe we need to reorient ourselves, to shift our emphasis toward the heart, toward values. We need to turn fundraisers into what I call "heartraisers," particularly if we want to be successful in the major gifts area. Now, I don't think that every fundraiser necessarily has the capacity to become a heartraiser, though perhaps everyone can use some of the principles we have talked about here. But I think that there are pastors, rabbis, department heads, executive directors, CLU's, attorneys, medical doctors, social workers, counselors, and volunteers with the potential to become extremely effective heartraisers.

Donors themselves often make the best heartraisers, and we can create a network within our organizations that will help us

use this valuable asset — i.e., our donors — to great advantage. For example, there is a woman at the University of Minnesota who oversees our switchboard and information operators. Whenever a call comes in regarding a possible gift or bequest, her telephone operators are to transfer the call to her. Although I can't prove this, I have a pretty good idea that she tells the caller what a wonderful thing it is he or she is thinking about doing, and then she talks about her own bequest to the University, explains that she is a member of the University's Presidents Club, etc. She and her husband have made a bequest to the University of over \$150,000, and she told me herself, "John, the older we get, the less people are going to get, the more charity's going to get." She has become a heartraiser, and I hope that you can become one too.



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Figure 2. Principles

1. Donors are in a quandary.
2. The quandary can immobilize all progress.
3. The quandary is a cry for help in disguise.

4. Focus on the donor's welfare, rather than your organization's needs.
5. Donors don't like being in the dark as to how much their heirs are going to receive.
6. Measurable goals for heirs can be established.
7. Donors enjoy keeping control.
8. Donors usually like to set upper limits for bequests.
9. People who originally didn't intend to, end up becoming "mini-philanthropists."
10. Don't end up settling for a "crust of bread" when your organization could benefit from the whole loaf.
11. The most profitable place for your organization to end up is in the "Rest, Residue, and Remainder" section of the donor's estate.

RESPONDING TO SPECIAL GIFT SITUATIONS

Clinton A. Schroeder, Esq.

Gray, Plant, Mooty, Mooty & Bennett

I. Mortgaged Property

A. Background

1. Normally involves Real Estate with existing mortgage.

— Originally there was some concern you could not receive real estate into a charitable remainder trust.

— Now well accepted; several favorable letter rulings have been issued.

B. Bargain Sale Rule

1. Statutory Provisions:

a. *Section 1011(b) of the Internal Revenue Code* provides:

“(b) Bargain Sale to a Charitable Organization. — If a deduction is allowable under Section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.”

b. *Section 1.1011-2(a)(3) of the Regulations* provides that, where property is transferred subject to an indebtedness, the amount of the indebtedness is to be treated as an amount realized for purposes of determining gain or loss in a bargain sale even though the transferee may not agree to assume or pay the indebtedness.

c. *Section 1.642(c)-5 of Regulations* states that transfer of mortgaged property to a pooled income fund is a bargain sale.

2. Application to Outright Gifts of mortgaged property: Amount of mortgage is treated as sale proceeds. Basis is allocated between sale portion and gift portion; partial capital gain is recognized.

3. Application to G.A.A.

C. *Self-Dealing Rules*

1. Statutory Provisions:

- a. *The private foundation self-dealing prohibitions* are applicable to charitable remainder trusts, pooled income funds and charitable lead trusts. Sec. 4947(a) (2) I.R.C.
 - b. *Transfer of mortgaged property* to a private foundation is self-dealing if the mortgage was placed on the property within the last ten years. Sec. 4941 I.R.C.
 - c. *But the initial transfer of property to a foundation* (or trust) probably would not constitute self-dealing. See Regs. Sec. 53.4941(d)-1(a).
2. Does not apply to outright gift or gift annuity.
 3. Some uncertainty exists if mortgage is on property less than ten years.
 - a. 1978 letter ruling approved transfer by will to charitable remainder trust of property with mortgage of less than ten years. Letter Ruling 7807041.
 - b. For lifetime transfer, constituting initial transfer of property to a charitable remainder trust, suggest securing private letter ruling.

D. *Unrelated Business Income*

1. IRC § 513 defines UBI as a "trade or business the conduct of which is not substantially related" to the organization's exempt functions.
2. Acquisition Indebtedness as defined by § 514, with respect to debt financed property will result in UBI.
3. Major problem — Regs. §1.664-1(c) provides if trust has any UBI, all income that year is taxable.
 - a. Goes beyond usual application of rule.
4. Remedies
 - a. If mortgage on property more than five years prior to transfer, permissible then to hold for ten years.
 - 1) This applies to gift annuity agreements also.
 - b. If property subject to mortgage is held in cor-

poration, then it will not be debt-financed property if stock is placed in charitable remainder trust (but beware step transactions). Letter Ruling 8139045 (discussed in TAXWISE GIVING Feb. '82)

II. Oil and Gas Mineral Interests

A. Valuation

1. Valuation is crucial and a likely area for IRS challenge. An independent appraisal may be helpful in sustaining a claimed contribution deduction.
2. The problem may be minimized in the case of publicly held limited partnerships as to which the general partner or an affiliate maintains a market for partnership units by offering to buy them at prices set from time to time on the basis of independent valuations of the partnership's future prospects.

B. Distinction between Royalty Interest and Working Interest

1. For exempt organizations, fundamental concern usually would be whether or not income from the property qualifies as royalty income, and the usual distinction is between a royalty interest and an operating or working interest.
 - a. Royalty interest: Participates in no portion of the costs of exploration development and production.
 - b. Overriding royalty: As defined in Rev. Rul. 67-118, 1967-1 C.B. 1963, an overriding royalty interest is created from a working interest in an oil and gas property and entitles its owner to a specified fraction of gross production, free from operating and development costs.
 - c. Working interest: It appears that having to bear either development costs or operating costs is enough to make an interest an operating or working interest.
2. Unrelated Business Income: IRC §512(b) provides the general rule that there shall be excluded from unrelated business income "all royalties (including overriding royalties) whether measured by produc-

tion or by gross or taxable income from the property”

C. *Mineral Interest: May be Gift of “Less than Entire Interest in Property.”*

1. Sever royalty interest from working interest: An owner of an operating interest may give a royalty interest providing for a stated percentage of gross receipts from production. Rev. Rul. 67-118.
2. Sever mineral interests from overall title to property: gift of mineral interests after such severance constitutes a gift of less than donor’s entire interest in property, and no deduction is allowed. Sec. 170(f)(3) IRC

D. *Recent Legislative Proposal:*

1. Would treat oil and gas income from working interest held in limited partnership as passive income in hands of certain charitable institutions. (H.R. 821, and S. 1549)
2. Limited to college endowment funds and qualified pension plans.

III. Closely Held Stock

A. *Background*

1. Gift of stock of closely held corporation often utilized to preserve family control and to avoid necessity of sale of stock to provide liquidity for payment of estate taxes.
2. Valuation often challenged by IRS. Independent appraisal helpful.

B. *Uses of Closely Held Stock*

1. Outright Gift
2. Outright Gift combined with later sale to Employee Stock Ownership Plan
3. Charitable Remainder Trusts
 - a. Exclusion from §4943 (Excess Business Holdings) provided by §4947(b)
 - b. Beware of self dealing limitations of §4941
4. Charitable Lead Trust
 - a. Charitable Income interest must be less than 60% of trust corpus for the §4943 exclusion.

5. As part of a combined estate freeze recapitalization plan, Preferred stock gifted to charity. See Letter Rul. 8221129
6. In exchange for a gift annuity.
7. As a Bargain Sale to charity followed by Installment Redemption. See Letter Rul. 8307134

C. *Gifts and Subsequent Transactions*

1. Gift of stock to charity followed by later redemption by company does not produce income to donor, provided donee is not legally bound to surrender shares for redemption. Rev. Rul. 78-197.
2. Above plan can be used with Bargain Sale of the stock to charity followed by redemption. See Letter Rul. 8370134
3. Problems arise if IRS perceives prearranged plan to use gift to buy another asset from donor. *Blake v. Commissioner*, 679 F. 2d 473 (2nd Cir. 1982).

IV. *Gifts of U.S. Savings Bonds*

A. *Background*

1. Savings Bonds will normally have substantial amounts of accrued interest in the hands of the potential donor. Treasury regulations provide strict rules as to transferability and taxation of such accrued interest.
2. Unrealized income on savings bonds at time of owner's death is "income in respect of a decedent" under IRS §691. This means that the income will be taxed to whomever redeems the bonds after the donor's death.

B. *Outright Gift*

1. Bonds may be reissued in the name of the owner and another natural person without triggering realization of accrued income.
 - a. Charitable institutions are not natural persons; "rollover" of accrued interest not available when transferred to charity.
2. Present gift to charity would require redemption of bonds, and donor would be required to record entire untaxed interest income in the year of redemption.

C. *Testamentary Gift*

1. If savings bonds bequeathed to charity by Will of the donor, the redemption value of the bonds will be included in the donor's estate, but would qualify for estate tax charitable deduction.
2. The unrealized income on such bonds would be income in respect of the decedent, and normally taxable to the devisee. However, if the recipient charity is tax exempt, there would be no income payable by donor, donor's estate, or the charity on redemption of the bonds.

D. *Transfer to a Revocable Trust*

1. Savings bonds may be reissued, without triggering realization of accrued interest, to the trustee of a "personal trust estate created by donor." Cir. 530, §315.47(a) (2). Therefore, it is likely that transfer to a revocable trust established by the donor would not result in taxation of accrued interest.
2. The irrevocable trust instrument could provide that future interest earned on the bonds would be paid annually to the donor, and reported as interest income on the donor's income tax return.
3. The income accrued to the date of transfer to the revocable trust would normally be taxable to the trust beneficiary after the death of donor, however, if the beneficiary is a charitable organization, such redemption would be taxfree as noted above.

E. *Transfer to Irrevocable Trust*

1. A present transfer to an irrevocable trust of a donor's savings bonds (i.e. to fund a charitable remainder unitrust) might well result in the taxation of accrued interest to the donor.
2. Before attempting such a transfer, it is recommended that a private letter ruling be obtained as to the imposition of income tax.

V. *Collections and Art Objects*

A. *Tangible Personal Property-SPECIAL RULES*

1. Tangible Personal Property — Reduce charitable gift by 40% of gain. §170(e) (1) (B)

2. Future interest — No deduction until intervening interests expire. Sec. 170 (a) (3)
 3. Ordinary income property — deduction limited to cost basis. Sec. 170 (e)
- B. *Use of Deferred Gift Methods with Collections of Art Objects.*
1. Lifetime Transfers
 - a. Artists or Dealers not permitted to claim deduction for inter vivos deferred gift (Ordinary income rule and future interest)
 - b. Collectors
 - i. Permissible to Fund Gift Annuity Agreement
 - ii. Not, however, charitable remainder trusts or pooled fund, because of future interest prohibition of Sec. 170 (a) (3)
 2. At Death
 - a. Artist and Collector treated alike.
 - b. Estate tax deduction for a remainder interest allowed only for a gift in trust which is a charitable remainder trust or pooled fund gift. Sec. 2055(e) (2) (A).
 - i. Appears that all three trusts qualify.
 - ii. Problem because not income-producing property — But See Rev. Rul. 73-610.
 - c. Permissible to fund Gift Annuity Agreement
 - d. Rules do *not* apply to testamentary transfer:
 - i. Ordinary income
 - ii. Future interest
 - iii. Private Foundation limits
 - iv. Use rule

VI. Gifts in Will

Testamentary Gifts — Drafting Suggestions:

- A. Unitrusts and Annuity Trusts
 1. New language is now *required* for Testamentary unitrusts and annuity trusts repayments from date of donor's death to date of funding.
 - Rev. Rul. 82-165, IRB 1982-40 p.8
 2. Originally this language was "optional" per Rev. Rul. 72-395, 1972-2 C.B. 340
 3. Then in 1980, IRS said language was mandatory. Rev. Rul. 80-123, 1980-1 C.B. 205

4. Now IRS says the 1972 Rev. Rul. language is not adequate. New ruling (82-165) gives new sample language.
 5. IRS recently ruled a testamentary unitrust without the language did *not* qualify. Ltr Rul. 8235050
- B. Charitable Lead Trusts
— Should probably use similar language.
- C. Related Problem — Outright gift to charity in will may not qualify if income during administration can be paid to third persons:
Recent ruling: Corporate stock bequeathed to charity
Dividends during administration go to Donor's spouse.
This is a split interest gift not in form of CRT or pooled fund — No deduction.
Rev. Rul. 83-45, IRB 1983-11 p. 7
- D. Another ruling reached similar result:
Residue left to charity. Support allowance of \$500 a month awarded to spouse by probate court. Value of residue reduced by \$30,000 ($500 \times 12 \times 5$ years).
Rev. Rul. 83-20, IRB 1983-4, p. 13

FEDERAL TAX LEGISLATION

Conrad Teitell, Esq.

Member, Prerau & Teitell

I. Charitable Remainder Unitrusts and Annuity Trusts

A. *Brief description.*

1. Charitable remainder unitrust. Specifies that income beneficiary (recipient) is to receive annual payments determined by multiplying a fixed percentage (which cannot be less than five percent) by the net fair market value of the trust assets, as determined each year. On death of beneficiary (or survivor beneficiary, if more than one) charity gets the remainder. IRC §664 (d)(2).
 - a. A variation calls for the trustee to pay only trust income if actual income is less than stated percentage. Deficiencies in distributions (i.e., where trust income is less than stated percentage) are made up in later years if trust income exceeds the stated percentage.
 - b. Another variation provides that deficiencies are not to be made up. IRC §664(d)(3); Reg. §1.664-3(a)(1)(i)(b).
2. Charitable remainder annuity trust. Specifies a fixed dollar amount (at least five percent of initial net fair market value of transferred property) which is to be paid annually to income beneficiary (recipient) for life. On death of beneficiary (or survivor beneficiary, if more than one) charity gets the remainder. IRC §664(d)(1).
3. How payments taxed to recipient
 - a. For unitrusts and annuity trusts, amounts paid to the recipient retain the character they had in trust.
 - b. Each payment is treated as follows:
 - i. First, as ordinary income to the extent of the trust ordinary income for the year and undistributed ordinary income for prior years.
 - ii. Second, as capital gain to the extent of the

- trust capital gains for the year and undistributed capital gains for prior years.
- iii. Third, as other income (e.g., tax exempt income) to the extent of the trust's other income for the year and undistributed other income for prior years.
 - iv. Fourth, as a tax-free distribution of principal. IRC §664(b); Reg. §1.664-1(d).
4. Unitrusts and annuity trusts are exempt from taxation. IRC §664(c).
 - a. But a trust is not exempt in any year it has income which would be taxable unrelated business income if trust were an exempt organization. IRC §664(c).
 - b. Payments to income beneficiary taxed as described above.
 5. Governing instrument requirements. To assure charitable deductions and avoid adverse tax consequences, governing instrument must contain specific provisions. See Reg. §1.664-1 through §1.664-3; IRC §508(e); IRC §4847(a)(2); Rev. Rul. 72-395, 1972-2 C.B. 340. Rev. Rul. 82-128, IRB 1982-27, 7; IRB 82-165, IRB 1982-40, 8.
 6. Income tax aspects. Contribution deduction allowed for value of remainder interest — computed using Treasury tables. Unitrusts — IRC §170(f)(2); Reg. §1.664-3(c) and §1.664-4; IRS Pub. 723B. Annuity trusts — IRC §170(f)(2); Reg. §1.664-2(c); Reg. §20.2031-10; IRS Pub. 723A. IRS considering new tables. See Section VI.
 7. Caveat. Annuity trust must meet "five percent probability test" of Rev. Rul. 77-374, 1977-2 C.B. 329. See E 4 (below).
 8. Capital gains.
 - a. No capital gain incurred on transfer of appreciated assets to trust. Rev. Rul. 55-275, 1955-1 C.B. 295; Rev. Rul. 60-370, 1960-2 C.B. 203.
 - b. Nor is there capital gain to donor on a sale by trust (except as taxable under four-tier system, above).

- c. Exception: Gain taxable to donor if trust assets sold and proceeds invested in tax-exempt securities pursuant to express or implied agreement between donor and trustee. Rev. Rul. 60-370, 1960-2 C.B. 203. See E 9 (below).
- B. Major benefits of charitable remainder unitrusts and annuity trusts.
- 1. Individual who makes outright lifetime charitable gift gets double benefit — an income tax charitable deduction plus, in effect, an estate tax charitable deduction because gifted property is not in gross estate.
 - 2. Many individuals have to forgo the income tax charitable deduction and just receive an estate tax charitable deduction for a charitable gift by will because they can't give away property during lifetime (they need the income the property earns).
 - 3. Charitable remainder trusts to the rescue.
 - a. Donor can create inter vivos trust and retain life income for himself/herself and/or others and get income tax charitable deduction now for remainder interest and have same estate tax savings as for charitable gift by will.
 - b. Enables donor to avoid capital gains tax on changing investments to get a higher yield or for diversification.
 - c. Possibility of having income taxed to the beneficiary more favorably than donor presently being taxed on income earned by his/her assets.
 - d. When the income tax savings are added to the estate tax savings and avoidance of capital gains on changing appreciated investments is taken into account, substantial charitable gifts can often be made at a much lower cost than initially imagined.
 - e. For the individual who does not wish to create an inter vivos charitable remainder trust, a testamentary charitable remainder trust can:
 - i. Provide life income for a survivor.

- ii. Reduce or eliminate estate tax for an estate which would otherwise be taxed.
- C. Gift tax rules — including marital deduction rules.
1. One-life unitrust or annuity trust for donor's life. Value of charitable remainder interest in qualified trust is not subject to gift tax. Donor must report remainder gift (regardless of size because it is a future interest) on federal gift tax return. IRC §6019. Donor takes offsetting gift tax charitable deduction.
 2. One-life unitrust or annuity trust for beneficiary other than donor. Donor who creates a charitable remainder trust calling for payments to another for life, with the principal to be delivered to remainderman on life beneficiary's death makes two gifts — one to beneficiary of value of life interest and one of charity of value of remainder interest.
 - a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return. Then deductible as a charitable contribution — resulting in a washout. IRC §2522(c)(2)(A); Reg. §25.2522(c)-3(c)(2)(iv); Reg. §1.664-4.
 - b. Life beneficiary's interest when beneficiary is not donor's spouse. Donor makes gift to life beneficiary of value of life interest. Life interest is present interest and qualifies for annual exclusion. If tentative tax on gift is not offset by any remaining unified transfer tax credit, gift tax will be due. IRC §2503(a); Reg. §25.2503-3(b).
 - c. Life beneficiary's interest when beneficiary is donor's spouse. Rules are the same as in b (above) with this positive exception: Spouse's life interest automatically qualifies (no election need be made) for unlimited gift tax marital deduction. IRC §2523(g).
 3. Two-life unitrust or annuity trust funded with donor's separate property and donor is first beneficiary. Donor who creates charitable remainder trust —

using his or her own separate property — which pays income to donor for life and then to survivor beneficiary for life makes two gifts — one to charity of remainder interest and one to survivor beneficiary of right to receive unitrust or annuity payments if he or she survives donor.

- a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on gift tax return, then deductible as charitable contribution — resulting in a washout.
- b. Second life beneficiary's interest when beneficiary is not donor's spouse.
 - i. Donor makes gift to beneficiary of value of survivorship life interest. Gift is of a future interest — it does not qualify for annual exclusion. If tentative tax on gift is not offset by unified transfer tax credit, gift tax will be due. IRC §2503(a); Reg. §25.2503-3(a).
 - ii. Pointer. Donor can avoid making gift to survivor by providing in inter vivos trust instrument right exercisable only by will to revoke survivor's life interest. Should donor exercise that right, trust terminates on donor's death. Trust principal then delivered to charitable remainderman. Donor need not actually exercise right in will. Mere retention of right avoids donor's making completed gift to survivor beneficiary. Rev. Rul. 79-243, 1979-2 C.B. 343; Reg. §1.664-3(a)(4); Reg. §25.2511-2(c).
- c. Second life beneficiary's interest when beneficiary is donor's spouse. Spouse's future interest in a charitable remainder unitrust or annuity trust automatically qualifies (no election need be made) for gift tax marital deduction. IRC §2523(g). Alternatively, gift tax concerns can be avoided as discussed in b (above), by having donor reserve

right in the inter vivos trust instrument to revoke by will surviving spouse's life interest.

4. Two-life unitrust or annuity trust funded with jointly owned property when donors who are not spouses are the beneficiaries. Trust should provide payments to donors jointly for life and then to survivor for life.
 - a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return. Then deductible as charitable contribution — resulting in a washout.
 - b. The interests of the life beneficiaries. The actuarially older of joint tenants makes gift to actuarially younger of difference in their survivorship interests. To avoid adverse gift tax implications, each beneficiary should — in inter vivos trust — reserve right exercisable only by will to revoke survivor's interest in one-half of joint property. If right is exercised, one-half of trust principal would be delivered to charitable remainderman on death of beneficiary exercising right in will.
5. Two-life unitrust or annuity trust funded with joint property or community property and donors are spouses. Trust should provide payments to donors jointly for life and then to survivor for life.
 - a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return — then deductible as charitable contribution — resulting in a washout.
 - b. The interest of the life beneficiaries. Actuarially older spouse makes gift to actuarially younger spouse of difference in value of their survivorship interests. However, gift automatically qualifies (no election need be made) for gift tax marital deduction. Unnecessary (although can't hurt) for spouses to reserve right to revoke outlined in 4b (above).

6. Cautions regarding right to revoke a beneficiary's interest.
 - a. Right, although retained in inter vivos instrument creating charitable remainder trust, should be exercisable only by will. If right is exercisable during donor's lifetime, trust will be disqualified.
 - b. Right to revoke should not be retained unless the donor is himself or herself a trust beneficiary. For example, in a trust providing payments to donor's son for life, with remainder to charity, donor's retaining right to revoke son's interest could disqualify trust because it would be potentially measured by donor's life and not by son's life. Reg §§1.664-2(a)(5), -3(a)(5).
 - i. Absent retained right, son's interest would not be includable in donor's gross estate.
 - ii. Even absent donor's retained right to revoke, son's interest would have been included in donor's gross estate had he died before 1982 and within three years of creating trust. IRC §2035(a).
 - c. Keep in mind that inter vivos gifts after December 31, 1976 are taken into account in determining base upon which tentative federal estate tax is computed.
- D. Estate tax rules — including marital deduction rules.
 1. Donor is the sole beneficiary ("recipient") of an inter vivos unitrust or annuity trust. Value of trust assets at donor's death (or at the alternate valuation date) is includable in the gross estate when donor retains life interest in the trust. Estate deducts value of trust assets as charitable contribution, resulting in a wash-out. IRC §2036; IRC §2055(e)(1)(B); Reg. §1.664-4.
 2. Inter vivos unitrust or annuity trust for beneficiary or beneficiaries other than donor.
 - a. Value of trust assets not included in donor's gross estate unless donor died before 1982 and transfer

was made within three years of donor's death. IRC §2035(d).

- b. If value of trust assets is included in gross estate under pre-1982 "three-year rule," estate tax charitable deduction is allowable for value of the charitable remainder interest.
3. Two-life inter vivos unitrust or annuity trust funded with donor's separate property with payments to donor for life, then to non-spouse second beneficiary ("recipient") for life.
 - a. Include value of trust assets at donor's death (or alternate valuation date) in the gross estate whether or not second beneficiary survives donor. IRC §2036.
 - b. If second beneficiary does not survive donor, deduct as a charitable contribution the amount which was included in the gross estate — resulting in a washout. IRC §2055(e)(1)(B); Reg. §20.2031-10.
 - c. If second beneficiary does survive donor, deduct value of charitable remainder as charitable contribution [applicable factor for survivor's age (at nearest birthday) at donor's death and stated percentage x value of trust assets at death (or alternate valuation date)]. In effect, only value of survivor beneficiary's life interest is subject to tax. If alternate valuation date is elected, in computing value of charitable remainder, use value of assets at alternate valuation date but use age of the survivor beneficiary (at the nearest birthday) at date of donor's death. IRC §2032(b)(2).
4. Two-life inter vivos unitrust or annuity trust funded with donor's separate property with payments to donor for life, then to spouse as second beneficiary for life. Rules are same as discussed in 3 (above) except that for estates of donors dying after 1981, an estate tax marital deduction is allowed for value of surviving spouse's life interest. Trust assets are completely immune from estate tax because charity's remainder interest qualifies for estate tax charitable

deduction and surviving spouse's life interest automatically qualifies (no election need be made) for estate tax marital deduction. IRC §2056(b)(8).

5. Two-life inter vivos unitrust or annuity trust funded with jointly owned property and the donors who are the beneficiaries are not spouses.
 - a. General rule. When property is held jointly, full value of property is includable in gross estate of first of joint tenants to die unless decedent's estate can show that survivor furnished all or part of property's consideration.
 - b. Special rule for charitable remainder trusts. Once property is transferred to charitable remainder trust, it makes no difference for estate tax purposes who furnished consideration. On death of the first joint tenant to die, only one-half of the property will be included in the gross estate. Rev. Rul. 69-577, 1969-2 C.B. 173. Estate tax charitable deduction for charitable remainder interest in one-half of the assets included in the gross estate allowed—based on percentage payout and survivor's age (to nearest birthday) at first to die's death.
6. Two-life inter vivos unitrust or annuity trust funded with jointly owned property and donors who are beneficiaries are spouses. For estates of spouses dying after 1981, only one-half of jointly held property owned by spouses is includable in estate of first spouse to die—regardless of who furnished consideration. IRC §2040(b). Estate of first to die receives estate tax charitable deduction for remainder interest in one-half of property includable in the gross estate and automatically receives (no election need be made) marital deduction for value of surviving spouse's life interest in one-half of joint property includable in the gross estate. IRC §2055(e)(2)(A); IRC §2056(b)(8).
7. Two-life inter vivos unitrust or annuity trust funded with community property and donors are benefi-

ciaries. Include value of one-half trust assets in the gross estate of first spouse to die. Estate is entitled to charitable deduction for value of charitable remainder interest and marital deduction (automatic) for spouse's life interest in that half.

8. Unitrust or annuity trust created by donor's will for benefit of spouse.
 - a. For estate of donor dying after 1981, estate automatically receives estate tax marital deduction for value of surviving spouse's life interest and estate tax charitable deduction for value of charity's remainder interest. Thus entire value of trust assets is not subject to tax. IRC §2055(e)(2)(A); IRC §2056(b)(8).
 - b. Estate tax marital deduction for spouse's life interest is allowable only if he or she is sole beneficiary. For example, remainder trust created by donor's will providing payments to spouse for life and then to son for life would not qualify for estate tax marital deduction. Would, however, still qualify for estate tax charitable deduction for value of charitable remainder interest.
9. Unitrust or annuity trust created by donor's will for benefit of one or more survivors. Donor's estate is entitled to charitable deduction for value of remainder interest based on percentage payout and ages of beneficiaries. Use ages (to nearest birthday) at donor's death even if alternate valuation date is elected. Reg. §1.664-4; Reg. §20.2031-10.

E. Planning considerations.

1. This outline does not give an all-inclusive listing of pitfalls but only some more recent problems and some not-so recent problems that may not be widely known.
2. The charitable remainderman must be an organization described in both IRC §170(c) and IRC §170(b)(1)(A), otherwise the income tax charitable deduction is limited to 20 percent of adjusted gross income (with no five-year carryover for any "excess").

Rev. Rul. 79-369, 1979-2 C.B. 226. Further, if a trust is funded with long-term appreciated securities or real property, the value of the charitable remainder would not be based on the full fair market value but would have to be reduced by 40 percent of the appreciation attributable to the remainder interest.

- a. IRS will not so limit the income tax charitable deduction when a publicly supported charity is named as the remainderman and the trust instrument provides that if at the time the remainder interest is to be distributed, the charity named in the trust instrument is not exempt under IRC §170(c), the trustee shall select an alternative charitable remainderman exempt under IRC §170(c) [with no requirement that it also be exempt under IRC §170(b)(1)(A)] when the possibility that the named charity will not be exempt is so remote as to be negligible. Rev. Rul. 80-38, 1980-1 C.B. 56.
- b. A further problem with stating that the charitable remainderman must be one specified in IRC §170(c) and not also in IRC §2055(a) and IRC §2522(a) is that the remainder interest will not qualify for the gift and estate tax charitable deductions unless the possibility that the named charity will not be exempt under those sections (when it is to receive any income or principal) is so remote as to be negligible. See Rev. Rul. 76-307, 1976-2 C.B. 56.
- c. Suggested language: "Upon the Beneficiary's death, the Trustee shall distribute all of the then principal and income of the Annuity Trust (Unitrust), other than any amount due the Beneficiary to ABC COLLEGE for its general purposes. If ABC COLLEGE is not an organization described in each of section 170(b)(1)(A), section 170(c), section 2055(a) and section 2522(a) of the Code at the time when any principal or income of the

Annuity Trust (Unitrust) is to be distributed to it, the Trustee shall distribute the principal or income to one or more organizations then so described as the Trustee shall select in its sole discretion and in such shares as it shall determine."

3. Trustee's fee must not be charged against beneficiary's payment. Rev. Rul. 74-19, 1974-1 C.B. 155.
4. Charitable remainder annuity trust — "five percent probability test."
 - a. To receive a charitable deduction for a remainder interest in a charitable remainder annuity trust, two tests must be met:
 - i. Test 1 — actuarial value test. There must be a charitable remainder computed using the tables prescribed in Reg. §1.664-2 (for one-life trusts) and in IRS Pub. 723A (for two-life trusts); and
 - ii. Test 2 — five percent probability test. Even if there is an actuarially determined value for the remainder interest satisfying Test 1, charitable deductions (income, gift and estate) are not allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If the probability that the noncharitable income beneficiary (or beneficiaries) will survive the exhaustion of the fund in which the charity has a remainder interest exceeds five percent, that probability is not so remote as to be negligible. Rev. Rul. 77-374, 1977-2 C.B. 329.
 - b. Charitable organizations and their donors will be astonished to learn that a sizable charitable deduction computed using the Treasury's own actuarial tables (meeting Test 1) will not be allowable in many cases because Test 2 is not met.
 - c. If the five percent probability test is not met, capital gains on a trust's sale of appreciated property could be taxable.
 - d. Tax Court case. The so remote as to be negligible

rule applies to charitable remainder annuity trusts. However, the "five percent probably" test of that rule is satisfied as long as the trust's annual earnings can be reasonably anticipated to exceed the required annual payout to the trust beneficiary. The court also suggested — and might be construed as holding — that, in any event, the five percent figure used by IRS is too low. Moor, T.C.M. ¶12,732 (1982).

- i. The Tax Court said that Treasury tables may be disregarded if application of those tables is shown to be unreasonable or inappropriate. However, "the determination of whether the chance that the charity will not take is remote is to be made at the date of death," (emphasis added). Considering all the facts, the court concluded that a return on the assets of the two trusts in question of at least 6.2 percent could be reasonably anticipated as of the date of Donor's death. Using a 6.2 percent rate rather than the six percent rate of the Treasury tables, the chance that the corpus of either trust would be totally exhausted by payment of the annuity to the life beneficiaries is less than five percent.
- ii. The court also suggested that even if the Treasury tables are used to compute the probability, the chance that charity will receive nothing from the trusts is still so remote as to be negligible. Using a six percent rate of return, the probability that the trusts' assets would be depleted before the income interests terminate was actuarially computed to be 7.63 percent for one trust and 7.09 percent for the other trust. "Considering all the facts present in this case," said the court, "there is doubt as to whether even the 7.63 and 7.09 percent possibilities should not be considered to be negligible."

iii. Comment. If a charitable deduction is denied for failure to meet the so remote as to be negligible test, the donor (or his estate) should argue that:

- (1) No such test is authorized by the Code, Treasury regulations or the legislative history.
- (2) In any event, the five percent figure is too low for determining whether the test is met.
- (3) The trust earnings (if this is the case) can be reasonably anticipated to exceed the required payout so — even under the five percent probability test — the corpus cannot be depleted.
- (4) The trust assets won't be depleted because the trust is or will be invested in growth stocks — and the trust will increase in value because of inflation. The court in this case ignores the possibility of trust growth and in several places in its opinion dwells on the likely earnings to show the corpus won't be depleted. Another court, however, might be convinced that because of likely trust growth, the possibility that the annuity payments will deplete the trust corpus is so remote as to be negligible (even though the trust has low income).

iv. Caution. Donors creating new charitable remainder annuity trusts should not rely on this decision but should make sure their trusts satisfy the five percent probability test using the tables in Treasury regulations as spelled out in Rev. Rul. 77-374. It is not known whether IRS (or other courts) will agree with this decision.

5. Asking IRS for a remainder interest factor.

- a. Caveat Settlor. Before IRS will furnish a factor for computing the charitable deduction, it must first

- approve the trust instrument.
- b. If you wish a revenue ruling approving the trust instrument, seek it before the trust is funded.
 - c. If you wish a remainder interest factor (and you can't compute it using Treasury tables), obtain it from a qualified actuary.
 - d. Asking IRS to furnish the factor may result in a charitable deduction being disallowed on a hypertechnical point.
6. An in terrorem clause raises the possibility that the interest of a beneficiary may continue for a period other than for his life or for a term of years not to exceed 20 years. This violates Reg. §1.664-3(a)(1)(i)(b)(1), according to Letter Rulings 7732011 and 7942073.
7. Investing unitrust and annuity trust assets.
- a. Commingling unitrust assets. IRS allows charity, as trustee of a charitable remainder unitrust, to commingle the assets of a unitrust with its general endowment investment assets or with the assets of another unitrust without adversely affecting the unitrusts' qualification under IRC §664. Letter Rulings 8212067 and 8220120.
 - b. Caution. State law may not allow a charitable organization to commingle trust assets even if authorized by the trust instrument. Further, the S.E.C. is likely to take a dim view of commingling unitrust or annuity trust assets with other trust assets or with an institution's own assets. Before doing this, a charitable organization should get a "no action" letter similar to the no action letters issued by S.E.C. for pooled income funds.
 - c. Restrictions on investments. A trust is not qualified "if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets." Reg. §1.664-1(a)(3).

- i. Test every charitable remainder trust for compliance with this regulation.
 - ii. IRS often cites this when it denies a charitable deduction.
 - iii. Drafting suggestion. Although not required by the Code or regulations as a governing instrument provision, it is wise to provide in the trust. "No trust provision shall be construed to restrict the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets."
8. Last taxable year of charitable remainder unitrust.
 - a. Prorating unitrust payments.
 - i. The pro rata payment for the year in which the trust term ends must be based on the number of days in the trust term in the last taxable year (the number of days the beneficiary lived in the taxable year of his or her death) and not on the number of days in the last taxable year. The number of days in the last taxable year is generally greater than the number of days in the trust term in the last taxable year because the taxable year usually runs until the assets are distributed to the charitable remainderman and the distribution is generally not made at the very moment the trust term ends.
 - ii. Comment. Section 6.05 of Rev. Rul. 72-395, 1972-2 C.B. 340 (containing specimen charitable remainder unitrust provisions which "may be used to satisfy the requirements of section 664 of the Code and the applicable regulations") mistakenly bases the payments on the number of days in the last taxable year.
 - b. Valuing unitrust assets.
 - i. The trust instrument may set any day of the taxable year as the annual valuation date. Most unitrusts are valued on the first day of

each taxable year. If the valuation date is other than the first day of the taxable year, in some cases there will not be a valuation date before the trust terminates — for example, the valuation date occurs after the income beneficiary dies. In this situation, the regulations say that the governing instrument must provide that the trust assets will be valued on the last day of the trust period. Reg. §1.664-3(a)(v)(a)(3)(1)(iii) and Reg. §1.664-3(a)(v)(b)(1)(iii).

- ii. IRS gives a sample provision it says satisfies the requirements of the regulations for unitrusts not valued on the first day of each taxable year:

“If the valuation date selected does not occur in a taxable year of the trust, other than the year in which the non-charitable interests terminate, the trust assets shall be valued as of the last day of such taxable year. In the case of the taxable year in which the noncharitable interests terminate, if the selected valuation date does not occur before the day the noncharitable interests terminate, the trust assets shall be valued as of the day the noncharitable interests terminate.” Rev. Rul. 82-165, IRB 1982-40, 8.

9. Tax-exempt unitrusts and annuity trusts.

a. Trust funded with tax-free securities.

- i. The fact that a trust may be funded with tax-exempt bonds will not disqualify the trust as a charitable remainder trust and will not affect the trust's exemption from income taxation under §664(c) of the Code.
- ii. In addition, the investment or reinvestment in tax-free bonds will not disqualify the trust as a charitable remainder trust and will not “affect the trust's exemption from income taxation under section 664(c) of the Code as long as there is no express or implied agreement that

the trustee must invest or reinvest in such bonds." Letter Ruling 7803041.

b. Trust funded with appreciated property to be sold and proceeds invested in tax-exempts.

i. Donor asked IRS to rule that gains from the sale of the initial trust property would not be gross income to him. The trust will be funded with appreciated securities, but the donor, as trustee, expects to diversify the trust holdings to include tax-exempt bonds.

ii. Background. Rev. Rul. 60-370, 1960-2 C.B. 203 holds that, if the trustee is under an express or implied obligation to sell or exchange, the transferred property and purchase tax-exempt securities, the donor is deemed to have sold the property himself and given the trustee the proceeds. The gain from the sale is includable in donor's gross income.

iii. IRS rules. Citing Rev. Rul. 60-370, IRS says it may be necessary to go beyond the trust instrument to determine whether the trustee has an obligation to sell the property and invest the proceeds in tax-exempts. We will not rule, says IRS, whether there is such an obligation; nor will we rule that gains from the sale of the initial trust property after the trust is executed and funded will not be includable in your gross income. Letter Ruling 7815017.

iv. Heads you lose — tails you lose.

(1) If donor loses the Rev. Rul. 60-370 argument, he has to pay capital gains tax out of his own pocket (not out of proceeds of sale).

(2) If donor wins the Rev. Rul. 60-370 argument, he does not have tax-exempt income until entire gain deemed distributed to him under the 4-tier provision in satisfaction of his annual payments.

- (3) Argument can be made, however, that 4-tier provision does not apply to a net income unitrust (a literal reading of the Code). But, Treasury reading its own regulations maintains that it does. Letter Rulings 7905024 and 7904028.
10. Trust not qualified if a pet is a beneficiary because a pet is not a "person" as defined in the Internal Revenue Code. Rev. Rul. 78-105, 1978-1 C.B. 295.
11. Life beneficiary in extremis — value of deduction.
- a. What happened. Donor's will created a charitable remainder trust for a life beneficiary. During the administration of the donor's estate, the life beneficiary died from an incurable disease. Donor's estate asked IRS to rule that the life beneficiary's actual life expectancy, rather than the actuarial tables, be used to compute the estate tax charitable deduction.
- b. The law. If on the valuation date it is known that a life beneficiary has a fatal and incurable disease in its advanced stages and that he cannot survive for more than a brief period of time, the value of a life, or remainder, interest should be determined using that knowledge. Jennings, 10 T.C. 323 (1948); Butler, 18 T.C. 914 (1952); Denbigh, 7 T.C. 387 (1946). IRS has ruled that the actuarial tables may be disregarded only if an individual is known to have been afflicted, at the time of the transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent. Death is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period. Rev. Rul. 80-80, 1980-1 C.B. 194.
- c. IRS rules. Donor's estate is allowed a charitable deduction based upon the known life expectancy of the life beneficiary at the date of the decedent's death. Letter Ruling 7807012.

- d. Comment. In almost all cases, the remainder interest tables in the Treasury regulations are used to compute the charitable deduction, and it is the taxpayer's burden to show that the known life expectancy rather than the actuarial tables should be used. The test is not that the life beneficiary died soon after the trust was created, but rather that on the date the trust was created it was known that the life beneficiary had an incurable disease and did not have long to live.
12. If charitable remainder trust is a "generation skipping" trust, it will be disqualified. Income, gift and estate tax deductions will be lost and all capital gains will be taxable.
 13. If a personal residence is used to fund a charitable remainder trust, beneficiary cannot live in residence and must vacate before trust is funded. Rev. Rul. 76-357, 1976-2 C.B. 285; Letter Ruling 7802016.
 14. Donor furnishes personal services to trust.
 - a. Facts. Donor funds a charitable remainder trust with stock in a closely held corporation or with real estate and thereafter furnishes personal services to the corporation or regarding the real property, for which he is compensated.
 - b. IRS rules.
 - i. There is no prohibited act of self-dealing if (1) the compensation is not excessive and (2) the services rendered are reasonable and necessary to insure that the corporation or real property continues to produce income for the life income beneficiary and to safeguard the eventual charitable remainder interest.
 - ii. Whether compensation is "excessive" or personal services are "reasonable and necessary" are essentially fact questions to be determined upon audit of the trust activities. Information Letter, 6/14/77.

15. Tangible personal property. Do not use tangible personal property to fund a charitable remainder trust. Charitable deductions are not allowed for a trust funded with tangible personal property if the donor or a related party is the beneficiary. IRC §170(a)(3).
16. Mortgaged property implications, pitfalls and possible solutions.
 - a. Self dealing. The private foundation self-dealing prohibitions (§4941) are applicable to charitable remainder trusts. However, the self-dealing prohibition should not apply to the initial transfer of mortgaged property to the remainder trust at the time the trust is created. Reg. §53.4941(d)-1(a) provides that: "(T)he bargain sale of property to a private foundation is not a direct act of self-dealing if the seller becomes a disqualified person only by reason of his becoming a substantial contributor as a result of the bargain element of the sale." Letter Ruling 7807041 holds that because donor's disqualified person (substantial contributor) status arises only as a result of the pro rata distribution of the mortgaged property to a unitrust, the distribution is not an act of self-dealing. Neither the unitrust nor its trustee is subject to the self-dealing tax. Caution. A letter ruling is not a precedent.
 - b. Capital gains. The mere transfer of mortgaged property (assuming it does not violate the self-dealing prohibition of IRC §4941) is a bargain sale generating capital gains for the donor. Reg. §1.1011-2(a)(3) apparently applies to charitable remainder unitrusts and annuity trusts. Reg. §1.642(c)-5 specifically states that transfer of mortgaged property to a pooled income fund is a bargain sale. Treasury takes same position respecting unitrusts and annuity trusts. Letter Ruling 7908016. See also Guest, 77 T.C. 9 (1981).

- c. Unrelated business taxable income. Charitable remainder unitrusts and annuity trusts are not exempt from taxes if they have any unrelated business taxable income. A trust can have unrelated business income if it runs a business or if it holds debt-financed property. However, if the mortgage was placed on the property more than five years before the inter vivos transfer to the trust and the donor owned the property more than five years before the transfer to the trust, there should not be deemed to be an acquisition indebtedness during the 10 years following the transfer to the trust. If property is transferred by donor's will, "five-year requirement" before the transfer does not apply. IRC §514(c).
- d. A possible way to make the mortgaged property and capital gains problems disappear. Instead of transferring mortgaged property to the trust, a donor could create a corporation, transfer the property to the corporation (a non-taxable event under IRC §351) and later make a charitable contribution of the stock.
- i. Forming a corporation, transferring tangible personal property to the corporation and then funding a charitable remainder trust with stock may also avoid the problem of funding a remainder trust with tangible personal property. See discussion at 15 above.
 - ii. Caution. Donors who create corporations to avoid the tax problems on gifts of mortgaged property and tangible personal property will walk on thin ice. A donor should have a valid business purpose for forming the corporation and wait a decent interval before transferring the stock. IRS and the courts take seriously the business purpose doctrine and will not hesitate to recharacterize the transaction as a direct transfer of mortgaged property or tangible personal property.

17. Testamentary charitable remainder trusts—governing instrument requirement.

a. Background. Because a testamentary trust is usually not funded on the date of a donor's death, Reg. §1.664-1(a)(5) says that a charitable remainder trust is deemed created as of the date of the donor's death even though it is not yet funded. The regulations go on to say that the unitrust or annuity payments may be deferred until the trust is fully funded provided (1) the obligation to pay begins as of the date of death and (2) when the trust is funded, the trustee will pay out or will receive, whichever is appropriate, the difference between what has been paid out and what should have been paid out during the period between the donor's death and full funding. The regulation tells how to determine retroactively the proper amounts payable when the unitrust or annuity amount has been deferred.

i. In 1972, IRS (in Rev. Rul. 72-395, 1972-2 C.B. 340) explained the rules for making retroactive determinations of the amounts payable and gave sample provisions for drafting testamentary trusts. However, the ruling said that the governing instrument provisions [of Reg. §1.664-1(a)(5)] were "optional."

ii. In 1980, IRS (in Rev. Rul. 80-123, 1980-1 C.B. 205) said that, to the extent Rev. Rul. 72-395 implied that the provisions contained in Reg. §1.664-1(a)(5) were optional, that ruling is modified: "A governing instrument of a testamentary charitable remainder trust must contain mandatory provisions conforming to §1.664-1(a)(5) of the regulations in order for the charitable interest to qualify for the estate tax charitable deduction; that is, the governing instrument must provide

that the obligation to pay the unitrust or annuity amount begins on the date of death, and for collective payments in the case of an underpayment or overpayment of the annuity or unitrust amount determined to be payable."

- iii. Rev. Rul. 80-123 does not apply to charitable remainder trusts created by decedents who died before May 6, 1980.
- iv. Rev. Rul. 80-123 does not apply to wills executed before May 6, 1980 if:
 - (1) The decedent died after May 5, 1980 but before May 5, 1981, without having amended any dispositive provision of his or her will after May 5, 1980, by codicil or otherwise.
 - (2) The decedent dies after May 5, 1980 and at no time after that date had the right to change the portions of the will pertaining to the passing of property to, or for the use of, an IRC §2055(a) charitable organization.
 - (3) No dispositive provision of the will was amended, by codicil or otherwise, after May 5, 1980 and before May 5, 1981 and the decedent was on May 5, 1981 and at all times thereafter under a mental disability [as defined in Reg. §1.642(c)-2(b)(3)(ii)] to amend the will.
- v. Based on Rev. Rul. 80-123, some lawyers went straight to the regulations and used the language of Reg. §1.664-1(a)(5) when drafting testamentary charitable remainder trusts. Those trusts should meet muster because the regulations clearly tell how to determine the amount due when payment of the unitrust or annuity amount is deferred until the trust is completely funded. However, donors who went back to Rev. Rul. 72-395 and used IRS's

own language have not complied with the regulations because IRS's suggested language was incomplete.

- b. Latest development. IRS now rules (in Rev. Rul. 82-165, IRB 1982-40, 8) that the sample provisions in Rev. Rul. 72-395 "do not adequately deal with the handling of underpayments or overpayments of the amount determined to be payable." IRS gives this sample provision for charitable remainder annuity trusts to satisfy the requirements of §1.664-1(a)(5):

"The obligation to pay the annuity amount shall commence with the date of my death, but payment of the annuity amount may be deferred from the date of my death until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable time after the end of the taxable year in which the complete funding of the trust occurs, the trustee must pay to A, in the case of an underpayment, or must receive from A, in the case of an overpayment, the difference between:

- (a) Any annuity amounts actually paid, plus interest on such amounts computed at six percent a year, compounded annually; and
- (b) The annuity amounts payable, plus interest on such amounts computed at six percent a year, compounded annually."

IRS gives this sample provision for charitable remainder unitrusts:

"The obligation to pay the unitrust amount shall commence with the date of my death, but payment of the unitrust amount may be deferred from the date of my death until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable time after the end of the taxable

year in which the complete funding of the trust occurs, the trustee must pay to A, in the case of an underpayment, or must receive from A, in the case of an overpayment, the difference between:

- (a) Any unitrust amounts actually paid, plus interest on such amounts computed at six percent a year, compounded annually; and
- (b) The unitrust amounts payable, determined under the method described in section 1.664-1(a)(5)(ii) of the federal income tax regulations, plus interest on such amounts computed at six percent a year, compounded annually."

c. Suggestions.

- i. Review all wills to determine compliance with Rev. Rul. 82-165.
- ii. Review all revocable trusts which become irrevocable charitable remainder unitrusts or annuity trusts on death for compliance with the new governing instrument requirement. Although the new ruling does not mention those inter vivos trusts, they apparently are equivalent to testamentary trusts for purposes of the new required recitation of the rule for retroactive determination of the unitrust or annuity trust amounts.
- iii. If there is a possibility that the will of an individual provides a "pour over" into an inter vivos charitable remainder unitrust, include the new governing instrument language in the inter vivos instrument. It is a good idea also to include the language in the will. If the language is in the will but not in the inter vivos instrument, it is a question of state law whether the transfer to an existing charitable remainder trust is

- governed by language in the will.
- iv. Caution. The specimen language in Rev. Rul. 82-165 incorporates by reference the formula contained in Reg. §1.664-1(a)(5) for determining the unitrust amount. If state law does not permit incorporation by reference, the formula should be restated in the governing instrument.
 - v. Further caution. A donor may now live in a state allowing incorporation by reference and die in one which does not. Thus, it is best to recite the formula in the governing instrument.
 - vi. Which formula to use? For unitrusts, use either the formula in Reg. §1.664-1(a)(5)(i) or Reg. §1.664-1(a)(5)(ii). For annuity trusts, use only the formula in Reg. §1.664-1(a)(5)(i).
 - vii. Caution. Do not pour over into an existing charitable remainder annuity trust because no additional contributions are permitted.
 - viii. Something else to think about. Although not yet required by a Treasury regulation or revenue ruling, consider including a comparable formula in testamentary charitable lead trusts.
18. Governing instrument requirement regarding federal estate and state death taxes.
- a. For two-life charitable remainder trusts, where the donor is the first life beneficiary, the trust instrument must provide that the life estate of the second life beneficiary will take effect on the donor's death only if the survivor furnishes the funds to pay federal estate or state death taxes for which the trustee may be liable on the donor's death. Rev. Rul. 82-128, IRB 1982-27, 7. The revenue ruling discusses these two situations:
 - i. Situation One. Donor created a six percent

charitable remainder unitrust, paying the unitrust amount to Donor for life then to a survivor beneficiary for life, with the remainder to charity.

Under the law of State X, where Donor and the second life beneficiary reside and where the trust was created, federal estate or state death taxes, in the absence of a clear direction to the contrary in a decedent's will, must be equitably apportioned against and payable from the separate interests in the estate that will give rise to these taxes. Taxes that are apportioned against an interest in trust are payable out of the general assets of the trust. Because state law permits the payment of federal estate or state death taxes apportioned against the second beneficiary's life interest from the general assets of the unitrust, the possibility exists that federal estate or state death taxes will be paid out of the trust corpus at Donor's death. This possibility results in disqualification of the trust under §664, says IRS, because the provision for the secondary life interest creates a possibility of an invasion of the unitrust assets to pay death taxes in violation of IRC §644(d)(2)(B).

- ii. Situation Two. The facts are the same as those in Situation One, except, that the trust instrument contains a provision that the life estate of second life beneficiary will take effect on Donor's death only if the second life beneficiary furnishes the funds for payment of any federal estate taxes or state death taxes for which the trustee may be liable on Donor's death. Because the survivor must pay any death taxes for which the trustee may become liable or else lose the life interest, there can be no invasion of the trust assets upon Donor's

death and thus no interference with the charity's remainder interest. Thus, the trust qualifies as a charitable remainder unitrust under IRC §664 and deductions for the contributions to it are allowable under IRC §§170 and 2522.

- b. Effective date. This drastic ruling does not apply to charitable remainder trusts created before October 4, 1982.
 - c. Caution. After October 3, 1982, be careful about additions to trusts created before October 4, 1982.
 - d. More caution. Although specifically directed at charitable remainder unitrusts and annuity trusts, this ruling could also apply to remainder interests in pooled income funds and personal residences and farms.
 - e. Still more caution. The facts of Rev. Rul. 82-128 deal with a two-life unitrust where Donor is the first life beneficiary. Include such a provision requiring the trust beneficiary or beneficiaries to pay the estate and death taxes attributable to the trust in all charitable remainder trusts if there is a possibility that the trust assets may be includable in Donor's gross estate — for any reason — even though he is not a trust beneficiary. Also, of course, include the provision in trusts where the donor is the beneficiary and there is more than one survivor beneficiary.
 - f. Generally, Donor will not want the survivor beneficiary to have to choose between paying the death taxes or forfeiting his or her life interest. Put the magic words of Rev. Rul. 82-128 in the trust instrument to preserve the tax benefits, but provide in the donor's will or otherwise for the payment by Donor's estate of any death taxes attributable to a survivor's life interest.
19. Reforming nonqualified trusts.
- a. The Tax Reform Act of 1969 (TRA '69) drastic-

ally altered the rules governing the deductibility of charitable remainder trust gifts. A transitional rule allowed amendment of faulty charitable remainder trusts to obtain charitable deductions when these conditions were met:

- i. The trust was created before December 31, 1978;
- ii. The faulty trust was amended to comply with the TRA '69 requirements before January 1, 1982 (or a reformation proceeding was begun before that date); and
- iii. The faulty trust complied with the pre-TRA '69 rules.

(1) Although a trust as amended may meet the requirements of TRA '69, no deduction is allowable if the trustee's power to invade trust corpus was not limited by an ascertainable standard. *Strafford Nat'l Bank, — F. Supp. — (D.N.H. 1981); Reitmeister, CCH T.C.M. §38,925 (1982).*

- b. The latest deadline for amending nonqualified charitable remainder trusts and charitable lead trusts (or to begin a judicial reformation proceeding) expired on December 31, 1981 for trusts which were created before December 31, 1978.
- c. The Joint Committee Staff, Treasury and lawyers for interested charitable institutions have discussed a law which would extend indefinitely the time for amending faulty charitable remainder trusts to qualify for the charitable deduction as long as: (1) the statute of limitations has not expired; and (2) a good faith effort was made to create a unitrust, annuity trust or pooled income fund trust.

F. Q-Tip trust vs. unitrust or annuity trust. Why should you create a testamentary charitable remainder unitrust or annuity trust for a surviving spouse if you can create a qualified terminable interest property trust (with remainder to charity) and get a marital deduction

for full amount used to fund trust? [Charitable remainder unitrusts and annuity trusts generate a marital deduction for spouse's life interest and a charitable deduction for the charitable remainder interest. See C (above)].

1. That's a good question — especially since trustees can invade principal for spouse's benefit in qualified terminable interest property trust and donors need not be concerned about those picky governing instrument requirements for unitrusts and annuity trusts.
2. On the other hand, unitrusts and annuity trusts are tax-exempt and pay no taxes on any income or capital gain not distributed to the recipient (beneficiary) in satisfaction of the required annual payment. And, by creating a unitrust or annuity trust during lifetime, donor will be entitled to an income tax charitable deduction.
3. Further, if donor makes the Q-tip election, the trust assets will be includable in the surviving spouse's gross estate. Even though the surviving spouse's estate will be entitled to an offsetting estate tax charitable deduction, the trust assets will increase the size of his or her gross estate and adjusted gross estate (see II C 13 below), possibly disqualifying the estate for IRC §2032A special use valuation, 15-year deferral under IRC §6166 or special redemption treatment under IRC §303.
4. Consider two trusts — A Q-tip trust and a unitrust or annuity trust.

II. Pooled Income Funds

A. Brief description.

1. Donor transfers money or securities to school, church, hospital or other publicly supported charity [only charities described in IRC §170(b)(1)(A)(i) through (vi) can have pooled income funds].
 - a. Charity adds donor's gift to its separately maintained pooled income fund where it is invested together with gifts of other donors who make

similar gifts.

- b. Each donor gets his/her pro rata share of pooled income fund earnings each year for life. Income the beneficiary receives taxed as ordinary income.
 - c. On income beneficiary's death, charitable organization removes assets from fund equal to his/her share of the fund and uses it for its charitable purposes.
 - d. Donor's pooled income fund gift can also provide life income for a survivor — e.g., a spouse. IRC §642(c)(3), (4), (5); Reg. §1.642(c)-5 and (c)-6.
2. Governing instrument requirements. To assure charitable deduction and avoid adverse tax consequences, governing instrument must contain specific provisions. See Reg. §1.642(c)-5 and (c)-6; IRC §508(e); IRC §4947(a)(2); Rev. Rul. 82-38, IRB 1982-11,6.
 3. Income tax aspects. Charitable deduction allowed for value of remainder interest determined using Treasury tables. IRC §170(f)(2)(A); Reg. §1.642(c)-6(d); IRS Pub. 723B. IRS considering new tables. See Section VI.
 4. Capital gains aspects.
 - a. No capital gain incurred on transferring appreciated non-mortgaged assets to pooled income fund. Reg. §1.642(c)-(5)(a)(3).
 - b. Fund takes over donor's basis and holding period.
 - c. No capital gain to donor or fund on sale by fund of long-term assets.
 - d. On sale of assets, short-term gain is taxable to fund. IRC §642(c)(3).
- B. Gift tax rules — including marital deduction rules.
1. One-life pooled income fund gift for donor's life. Value of the charitable remainder interest in gift to qualified pooled income fund is not subject to federal gift tax. Donor must report remainder gift (regardless of size because it is a future interest) on federal gift tax return. IRC §6019. Donor then takes an offsetting gift tax charitable deduction.

2. One-life pooled income fund gift for beneficiary other than donor. Donor who creates pooled income fund gift calling for payments to another for life with the remainder to charitable institution maintaining fund makes two gifts — one to income beneficiary of value of life interest and one to charity of value of remainder interest.
 - a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return — then deductible as a charitable contribution — resulting in a washout. IRC §2522(c)(2)(A); Reg. §25.2522(c)-3(c)(2)(iv); Reg. §1.642(c)-6.
 - b. Life beneficiary's interest when beneficiary is not donor's spouse. Donor makes a gift to life beneficiary of value of life interest. Life interest is a present interest and qualifies for annual exclusion. If tentative tax on gift is not offset by unified transfer tax credit, gift tax will be due. IRC §2503(b).
 - c. Life beneficiary's interest when beneficiary is donor's spouse. For pre-1982 transfers and for post-1981 transfers for which the Q-tip election is not made, the rules are the same as in b (above). For pooled income fund gifts created after 1981, the entire amount transferred by donor to the pooled income fund (not just the spouse's life interest) should be eligible for the unlimited gift tax marital deduction if donor elects on a gift tax return to have the transfer to the fund be considered qualifying terminable interest property. IRC §2523(b).
 - d. The general rules governing qualified terminable interest property should allow a marital deduction for the full value of the entire interest (spouse's life interest and charitable remainder interest).
 - i. If donor elects to treat the gift on a gift tax return as a qualified terminable interest, full

value of the assets in the fund on the surviving spouse's death would then be included in his or her gross estate. IRC §2044.

- ii. But the surviving spouse's estate will be entitled to an offsetting charitable deduction — resulting in a washout. See C. 13 (below).
3. Two-life pooled income fund gift funded with donor's separate property and donor is first beneficiary. Donor who makes gift to pooled income fund — using his or her own separate property — which pays income to the donor for life and then to successor for life makes two gifts — one to charity of remainder interest and one to successor beneficiary of right to receive payments if he or she survives the donor.
- a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return — then deductible as charitable contribution resulting in a washout.
 - b. Second life beneficiary's interest when beneficiary is not donor's spouse.
 - i. Donor makes gift to beneficiary of value of survivorship life interest. Because gift is a future interest, it does not qualify for gift tax annual exclusion. If tentative tax on gift is not offset by unified transfer tax credit, gift tax will be due.
 - ii. Pointer. Donor can avoid making gift to survivor by providing in instrument of transfer that he or she retains right, exercisable only by will, to revoke survivor's life interest. Should the donor exercise right, payments terminate not on death of survivor of donor and second beneficiary, but on donor's death. Donor need not actually exercise right in will. Mere retention of right avoids donor's making completed gift to survivor beneficiary. Reg. §1.642(c)-5-(b)(2); Reg. §25.2511-2(c); Letter Ruling 7908026.

- c. Second life beneficiary's interest when beneficiary is donor's spouse. Appears that spouse's future interest in pooled income fund gift cannot qualify for gift tax marital deduction as qualified terminable interest property. Spouse must be entitled for life to all of income from entire or a specified portion of interest, payable annually or more frequently. IRC §2523(f) (2), (3). Because spouse's life interest starts in the future, it appears that this test is not met. To avoid gift tax concerns, have donor reserve right in inter vivos instrument of transfer to revoke by will surviving spouse's life interest as described above in 3 b (ii).
4. Two-life pooled income fund gift funded with jointly owned property when donors who are not spouses are the beneficiaries. Agreement should provide payments to donors jointly for life and then to survivor for life.
 - a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return — then deductible as charitable contribution resulting in a washout.
 - b. The interest of the life beneficiaries. Actuarially older of joint tenants makes gift to actuarially younger of difference in value of their survivorship interests. Reserve right, exercisable only by will, to revoke survivor's interest in one-half of joint property. Thus, no completed gift. If right is exercised, one-half of assets attributable to donors' participation in fund would be removed from fund and delivered to charitable remainderman on the death of donor exercising right. Reg. §1.642(c)-5(b)(2); Reg. §25.2511-2(c); Letter Ruling 7908026.
5. Two-life pooled income fund gift funded with joint property or community property and donors are spouses. Instrument of transfer should provide payments to donors jointly for life and then to survivor

for life.

- a. The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return — then deductible as charitable contribution resulting in a washout.
 - b. The interest of life beneficiaries. Actuarially older spouse makes a gift to actuarially younger spouse of difference in value of their survivorship interests. Appears that spouse's survivorship interest is not qualified terminable interest property. Best for each spouse to reserve right to revoke as described above in 4 b.
6. Cautions regarding right to revoke a beneficiary's interest.
- a. Right should be exercisable only by will. If exercisable during a donor's lifetime, gift of the charitable remainder interest will not qualify for income tax charitable deduction.
 - b. Right to revoke should not be retained unless donor is income beneficiary. For example, in pooled income fund gift providing payments to donor's son for life with remainder to charity, donor's retaining right by will to revoke son's interest could result in loss of all tax benefits. Rev. Rul. 79-61, 1979-1 C.B. 220.
 - c. Absent retained right, value of son's interest would not be includable in donor's gross estate. IRC §2038. Even absent retained right to revoke, son's interest would have been included in gross estate had the donor died before 1982 and within three years of creating the trust. IRC §2035(a).
 - d. Keep in mind that inter vivos gifts after December 31, 1976 are taken into account in determining base upon which tentative federal estate tax is computed.
- C. Estate tax rules — including marital deduction rules.
1. Donor is sole beneficiary of inter vivos pooled income fund gift. Value of donor's units in fund at his

or her death (or alternate valuation date) is includable in the gross estate when donor retains life interest in pooled income fund gift. IRC §2036. Estate then deducts as charitable contribution amount included—resulting in a washout. IRC §2055(e)(2)(A); Reg. §20.2055-2(e)(2)(iv); Reg. §1.642(c)-6.

2. Single life inter vivos pooled income fund gift for beneficiary other than donor. Value of the units in fund attributable to donor's gift is not includable in donor's gross estate unless donor died before 1982 and transfer was made within three years of donor's death. IRC §2035(a). If value of units is included an estate tax charitable deduction is allowable for value of charitable remainder interest. IRC §2055(e)(2)(A).
3. Two—or more—life inter vivos pooled income fund gift for beneficiaries other than donor. Value of units in fund attributable to donor's gift is not includable in donor's gross estate unless donor died before 1982 and transfer made within three years of death. If value is included, estate tax charitable deduction is allowable for charitable remainder interest.
4. Two-life inter vivos pooled income fund gift funded with donor's separate property with payments to donor for life, then to non-spouse second beneficiary for life.
 - a. The value of the units attributable to the donor's gift at the date of his or her death (or the alternate valuation date) is included in the donor's gross estate whether or not the second beneficiary survives the donor. IRC §2036.
 - b. If the second beneficiary does not survive the donor, the amount which was included in the gross estate is deductible as a charitable contribution—resulting in a washout. IRC §2055(e)(2)(A).
 - c. If the second beneficiary does survive the donor, the value of the charitable remainder is deductible as a charitable contribution at the donor's death.

In effect, only the value of the survivor beneficiary's life interest is subject to estate tax. If the alternate valuation date is elected, in computing the value of the charitable remainder use the value of the assets at the alternate valuation date but use the age of the survivor beneficiary (at his or her nearest birthday) at the date of the donor's death. IRC §2032(b)(2).

5. Two-life inter vivos pooled income fund gift funded with donor's separate property with payments to donor for life, then to spouse as second beneficiary for life.
 - a. Rules are same as discussed in 4 (above) except that for estates of donors dying after 1981, estate tax marital deduction will be allowed (when donor and spouse are only income beneficiaries) for full value of donor's units in fund at death if executor elects to treat pooled income fund gift as qualifying terminable interest. IRC §2056(b)(7).
 - b. If Q-tip election is made, full value of donor's units in fund will be deductible as marital deduction (not just spouse's life interest).
 - c. If Q-tip election has been made, value of donor's units in fund will be includable in surviving spouse's gross estate. IRC §2044. However, charitable deduction will be allowable in surviving spouse's estate — resulting in a washout. See C 13 (below).
6. Two-life inter vivos pooled income fund gift funded with jointly owned property and donors who are beneficiaries are not spouses.
 - a. General rule. When property is held jointly, full value of the property is includable in the gross estate of first joint tenant to die unless decedent's estate shows that survivor furnished all or part of property's consideration. IRC §2040(a).
 - b. The rule does not apply if jointly held property was irrevocably transferred to charitable remainder trust. On death of first joint tenant to die, only

one-half of the property will be includable in the gross estate. Rev. Rul. 69-577, 1969-2 C.B. 173. Estate of the person who dies first will receive charitable deduction for the charitable remainder interest in one-half of the assets included in the gross estate.

7. Two-life inter vivos pooled income fund gift funded with jointly owned property and donors who are beneficiaries are spouses.
 - a. For estates of spouses dying before 1982, the rules are as described in 6 b (above). For estates of spouses dying after 1981, the result is the same but for reason stated in b (below).
 - b. For estates of spouses dying after 1981, only one-half of the jointly held property owned by spouses is includable in the estate of first spouse to die — regardless of who furnished consideration for property. IRC §2040(b). Estate tax charitable deduction is allowable for value of remainder interest. However, can get an estate tax marital deduction for the entire one-half included in the estate of the first to die if the executor of spouse who dies first elects to treat life income interest of surviving spouse as a qualified terminable interest. IRC §2056(b)(7). On death of surviving spouse, value of one-half interest in pooled fund will be includable in his or her estate but will qualify for estate tax charitable deduction — resulting in a washout. See C 13 (below).
8. Two-life inter vivos pooled income fund gift funded with community property and donors are beneficiaries. Include value of one-half of trust assets in the gross estate of first spouse to die. Estate is entitled to charitable deduction for value of remainder interest. However, if executor elects to treat value of surviving spouse's continuing life interest as qualified terminable interest, full amount includable in gross estate will be deductible as marital deduction. IRC §2056(b)(7).

9. Pooled income fund gift created by donor's will for benefit of spouse. For pre-1982 transfers to a pooled income fund and post-1981 transfers for which a Q-tip election is not made, estate is entitled to charitable deduction for value of charitable remainder interest. For a post-1981 transfer for which a donor's estate elects to treat transfer as qualified terminable interest, full value of assets transferred is deductible as marital deduction. Although value of the assets will be includable in surviving spouse's gross estate, estate will be entitled to offsetting charitable deduction.
10. Pooled income fund gift created by donor's will for benefit of survivor who is not spouse. Donor's estate is entitled to charitable deduction for value of remainder interest based upon age of survivor and appropriate tables based upon fund's highest rate of return in last three years. In making computation, use age of survivor (to nearest birthday) at donor's death even if alternate valuation date is elected.
11. Testamentary pooled income fund gift— income earned before assets transferred to fund. Pooled income fund disqualified if income accumulated during period of estate administration is transferred to fund and fund then pays income to beneficiary. Gift qualifies if estate pays income during period of administration directly to beneficiary. Rev. Rul. 76-445, 1976-2 C.B. 193.
12. Many pooled income funds provide that a beneficiary's payments terminate with payment preceding beneficiary's death. Because payments do not continue until spouse's death it can be argued that spouse does not have income interest for life. Technical Corrections Act does not directly address the problem, but both Senate Finance Committee and House Ways and Means Committee reports state that this will not disqualify trust for Q-tip election. S. Rep. No. 592, 97th Cong., 2d Sess.

20-21 (1982); H.R. Rep. No. 794, 97th Cong., 2d Sess. 17 (1982).

D. Planning considerations.

1. Pitfalls associated with charitable remainder unitrusts and annuity trusts [See I E (above)] may also apply to pooled income funds. Consideration should be made whether to include death tax governing instrument requirement of Rev. Rul. 82-128, IRB 1982-27, 7. See I E 18 (above).
 - a. Although Rev. Rul. 82-128 is aimed at unitrusts and annuity trusts, the same problem which concerns IRS also exists for pooled income funds. An extension of Rev. Rul. 82-128 (which IRS is considering) would disallow income and gift tax charitable deductions for transfers to pooled funds, unless the pooled income fund instrument of transfer contains the required death tax governing instrument provision.
 - b. Letter Ruling 8228078, released about the same time as Rev. Rul. 82-128, is interesting. IRS had approved a charity's pooled income fund in 1979. Charity later asked for and received a supplemental ruling that its original ruling is not adversely affected by an amendment to the fund which provides: "In making my gift to the Fund and as a condition of N's accepting such gift, I agree that no estate, inheritance, transfer, or similar taxes with respect to any interest created as part of my gift to the Fund shall be allocated to or recoverable from such interest or any other property of the Fund. I agree to provide, in my will or otherwise, for the payment of any such taxes from sources other than the Fund itself. If I fail to make such provision, I agree that N and/or the Trustee of the Fund will be entitled to recover from my estate or other property of mine or from the holder of the interest with respect to which the taxes were imposed, the amount of any such taxes which the Fund or the Trustee is required to pay."

- c. Now that Rev. Rul. 82-128 has been published, charities with existing pooled funds (which have previously received IRS approval) should consider seeking letter rulings approving amendments containing the death tax governing instrument provision of Rev. Rul. 82-128. And, of course, consider putting that provision in newly created life income agreements.
2. Alternative remaindermen.
 - a. Situation. Charity's pooled income fund provides that if it is no longer a public charity when an income beneficiary dies, the remainder interest is to be transferred to one or more alternative organizations which are public charities.
 - b. IRS rules. No deduction is allowable because the remainder may be transferred to more than one public charity. This violates Reg. §1.642(c)-5(b)(8), says IRS, which requires that the remainder be transferred to only one remainderman upon termination of an income interest. Letter Ruling 8130070.
 - c. Comment. Reg. §1.642(c)-5(b)(8) says that, upon termination of a life income interest, the amount severed from the fund must be paid to or retained for the use of "the designated public charity." This letter ruling illustrates IRS's consistently narrow interpretation of the Code and regulations applicable to pooled income funds and charitable remainder trusts. Moreover, it is contrary to a large number of previously issued IRS private letter rulings approving pooled income fund plans.
 - d. Important. Counsellors to organizations with pooled income funds having alternative remainderman provisions that this letter ruling now finds objectionable, and which do not have private letter rulings approving their fund's alternative remainderman provisions, should consider suggesting that the pooled income fund plans be amended.

- e. Organizations having pooled income funds containing the now offending provision and having private rulings approving their provision on alternative remaindermen are in better shape. An existing letter ruling is not revoked by a contrary letter ruling issued to a different taxpayer.
 - f. If this letter ruling should become IRS's position in a published revenue ruling (which would then revoke all contrary letter rulings), it can be argued that a pooled income fund should nevertheless qualify when the possibility that the named charity will not be a publicly supported charity at the end of a life interest is so remote as to be negligible. IRS has so ruled in analogous situations where a charitable remainder trust's governing instrument did not require alternative remaindermen to be an IRC §2055(a) or IRC §2522(c) organization. Rev. Rul. 76-307, 1976-2 C.B. 56.
3. Termination of income interest.
- a. A beneficiary's income interest must terminate with either the last regular payment made before death or be prorated to the date of death. On the termination of an income interest, the trustee is to sever from the fund an amount equal to the value of the remainder interest in the property on which the income interest is based (the then value of the fund's assets attributable to the beneficiary's units). The amount severed from the fund must either be paid to (or retained for the use of) the public charity remainderman (as provided in the governing instrument). Reg. §1.642(c)-5(b)(8). The value of the remainder interest for this purpose may be either —
 - i. Its value as of the determination (valuation) date next succeeding the termination of the income interest or
 - ii. Its value as of the date on which the last regular payment was made before the death of the

beneficiary if the income interest is terminated on that payment date.

- b. IRS, in 1976, issued a super-technical revenue ruling, Rev. Rul. 76-196, 1976-1 CB 178, stating the valuation date for assets to be removed from a pooled fund. The published ruling is contrary to a number of previously issued private letter rulings.
- c. The meaning of the ruling is best shown by an example.
 - i. A pooled income fund makes payments on the last day of each quarter — March 31, June 30, September 30 and December 31. The fund is valued on the first day of each quarter — January 1, April 1, July 1 and October 1. A beneficiary dies on January 15. The plan provides that payments to a beneficiary terminate with the payment preceding his death and assets representing the beneficiary's units in the fund are to be removed on the first valuation date following the beneficiary's death.
 - ii. In a number of private letter rulings IRS said, in effect, that based on the facts in the above example, the assets are to be removed from the fund on April 1 — at their value on April 1. The beneficiary's interest terminated on January 15 and April 1 is the first valuation date following the termination of his income interest.
 - iii. In the published ruling, IRS changed its mind and said because the payments terminate with the payment preceding death, the beneficiary's life interest terminates with the payment preceding death (and not the date of death). Thus, in the above example, the plan must provide that assets are to be removed from the fund on April 1 at their January 1 value — rather than at their April 1 value (as IRS had ruled in a number of letter rulings).

- d. Note. It makes poor sense to remove assets on April 1 at their January 1 value. This can result in distortions. But that is the way IRS says to do it and that procedure should be followed.
- e. Had the plan in the above example provided that the payments be prorated to the date of the beneficiary's death, then — any way you look at it — the assets would be removed from the fund on April 1 at the April 1 value. April 1 is the first valuation date following January 15 (the date of the beneficiary's death).

III. Gift of Personal Residence or Farm With Retained Life Estate

A. Brief description.

- 1. A donor can obtain income and estate tax benefits by making a charitable gift of his or her personal residence or farm even though the donor retains the right to life enjoyment. A life estate may be retained for one or more lives. An estate may also be retained for a term of years.
- 2. Remainder interest must be in a personal residence or farm. Does not include furnishings or other tangible personal property.
- 3. Gift may not be in trust.
- 4. Charitable deduction. For the income tax charitable deduction, depreciation (computed on the straight line method) and depletion must be taken into account in determining the value of the remainder interest. These values are, under current law, discounted at a rate of six percent per annum. Reg. §1.170A-12(a). For gift and estate tax purposes, depreciation (or depletion) need not be taken into account in valuing the remainder interest. IRS considering new tables. See Section VI.
- 5. Capital gains.
 - a. Capital gains are generally not taxable on a transfer of appreciated property to charity.
 - b. Capital gain is taxable to a donor if he transfers

property to charity which is subject to an indebtedness whether or not the indebtedness is assumed by the charity. IRC §1011(b); Reg. §1.1011-2(a)(3). See also Guest, 77 TC 9 (1981).

- c. When a donor bargain sells a remainder interest in an appreciated personal residence or farm to charity, he will have capital gains determined under IRC §1011(b) and Reg. §1.1011-2.

B. Gift tax rules — including marital deduction rules.

1. Gift of remainder interest with life estate reserved for donor's life. The value of the charitable remainder interest in a personal residence or farm is not subject to federal gift tax. IRC §2522(c)(2); Reg. §25.2522(c)-3(c) (2)(ii), (iii). However, the donor must report the remainder gift (regardless of size because it is a future interest) on a federal gift tax return. IRC §6019(b). The donor then takes an offsetting gift tax charitable deduction.
2. Gift of remainder interest with life estate reserved for beneficiary other than donor. A donor who donates a remainder interest in a personal residence or farm creating a life estate in another (e.g., a spouse or child) makes two gifts — one to the life beneficiary of the value of his or her life interest and one to the charity of the value of its remainder interest.
 - a. The charitable remainder interest. The charitable remainder interest is reportable (regardless of size because it is a future interest) on a federal gift tax return. It is then deductible as a charitable contribution — resulting in a washout.
 - b. Life tenant's interest when tenant is not donor's spouse. Donor makes a gift to the life tenant of the value of his or her life interest. The life interest is a present interest and qualifies for the \$10,000 annual exclusion. IRC §2503(b). If the "tentative" tax on the gift is not offset by any remaining unified transfer tax credit, gift tax will be due.
 - c. Life tenant's interest when tenant is donor's spouse. For pre-1982 transfers and for post-1981

transfers for which the qualified terminable interest property election is not made, the rules are the same as in b (above). For remainder interest gifts created after 1981, the entire value of the property (not just the spouse's life interest) should be eligible for the unlimited gift tax marital deduction if the donor elects on a gift tax return to have the transfer considered as qualifying terminable interest property. IRC §2523(f).

3. Gift of remainder interest with life estate retained for two lives. A donor who makes a gift of a remainder interest using his or her own separate property — reserving a life estate for his or her life and then for the life of another (a child, for example) makes two gifts — one to the charity of the remainder interest and one to the successor beneficiary of his or her life interest if he or she survives the donor.
 - a. The charitable remainder interest. The charitable remainder interest is reportable (regardless of size because it is a future interest) on a federal gift tax return. It is then deductible as a charitable contribution — resulting in a washout.
 - b. Second life tenant's interest when tenant is not donor's spouse.
 - i. Donor makes a gift to the life tenant of the value of his or her survivorship life interest. Because the gift is of a future interest, it does not qualify for the gift tax annual exclusion. If the "tentative" tax on the gift is not offset by any remaining unified transfer tax credit, gift tax will be due.
 - ii. Pointer. Donor can avoid making a gift to the survivor by providing in the deed of transfer that he or she reserves the right to revoke the survivor's life interest. Unlike charitable remainder unitrusts, annuity trusts and pooled income funds, the right to revoke the survivor's interest need not be exercisable only by will. A donor who makes a charitable re-

remainder gift of a personal residence or farm may retain the lifetime right to revoke a survivor's interest without losing the tax benefits for the charitable gift. The donor need not actually exercise the right to revoke. However, the mere retention of the right avoids the donor's making a completed gift, for gift tax purposes, to the survivor beneficiary. Should the donor exercise his right to revoke, he should get an income tax charitable deduction for the then value of the successor beneficiary's survivorship interest. Reg. §25.2511-2(c); Letter Ruling 7830103.

- c. Second life tenant's interest when tenant is donor's spouse. Spouse's future life estate appears not to qualify for the gift tax marital deduction as qualified terminable interest property. One of the conditions that a qualified terminable interest must meet is that the spouse is entitled for life to all of the income from the entire or a specified portion of the interest, payable annually or more frequently. IRC §2523(f)(2), (3). Because the spouse's life interest starts in the future, it appears this test is not met. Until this point is clarified by Treasury regulations (or otherwise), gift tax concerns can be avoided as discussed in ii (above) by having the donor reserve the right in the deed to revoke the surviving spouse's life interest.
4. Gift of remainder interest in jointly owned personal residence or farm when donors who are not spouses are the life tenants. The life estate should be retained by the donors jointly for life and then to the survivor for life.
 - a. The charitable remainder interest. The charitable remainder interest is reportable (regardless of size because it is a future interest) on a federal gift tax return. It is then deductible as a charitable contribution — resulting in a washout.

- b. The interests of the life tenants.
 - i. The actuarially older of the joint tenants makes a gift to the actuarially younger of the difference in value of their survivorship interests. To avoid adverse gift tax implications, each life tenant can — in the deed — reserve the right to revoke the survivor's interest in one-half of the joint property. If the right is exercised, one-half of the property would be transferred to the remainderman outright at the death of the donor who exercised the right. Neither beneficiary generally exercises the right, but the retention of the right avoids gift tax concerns.
 - ii. Caution. If the right is actually exercised, the surviving tenant would only have a one-half interest in the property.
- 5. Gift of remainder interest in joint property or community property and donors are spouses. The life estate should be retained by the donors jointly for life and then to the survivor for life.
 - a. The charitable remainder interest. The charitable remainder interest is reportable (regardless of size because it is a future interest) on a federal gift tax return. It is then deductible as a charitable contribution — resulting in a washout.
 - b. The interests of the life tenants. The actuarially older spouse makes a gift to the actuarially younger spouse of the difference in value of their survivorship interests. As discussed above, it appears that the spouse's survivorship interest does not qualify as terminable interest property. Until this is clarified by regulations (or otherwise), each spouse can reserve the right to revoke.
- C. Estate tax rules — including marital deduction rules.
 - 1. Gift of remainder interest with life estate reserved for donor's life. The fair market value of the personal residence or farm at the donor's death (or the alter-

- nate valuation date) is includable in his or her gross estate when the donor retains a life estate in the property. IRC §2036. The estate then deducts as a charitable contribution the amount included in the gross estate — resulting in a washout. IRC §2055(e)(2); Reg. §20.2055-2(e)(2)(ii),(iii).
2. Gift of remainder interest with life estate reserved for life tenant other than donor. The value of the personal residence or farm is not includable in the donor's gross estate unless the donor died before 1982 and the transfer was made within three years of the donor's death. IRC §2035(a). If the value of the property is included in the gross estate under the pre-1982 "three-year rule," an estate tax charitable deduction is allowable for the value of the charitable remainder interest. IRC §2055(e)(2)(A).
 3. Gift of remainder interest with life estate reserved for two or more life tenants other than donor. The value of the personal residence or farm is not includable in the donor's gross estate unless the donor died before 1982 and transfer was made within three years of his or her death. If the value of the property is included in the gross estate under the three-year rule, the donor's estate gets a charitable deduction for the value of the charitable remainder interest.
 4. Gift of remainder interest in personal residence or farm with life estate reserved to donor, then to non-spouse second life tenant.
 - a. When a donor makes a gift of a remainder interest using his own separate property — and retains a life estate for himself — the entire value of the property at the date of his death (or the alternate valuation date) is includable in the donor's gross estate whether or not the second life tenant survives the donor. IRC §2036.
 - b. If the second life tenant does not survive the donor, the amount which was included in the gross estate is deductible as a charitable contribution — resulting in a washout. IRC §2055(e)(2)(A).

- c. If the second life tenant does survive the donor, the value of the charitable remainder is deductible as a charitable contribution at the donor's death. In effect, only the value of the survivor life tenant's interest is subject to tax. If the alternate valuation date is elected, in computing the value of the charitable remainder, use the value of the property at the alternate valuation date but use the age of the survivor life tenant (at his or her nearest birthday) at the date of the donor's death. IRC §2032(b)(2).
5. Gift of remainder interest in donor's separate property with life estate reserved to donor, then to spouse as second life tenant. The rules are the same as discussed in 4 (above) except that for estates of donors dying after 1981, an estate tax marital deduction should be allowed (when the donor and his spouse are the only life tenants) for the full value of the personal residence or farm at his death if donor's executor elects to treat the property as a qualifying terminable interest. IRC §2056(b)(7).
6. Gift of remainder interest in jointly owned personal residence or farm and donors who are the life tenants are not spouses.
 - a. General rule. When property is held jointly, the full value of the property is includable in the gross estate of the first of the joint tenants to die unless the decedent's estate can show that the survivor furnished all or part of the property's consideration. To the extent that the estate can show that the survivor furnished consideration for the property, the property is not included in the gross estate of the first to die. IRC §2040.
 - b. Special rules for transfer of jointly owned property with retained life interest. The usual rules (above) for determining the amount of joint property included in the gross estate of the first joint tenant to die are changed if during lifetime the joint prop-

erty was transferred to charity with a retained life estate. *Heasty v. U.S.*, 370 F.2d 525 (10th Cir. 1966). Once property transferred, it makes no difference for estate tax purposes who furnished consideration. On death of the first joint tenant to die only one-half of the property will be included in the gross estate. Rev. Rul. 69-577, 1969-2 C.B. 173. Estate tax charitable deduction for charitable remainder interest in one-half of the assets included in the gross estate allowed.

7. Gift of remainder interest in jointly owned property and the donors who are life tenants are spouses.
 - a. For estates of spouses dying before 1982, the rules are as described in 6b (above).
 - b. For estates of spouses dying after 1981, the result is the same as described in 6b (above) but not for the reasons stated in that paragraph. The Internal Revenue Code specifically provides that only one-half of the jointly held property owned by the spouses is includable in the estate of the first spouse to die — regardless of who furnished the consideration for the property. IRC §2040(b). And there should be an estate tax marital deduction for the one-half included in the estate of the first to die if the executor elects to treat the life interest of the surviving spouse as a qualified terminable interest. IRC §2056(b)(7). On the death of the surviving spouse, one-half the value of the property at his or her death will be includable in the gross estate but should qualify for an estate tax charitable deduction — resulting in a washout.
8. Gift of remainder interest in community property and donors are the life tenants. Include the value of one-half of the personal residence or farm in the gross estate of the first spouse to die. The estate is entitled to a charitable deduction for the value of the remainder interest in that half. If the executor of the estate elects to treat the value of the surviving

spouse's continuing life interest as a qualified terminable interest, the full amount includable in the gross estate should be deductible as a marital deduction. IRC §2056(b)(7). On the death of the surviving spouse, one-half the value of the property at his or her death will be includable in the gross estate but should qualify for an estate tax charitable deduction — resulting in a washout.

9. Gift of remainder interest by will reserving life estate for donor's spouse. For pre-1982 transfers and post-1981 transfers for which a qualified terminable interest property election is not made, the estate is entitled to a charitable deduction for the value of the charitable remainder interest. For a post-1981 transfer for which a donor's estate elects to treat the transfer as a qualified terminable interest, the full value of the residence or farm should be deductible as a marital deduction. IRC §2056(b)(7). Although the value of the property at the time of the surviving spouse's death will be includable in his or her gross estate, that estate will be entitled to an offsetting charitable deduction.
 10. Gift of remainder interest by donor's will reserving life estate for survivor who is not a spouse. The donor's estate is entitled to a charitable deduction for the value of the remainder interest based upon the age of the survivor at the donor's death. In making the computation, use the age of the survivor (to the nearest birthday) at the donor's death even if the alternate valuation date is elected.
- D. Planning considerations.
1. Death tax governing instrument requirement. Although specifically aimed at charitable remainder unitrusts and annuity trusts, Rev. Rul. 82-128, IRB 1982-27, 7, could apply to gifts of remainder interests in personal residences or farms. See I E 18 (above).
 2. Charitable gift of proceeds from sale of farm or residence.
 - a. IRS's position.

- i. IRS maintains that no deduction is allowed for a gift of a remainder interest in a residence or farm when Donor's will directs that the property be sold and all or part of the sales proceeds be distributed to charity. Rev. Rul. 76-543, 1976-2 C.B. 287; Rev. Rul. 76-544, 1976-2 C.B. 288.
 - ii. IRS allows a deduction, however, if the second beneficiary's interest terminates (he dies) before the due date of donor's estate tax return so that the remainder interest passes directly to charity and is deductible under a special exception in IRC §2055(e)(3). Letter Ruling 7812005.
 - iii. IRS will also allow a deduction if state law permits the charitable remainderman to take the farm or residence itself, despite the terms of donor's will. Letter Ruling 8141037.
 - iv. IRS has allowed a deduction on these facts. Donor gave his personal residence to charity, retaining a life estate, and directed that on his death the charity sell the residence and add its proceeds to a trust Donor previously established for its benefit. Here, said IRS, the charity's remainder interest is in the residence itself, not just the proceeds of a future sale. Letter Ruling 7835010.
 - b. U.S. Tax Court allowed deduction even though the interest received by charity was not a remainder interest in a personal residence but rather a remainder interest in the proceeds from the sale of the residence. Blackford, 77 TC, No. 90 (1981).
3. Gift of remainder interest coupled with gift of undivided interest in property. Donor can give a charity a remainder interest and an undivided interest in the same property. Rev. Rul. 76-473, 1976-2 C.B. 306. For example, donor can deed his personal residence or farm to charity reserving the right for life to use

the property during the summer months as a vacation home. Donor will be entitled to a charitable deduction for:

- (i) the remainder interest; and
- (ii) the undivided portion of his entire interest in the property. Rev. Rul. 76-473, 1976-2 C.B. 306.

4. Charitable gift of life interest after gift of remainder interest.

a. A donor who has given a remainder interest in his residence or farm to charity, reserving a life estate for himself, should be entitled to an income tax charitable deduction if he later contributes his remaining life interest to the charitable remainderman, thereby accelerating the charitable remainder. The income tax charitable deduction would be for the then value of the remaining life interest.

b. Caution. If the property in which the partial interest exists was divided to create an interest which would avoid the "less than the entire interest" rule, no deduction is allowable. It is a fact question whether a donor created a partial interest for reasons other than avoidance of IRC §170(f)(3)(A). If a donor, for example, can show that he retained a life interest to provide for his security and that his security is now otherwise assured (or he is no longer concerned about it), he should be entitled to a charitable deduction of the current value of his remaining life interest. See, *e.g.*, Rev. Rul. 76-523, 1976-2 C.B. 54.

IV. Charitable Gift Annuities

A. Brief description.

1. A donor irrevocably transfers money, property or both to a qualified organization in return for its promise to pay the donor, another or both, fixed and guaranteed payments for life. In essence, the transfer is part charitable gift and part purchase of an annuity.

2. The amount of the annual payment — which can be paid in monthly, quarterly or semi-annual installments — is fixed at the outset and never varies. As with a commercial annuity: (1) The older the annuitant at the annuity starting date, the higher the annual payments; (2) When there are two annuitants, the annual payments are lower than if there is one annuitant; and (3) A sizable portion of each annuity payment is excludable from gross income. The excludable, or tax-free amount, is established at the annuity starting date and never fluctuates.
3. Charitable contribution for a one-life gift annuity is difference between the amount of money, or the fair market value of long-term securities or real estate transferred, and the value of the annuity (the so-called "investment in the contract"). Reg. §1.170A-1(d); Rev. Rul. 72-438, 1972-2 C.B. 38. The investment in the contract is the amount, determined using official Treasury tables, which approximates what an annuity paying the same rate of return would cost if purchased from a commercial insurance company. For a two-life charitable gift annuity, charitable contribution is the amount of money, or the fair market value of long-term securities or real estate transferred, minus the two-life investment in the contract (also computed using the Treasury tables). See Section VI regarding possible new IRS tables.
4. Comparison with annuity trusts.
 - a. The charitable gift annuity differs from the charitable remainder annuity trust. An annuity trust's payments are made only as long as the trust has sufficient assets. Gift annuity payments are backed by all of the charity's assets. Further, the size of the charitable deduction, the capital gains implications, how the rates are set, and the taxation of the annual payments also differ.
 - b. An arrangement whereby donor contributes

money to charity in return for an annual income based on the earnings on the donated monies is treated as a trust — not an annuity — and donor will be fully taxed on the trust's income. Letter Ruling 8223014.

5. Taxation of annual payments. A large percentage of each payment is excludable (tax-free). The percentage (called the exclusion ratio) is determined when the annuity is created and remains constant for the entire term. Reg. §1.72-4 *et seq.* Withholding on the taxable portion is not required unless the annuitant requests it. In determining the amount of each payment which is excludable, an exclusion ratio is computed. The numerator of the ratio is the investment in the contract. The denominator is the expected return (the annual annuity multiplied by the annuitant's life expectancy). The investment in the contract and expected return are computed using Treasury tables. The exclusion ratio multiplied by the annual payment gives the amount excludable. The difference between the payment and the excludable amount is taxable.
6. Capital gains implications.
 - a. Bargain sale. The transfer of appreciated property for a charitable gift annuity is deemed to be a bargain sale. In computing the amount of the capital gain, the cost-basis of the transferred property must be allocated between the gift portion and the investment in the contract. The amount of the capital gain is the difference between the investment in the contract and the cost-basis allocated to the investment in the contract. Reg. §1.1011-2(a)(4), (c) (example 8).
 - b. The "ratably" rule. The capital gain determined under the bargain sale rules is reportable by the donor-annuitant ratably over his or her life expectancy if (1) the annuity is nonassignable and (2) the donor is the sole annuitant or is one of the

annuitants in a two-life annuity. If the donor-annuitant dies before all of the capital gain have been reported, the remaining capital gain is buried with him or her — and is not reportable. In a two-life annuity funded with a donor's separate property in which the donor is the first annuitant, the gain is reported ratably over the donor's life expectancy and not the joint life expectancy of the two annuitants.

B. Gift tax charitable deduction.

1. The value of the charitable gift element of a gift annuity (deemed a present interest) is not taxable. However, the donor must report the gift on a federal gift tax return if it exceeds the annual \$10,000 gift tax exclusion. The donor then takes an offsetting gift tax charitable deduction. IRC §2522(a).
2. One-life gift annuity for annuitant other than donor. A donor who creates a gift annuity calling for payments to another (e.g. a spouse or child) for life makes two gifts — one to the annuitant of the value of his or her life interest (the "investment in the contract") and one to the charity of the gift element.
 - a. The charity's gift is a present interest gift and is reportable if it exceeds the annual gift tax exclusion. It is then deductible — resulting in a washout.
 - b. The gift to the annuitant may be taxable. It does qualify for the annual exclusion. If the "tentative" tax on the gift is not offset by any remaining unified transfer tax credit, gift tax will be due. A gift annuity for a spouse qualifies for the gift tax marital deduction. Reg. §25.2523(b)-1(b)(6)(ii).
3. Two-life gift annuity funded with donor's separate property and donor is first annuitant.
 - a. A donor who creates a gift annuity — using his or her own separate property — which pays an annuity to the donor for life and then to a survivor annuitant (a spouse, for example) for life makes two gifts — one to the charity which is reportable

(if it exceeds the annual exclusion) and then deductible, making it not taxable, and one to the survivor annuitant of the right to receive annuity payments if he or she survives the donor. There is no annual exclusion for the gift to the survivor beneficiary because the gift is a future interest gift. IRC §2503(b). There is no gift tax marital deduction. IRC §2523(b); Reg. §25.2523(b)-1(c).

- b. The donor can avoid making a gift to the survivor-annuitant by providing in the inter vivos instrument that the donor retains the right to revoke the survivor's life interest. Should the donor exercise that right, the payments are to terminate not on the death of the survivor of the donor and the second beneficiary, but on the donor's death. The donor need not actually exercise the right. However, the mere retention of the right avoids the donor's making a completed taxable gift to the survivor annuitant. Unlike charitable remainder trusts, donor can provide in the inter vivos instrument that he or she retains the right to exercise the power to revoke during life, by will or both. Reg. §25.2511-2(c).
4. Two-life gift annuity funded with joint or community property and donors are the annuitants. The inter vivos instrument should provide payments to the donors jointly for life and then to the survivor for life. To avoid adverse gift tax implications, each spouse should—in the inter vivos instrument—reverse the power to revoke the survivor's interest in the payments from his or her one-half share of the joint or community property.
- C. Estate tax charitable deduction—gift annuities created during donor's lifetime.
 1. Donor is the sole annuitant of an inter vivos gift annuity. For a single life annuity making payments to a donor-annuitant for life, no amount is included in his or her gross estate.
 2. Gift annuity for annuitant(s) other than donor. For

an annuity providing payments to an annuitant or annuitants other than the donor, no amount is included in the donor's gross estate.

3. Two-life inter vivos gift annuity funded with donor's separate property with payments to donor for life and then to a survivor annuitant for life.
 - a. If the second annuitant does not survive the donor, no amount is includable in the donor's gross estate.
 - b. If the second annuitant does survive the donor, includable in the donor's gross estate is the value of an annuity which pays the same amount to the survivor annuitant (at the survivor's age at the donor's death) as the donor received during his or her life (what it would cost to purchase a comparable annuity from a commercial insurance company). IRC §2039(c). The gift to the survivor qualifies for the estate tax marital deduction to the extent it is includable in the donor's gross estate. Reg. §20.2056(b)-1(g) (example 3). Any estate tax attributable to the survivor's annuity is allowed as an income tax deduction to the survivor annuitant if the survivor itemizes deductions on his or her income tax return — and is claimed over the survivor's life expectancy. IRC §691(c).

D. Gift annuities by will.

1. Estate tax charitable contribution. An estate tax charitable deduction is allowable for the difference between the amount transferred to the charity and the investment in the annuity contract (computed the same way as for an inter vivos annuity). Unlike the two-life annuity created during a donor's lifetime which qualifies for the estate tax marital deduction, no estate tax marital deduction is allowed. Reg. §20.2056(b)-1(f).
2. Caution. An estate tax charitable deduction for a charitable gift annuity will not be allowed, however, if a will does not properly define the amount of the

annuity to be paid. IRS will disallow a deduction if the annuity is unascertainable. See Letter Ruling 8045010. Caution. A letter ruling is not a precedent.

3. Capital gains rules. No capital gain is incurred by an estate on the difference between the donor's cost-basis of appreciated property used to obtain the annuity and the property's fair market value because the estate has a stepped-up basis. However, if the estate uses property to fund the annuity which has appreciated after the estate tax valuation date, a capital gain — computed under the bargain sales rules — will be incurred.

E. Planning considerations.

1. Gift annuity funded with remainder interest in personal residence. Donor can combine two deferred charitable gifts in one transaction: (1) a remainder interest in his personal residence (donor retains a life estate) and (2) a lifetime annuity payable to the donor from the charity's general assets. To the extent that the fair market value of the remainder interest exceeds the value of the lifetime annuity at the date of the transfer, the donor has made a charitable gift. Both income and gift tax charitable deductions are allowable for this amount. Donor recognizes capital gain on the transaction determined under IRC §1011(b) and Reg. §1.1011-2. Letter Ruling 8120089.
2. The debt-financed income rules.
 - a. If a charity accepts mortgaged property for a gift annuity, it will have taxable debt-financed income unless the mortgage was placed on the property more than five years before the inter vivos transfer for the annuity and the donor owned the property more than five years before the transfer. In that case, the mortgage is not considered an acquisition indebtedness during the 10 years following the transfer. If the property is transferred by a donor's will, the "five-year requirement" before the transfer does not apply. IRC §514(c)(2).

- b. Even if the charity receives unmortgaged property for gift annuity, it will be deemed to have debt-financed income unless these tests are met:
 - i. The value (investment in the contract) of the annuity is less than 90 percent of the value of the property received (the gift part is more than 10 percent);
 - ii. The annuity is payable over the life of one or two individuals living when the annuity is created;
 - iii. The annuity does not guarantee a minimum or maximum amount of total payments; and
 - iv. The annuity does not provide for adjustment of payments by reference to the income received from the transferred or other property. IRC §514(c)(5).
 - c. Capital gains implications when annuity funded with mortgaged property. Add the amount of the mortgage to the investment in the contract in determining the capital gains implications. Gain attributable to the indebtedness cannot be reported ratably over the donor-annuitant's life expectancy.
- F. The deferred payment gift annuity.
- 1. Brief description. A donor transfers money, property or both to a charitable organization in exchange for its promise to pay an annuity to the donor, another or both, to begin more than one year from the date of the transfer. The donor is able to make a gift now and get an income tax charitable deduction when he or she is in a high tax bracket, deferring payment until those years when the donor may need the income more (e.g., after retirement) and will generally be in a lower income tax bracket.
 - 2. The charitable contribution is the amount of money, or fair market value of long-term securities or long-term real estate transferred, minus the investment in the contract.
 - 3. Taxation of annual payments. The amount of each

payment that will be excludable, or tax-free, will depend on the rules in effect when the payments start. A reasonable rule would be that the "expected return" (which is needed to compute the exclusion ratio and hence the excludable amount) is to be computed at the time payments begin, using the life expectancy tables then in effect.

4. Capital gains implications. Treasury regulations and Rev. Rul. 72-438, 1972-2 C.B. 38, are silent on the capital gains implications of deferred payment gift annuities funded with appreciated property. An unpublished private letter ruling holds that the rules applicable to immediate charitable gift annuities apply to deferred payment annuities. Thus, the gain will be determined under the bargain sale rules and will be reportable ratably over the annuitant's life expectancy if (1) the annuity is non-assignable and (2) the donor is the sole annuitant in a one-life annuity or is one of the annuitants in a two-life annuity. The private letter ruling holds that the capital gain will not be reportable until payments begin and then will be reported ratably over the life expectancy determined as of the "starting anniversary" date.
5. Other tax rules. Gift tax, estate tax and tax implications involved when debt-financed property is transferred for a gift annuity, should be comparable to those discussed earlier for the immediate gift annuity.

V. Charitable Lead Trusts

- A. Often a nifty way for a generous individual in high gift and estate tax brackets to provide trust payments to a charitable institution for a number of years, with the trust principal then going to children, grandchildren or others at the end of the trust term — absolutely free of federal gift and estate taxes.
- B. Caution regarding prepayment provisions. Don't include a prepayment provision in a lead trust until IRS or the courts rule favorably on its inclusion. Although in at least one instance IRS allowed a deduction for a

lead trust containing a prepayment provision (Letter Ruling 8110159), IRS later announced that it will not issue advance rulings or determinations letters regarding the income, gift or estate tax deduction for a charitable lead trust when the trust instrument permits prepayment of the charitable lead interest before the expiration of the trust term. Rev. Proc. 82-11, I.R.B. 1982-8, 16.

- C. The tables on the following three pages show the combination of trust term and the percentage of initial trust principal to be paid annually to the charitable institution in order for the charity's guaranteed annuity interest to equal 100 percent of the assets used to fund the trust. Following the tables is a worksheet which will enable you to determine the amount to be paid to the charity annually if the charitable contribution under a charitable lead annuity trust is to be less than 100 percent.

**PERCENTAGE OF INITIAL TRUST PRINCIPAL TO BE
PAID ANNUALLY IN ORDER FOR THE CHARITY'S
GUARANTEED ANNUITY INTEREST TO EQUAL
100% OF THE ASSETS USED TO FUND THE TRUST***

Term of Trust Before Principal Delivered to Family Members**	Percentage if Payments to Charity Are at End of Each		
	Quarter	Half Year	Year
1	103.70%	104.45%	106.00%
2	53.36	53.74	54.54
3	36.60	36.86	37.41
4	28.23	28.24	28.86
5	23.22	23.39	23.74
6	19.90	20.04	20.34
7	17.52	17.65	17.91
8	15.75	15.87	16.10
9	14.38	14.49	14.70
10	13.29	13.39	13.59
11	12.40	12.50	12.68
12	11.67	11.76	11.93
13	11.05	11.14	11.30
14	10.53	10.60	10.76
15	10.08	10.15	10.30
16	9.68	9.76	9.90
17	9.33	9.40	9.54
18	9.04	9.11	9.24
19	8.77	8.83	8.96
20	8.53	8.59	8.72

*This chart is based on Treasury tables in Reg. Sec. 20.2031-10(b)(2).

**Take state law on the permissible trust term—the rule against perpetuities—into account.

**Term of
Trust Before
Principal
Delivered to**

**Family
Members***

**Percentage if
Payments to Charity
Are at End of Each**

	Quarter	Half Year	Year
21	8.32%	8.38%	8.50%
22	8.12	8.18	8.30
23	7.95	8.01	8.13
24	7.80	7.85	7.97
25	7.65	7.71	7.82
26	7.52	7.58	7.69
27	7.41	7.46	7.57
28	7.30	7.35	7.46
29	7.20	7.25	7.36
30	7.10	7.15	7.26
31	7.02	7.08	7.18
32	6.95	7.00	7.10
33	6.88	6.93	7.03
34	6.81	6.86	6.96
35	6.75	6.80	6.90
36	6.69	6.74	6.84
37	6.64	6.69	6.79
38	6.59	6.64	6.74
39	6.54	6.59	6.69
40	6.51	6.55	6.65
41	6.47	6.51	6.61
42	6.43	6.47	6.57
43	6.39	6.43	6.53
44	6.36	6.41	6.50
45	6.33	6.38	6.47
46	6.30	6.35	6.44
47	6.27	6.32	6.41
48	6.25	6.30	6.39
49	6.23	6.28	6.37
50	6.20	6.25	6.34

*Take state law on the permissible trust term—the rule against perpetuities—into account.

Term of Trust Before Principal Delivered to Family Members*	Percentage if Payments to Charity Are at End of Each		
	Quarter	Half	Year
		Year	
51	6.18%	6.23%	6.32%
52	6.16	6.21	6.30
53	6.15	6.20	6.29
54	6.13	6.18	6.27
55	6.11	6.16	6.25
56	6.10	6.15	6.24
57	6.08	6.13	6.22
58	6.08	6.12	6.21
59	6.07	6.11	6.20
60	6.06	6.10	6.19

Example — using the charts preceding this example. A charitable lead trust is to be funded with \$1 million. The donor wishes his grandchildren to have the trust assets in 12 years and would like a 100 percent charitable deduction. So he creates a trust paying our institution \$116,700 annually, (11.67 percent x \$1 million) for 12 years in quarterly installments.

The charitable deduction is 100 percent so no amount is subject to transfer tax. At the end of 12 years, the grandchildren receive the trust principal — which could well be worth much more than \$1 million.

On the next page is a worksheet which will enable you to determine the amount to be paid to the charity annually if the charitable contribution under a charitable lead annuity trust is to be less than 100 percent.

*Take state law on the permissible trust term — the rule against perpetuities — into account.

**WORKSHEET TO DETERMINE THE AMOUNT TO BE PAID
ANNUALLY IF THE CHARITABLE CONTRIBUTION UNDER
A CHARITABLE LEAD ANNUITY TRUST IS TO BE
LESS THAN 100%**

Example. Donor's estate plan calls for a \$1 million charitable lead annuity trust with only a 70 percent charitable deduction for the charitable lead interest. She wishes our institution to receive payments for 12 years, in quarterly installments, and then to have the trust principal given to her grandchildren.

Use the following worksheet to determine the annual payments necessary in a 12-year trust to produce a charitable deduction—for estate or gift tax purposes—of 70 percent of the value of the assets used to fund the trust.

	<i>Example</i>	<i>Your Case</i>
1. Payment percentage from chart on preceding pages for number of years and frequency of payments desired	11.67	
2. Desired charitable contribution as a percentage of principal	70%	
3. Percentage of principal to be paid annually under charitable lead annuity trust for number of years and frequency on Line 1 for the charitable deduction to be the percentage of principal on Line 2 equals Line 1 times Line 2 (taken to 2 nearest decimal places)	8.17%	
4. Annual payment to our institution equals amount used to fund trust times Line 3	\$81,700	

VI. Deduction for Split Interest Gifts—IRS Studying New Tables

IRS is considering increasing the interest assumption in some of the tables. The tables now used assume that money earns six percent a year, compounded annually. An increase in the interest assumption would reduce the charitable deduction for some split-interest gifts and would increase it for others.

- A. Charitable lead annuity trusts. Decreased charitable deduction for the charity's lead interest.
- B. Charitable lead unitrusts. Minimal or no change in the charitable deduction for the charity's lead interest.

- C. Charitable remainder annuity trusts. Increased charitable deduction for the charitable deduction for the charity's remainder interest.
- D. Charitable remainder unitrusts. Minimal or no change in the charitable deduction for the charity's remainder interest.
- E. Pooled income funds having more than three years of experience. Minimal or no change in the charitable deduction for the remainder interest.
- F. Pooled income funds having fewer than three years of experience. If the assumed earnings during the first three years are deemed greater than six percent (the current assumption), the charitable deduction for the remainder interest would be smaller.
- G. Gifts of remainder interest in personal residences and farms. Decreased deduction for the charity's remainder interest.
- H. Charitable gift annuities and deferred payment gift annuities. The government tables used to compute the charitable deduction (published in 1972) are based on what a typical commercial insurance company charges for an annuity. It is not known whether IRS is considering new tables for gift annuities. Tables based on current cost of purchasing commercial annuities would result in larger charitable deductions. However, the exclusion ratio would be smaller.
- I. Any new tables might take increased life expectancies into account. This would decrease the charitable deduction for remainder interest gifts.
- J. Pointer. Donors considering creating inter vivos charitable lead annuity trusts should consult their advisors about creating those trusts as soon as possible. While lead annuity trusts will still be attractive if the interest assumption is increased, the tax benefits will not be as great as currently obtainable.

WORKSHOP SESSION — GIFT ANNUITY & DEFERRED ANNUITY — ADVANCED

Jonathan R. Heintzelman
Senior Estate Planning Officer
Northwestern University

GIFT ANNUITIES — Tax Considerations

The purpose of this talk is to examine several of the tax considerations involved with establishing various types of gift annuities and deferred gift annuities, to review how such considerations impact on planning, and to explore some areas where the gift annuity might make more sense than another type of deferred giving vehicle.

I. Capital Gains Reporting

The tax aspects discussion will focus on three primary areas: capital gains reporting, gift taxes and estate taxes. When long-term appreciated property is used to fund a gift annuity, the donor must recognize a capital gain in the amount of his investment in the contract less his basis in the property allocated to the investment portion. In most cases, a donor will want to report this gain ratably over his annuity's expected term. In order to qualify for this ratable reporting of the gain, two requirements must be satisfied: (1) the donor must be one of the annuitants; and (2) the annuity contract can be assignable only to the issuing charity and no one else. If these requirements are satisfied, the reportable gain may be spread. Let's review how this capital gains reporting works in several gift annuity types:

- A. *One Life for Donor* — The gain is reportable over the donor's life expectancy. If the donor dies before all gain has been reported, the donor's estate is not liable to report the remaining gain. If the annuity is deferred, the donor begins to report the gain when the payments begin.
- B. *Two Life for Donor and Spouse or Third Party* — The gain is reportable over the donor's life expectancy. If the donor dies before all gain has been reported, the surviving

annuitant must report the remaining gain, based on the original life expectancy of the donor. If the surviving annuitant dies before all of the gain has been reported, the surviving annuitant's estate is not liable to report the remaining gain.

- C. *Gift Annuity established by will*— The estate will receive a stepped-up basis on long-term appreciated property passing from the donor so little or no capital gain should be reported.

II. Gift Tax Consequences

- A. *One Life for Donor*— The donor will have made a gift to charity of the remainder portion of the annuity. To the extent that charity's share exceeds \$10,000 (the amount of the annual gift tax exclusion), the Donor should file an annual gift tax return and claim a charitable deduction for the remainder share in excess of \$10,000.
- B. *One Life for Spouse or Third Party*— The donor has made a completed gift to both the annuitant and the charity. Both gifts will qualify for the annual exclusion and, if the annuitant is the donor's spouse, her interest will qualify for the marital deduction.
- C. *Two Life for Donor and Spouse*— The Donor has made a completed gift to the spouse and to charity. The spouse's gift will not qualify for the gift tax annual exclusion because it is considered a future interest. The spouse's interest also will not qualify for the marital deduction; it is considered a terminable interest since the donor quite possibly could outlive the spouse.
- D. *Two Life for Spouse and Third Party*— The donor has made a completed gift to both annuitants as well as the charity. The spouse's interest will qualify for the annual exclusion. It will not, however, qualify for the marital deduction since annuity payments may be made to the other annuitant following termination of the spouse's interest. As such, it is considered a terminable interest. The third party's interest will not qualify for the annual exclusion since it is a future interest.

III. Estate Tax Consequences

- A. *One Life for Donor* — Generally, nothing will be included in the donor's estate.
- B. *One Life for Spouse or Third Party* — Generally, nothing will be included in the donor's estate except, in the case of a gift annuity for a third party established within three years of the date of death of the donor, any gift taxes paid on the establishment of the annuity will be included in the donor's estate. There should be no such taxes in a one-life annuity for the donor's spouse since the marital deduction will be available.
- C. *Two Life for Donor and Spouse* — The date of death value of the spouse's annuity (should she survive the donor) will be included in the donor's estate and this annuity amount will qualify for the estate tax marital deduction.
- D. *Two Life for Donor and Third Party* — The date of death value of the third party's annuity will be included in the donor's estate. To the extent that there is any estate tax which may be attributable to the interest of the surviving annuitant, the surviving annuitant may claim such estate tax ratably over his or her remaining life expectancy as an income tax deduction.
- E. *One Life for Spouse — Testamentary* — Generally the full value of the interest transferred will be included in the donor's estate and the estate will be able to deduct the charitable remainder portion. The interest of the annuitant spouse does not qualify for the marital deduction. The recently enacted Technical Corrections Bill, however, indicates that a testamentary gift annuity for a spouse will qualify for QTIP treatment. Presumably then, the donor's executor should be able to elect QTIP treatment. The value of the spouse's annuity then would qualify for an estate tax marital deduction.

IV. Planning Ideas

- A. *Capital Gains Reporting* — One of the requirements for the ability of the donor to report his capital gains ratably is that the annuity contract be non-assignable or assignable by the donor only to the issuing charity. To avoid any confusion on this point, and to preserve the

favorable capital gains reporting, the annuity contract should contain the appropriate non-assignability language. Where the donor is planning to create a one-life gift annuity for someone else using long-term appreciated property, it should be pointed out to him that the reportable capital gain will not be able to be spread. In such cases, the donor might consider using cash instead or he may choose to use a vehicle in which he would not have to report such gain, e.g., the pooled income fund.

- B. *Reservation of Right to Revoke* — In a two-life gift annuity for the donor and his/her spouse, the present value of the gift to the spouse does not qualify for either the annual exclusion or the marital deduction. In such cases, the donor should reserve the right to revoke the surviving annuitant's interest during life and/or by will. Such reservation makes the gift to the survivor incomplete. The benefits of reserving the right to revoke also accrue to the two-life gift annuity with the donor and a third party as the successive beneficiaries.
- C. *Splitting Annuities* — Whenever a donor contemplates setting up a gift annuity for two successive beneficiaries, certain tax advantages can be gained by splitting the one annuity into two separate one-life annuities. First, with the two-life annuity for the spouse and a third party, the donor can only use the gift tax annual exclusion with respect to the spouse's interest and the spouse's interest will not qualify for the marital deduction (as a terminable interest). If, instead of one annuity, the donor created two separate annuities, one for the spouse and one for the third party, both annuity interests would then qualify for the annual exclusion and the spouse's annuity interest would qualify for the marital deduction as well. Even in the situation where neither intended annuitant is a spouse of the donor, a splitting of the gift creates the availability of an additional annual exclusion for the donor.
- D. *Testamentary Annuity for Spouse* — Prior to the enactment of the recent Technical Corrections Bill, it was usually not advisable for a donor to provide in his will for the

purchase by his representative of a gift annuity for his surviving spouse. The income tax regulations specifically provide that, in such circumstances, the annuity interest of the spouse will not be deductible by the donor's estate as an estate tax marital deduction. With the now apparent availability of the QTIP election in such circumstances, there should no longer be adverse estate tax consequences in establishing an annuity for a spouse in one's will. Even so, until further interpretations or guidelines are forthcoming, donors contemplating such testamentary gift annuities might be wise to wait until the picture on this issue gains clarity.

- E. *Tangible Personal Property*—When tangible personal property is used to establish a split interest charitable trust such as a Charitable Remainder Unitrust or a Charitable Remainder Annuity Trust, the donor is not entitled to an income tax charitable deduction for the charity's remainder interest in the trust. This result occurs because the income tax deduction is not available for a contribution of a future interest in tangible personal property until all of the intervening life income interests in the property have terminated. This problem is not present with the gift annuity since the tangible personal property is actually transferred to the issuing charity and the issued annuity is secured by the general assets of the issuer.
- F. *Remainder Interest in Farm or Residence*—Several institutions recently have issued charitable gift annuities in conjunction with accepting as a gift a remainder interest in a personal residence or farm. In such cases, the donor's gift is measured by the excess value of the remainder interest over the lifetime annuity. Valuation of the property is a critical concern. The donor's life expectancy must also be carefully considered, since the charity usually will begin making the annuity payments now but must wait until the life tenancy terminates in order to transform the property into an income producing asset.

G. *Deferred Gift Annuity for Vacant or Farm Land*— Accepting unproductive real estate in a charitable life income plan always poses problems. Even so, such assets may be very attractive due to a highly appreciated value and/or good marketability. Perhaps the most common charitable gift vehicle used with such property is the net income unitrust. The net income unitrust, however, is not without disadvantages for both the charity and the donor. If the charity is to serve as Trustee, it must be concerned with unrelated business taxable income along with the private foundation excise taxes. From the donor's perspective, assuming that the donor will not act as Trustee, once the unitrust is established and funded with the property, the donor has relinquished the ability to determine the eventual sales price of the property. In many such cases, a deferred gift annuity may offer a viable alternative to the unitrust. For the donor, it offers the appeal of certainty of value. His annuity payments will be fixed by the value that is placed on the property at the time of transfer to the charity and any subsequent sale of the property at the lesser price cannot alter the amount of the payments. The deferral period (a negotiable item) allows the charity a period of time in which to market the property, while the lack of a unitrust framework eliminates the concern that the Trustee/manager will lose the trust's exemption from taxation for any year or violate the private foundation excise tax rules.

One Life Gift Annuity Types	Capital Gains Recognition	Gift Tax Consequences	Annual Exclusion	Marital Deduction	Estate Tax Consequence	Marital Deduction
•donor is beneficiary	ratably over donor's life expectancy donor's death = gain lost	no gift tax return due if charity's portion is less than \$10,000	yes on first \$10,000 of gift to charity	N/A	only payments due but not yet received by donor included	N/A
•donor's spouse is beneficiary	at time of transfer	completed gift to spouse	yes	yes 25.2523(b)-1(b)(6)(iii)	not included	N/A
•third party (non-spouse) is beneficiary	at time of transfer	completed gift	yes	N/A	not included except for gift tax paid on gift within 3 years 2035(c)	N/A
•donor is beneficiary- <i>deferred</i>	ratably over donor's life expectancy- <i>when payments begin</i>	gift to charity	on first \$10,000 of gift to charity	N/A	not included-except for payments due but not received	N/A
•donor's spouse is beneficiary- <i>right to revoke</i>	at time of transfer	<i>during life-completed when paid/by will-complete for joint period of donor and spouse</i>	yes	yes	during life-DOD value of annuity included 2038 by will-DOD value of annuity included	yes yes
•donor's spouse is beneficiary- <i>testamentary</i>	step-up basis-only gain is any increase between DOD value and transfer to annuity	N/A	N/A	N/A	full value included- deduction allowed for charity's interest QTIP election possible	no 20.2056(b)-1(f)

Two Life Gift Annuity Types	Capital Gains Recognition	Gift Tax Consequences	Annual Exclusion	Marital Deduction	Estate Tax Consequences	Marital Deduction
<ul style="list-style-type: none"> •donor — 1st beneficiary •spouse — 2nd beneficiary 	ratably over life expectancy — if donor dies early — reported by spouse	gift to spouse 25.2511-2(b)	no 25.2503-3(a) future interest	no 25.2523(b) 1(c)(ii)	DOD value of survivor's annuity includible 20.2039-1(a)(b)	yes 20.2056(b)-1(g) Example 3
<ul style="list-style-type: none"> •donor — 1st beneficiary •non-spouse — 2nd beneficiary 	ratably over donor's life expectancy — if donor dies early — reported by non-spouse	gift to non-spouse 25.2511-2(b)	no 25.2503-3(a)	N/A	DOD value of survivor's annuity includible	1.691(a)-1-estate tax paid becomes income tax deduction for annuitant
<ul style="list-style-type: none"> •spouse — 1st beneficiary •non-spouse — 2nd beneficiary 	at time of transfer	gift to both spouse and non-spouse	yes, as to spouse's annuity interest	no 25.2523 (b)-1(b)(ii)	not included except gift taxes paid w/i 3 years of DOD	N/A
<ul style="list-style-type: none"> •non-spouse — 1st beneficiary •non-spouse — 2nd beneficiary 	at time of transfer	gift to both 1st and 2nd 25.2511-2(b)	yes, as to 1st beneficiary	N/A	not included except gift taxes paid w/i 3 year of DOD	N/A
<ul style="list-style-type: none"> •donor — 1st beneficiary •spouse — 2nd beneficiary <i>right to revoke reserved</i>	ratably over donor's life expectancy — spouse also reports if donor dies early w/o revoking	no present gift	N/A	N/A	DOD value of irrevocable annuity includible	yes 20.2056(b)-1(g) Ex. 3
<ul style="list-style-type: none"> •donor- 1st beneficiary •spouse — 2nd beneficiary <i>community property used</i>	ratably by each over his/her life expectancy-if donor dies early- reported by survivor	no gift for joint payments/gift of 1/2 of payments to survivor	no	no	DOD value for 1/2 of survivor's annuity included	yes

WORKSHOP SESSION — POOLED INCOME FUND — ADVANCED

James G. Marshall, Jr.

Executive Director

Methodist Health Foundation, Inc.

- The session was a workshop program with a number of general topics being introduced and then discussed with ideas exchanged between the entire group. No formal paper was presented. The workshop session was intended to surface various areas concerning advanced aspects of the Pooled Income Fund for further study and education by the members attending the session.

- The session was divided into two sections; the first being a section on some of the practical aspects of a Pooled Income Fund. The topics presented and discussed were as follows:
 1. Alternate means of administering a Pooled Income Fund. The discussion centered around the desirability and advisability of the administration of a Pooled Income Fund being done by the charitable organization or by any one of a number of banks in the country that administer such funds or by some other umbrella national organization.
 2. Marketing a Pooled Income Fund. A broad general discussion was held concerning ways and means of marketing a Pooled Income Fund. The ideas presented included volunteer peer solicitation, discreet advertising and direct mail solicitation.

- The second section involved some of the technical aspects of the Pooled Income Fund. The following subjects were discussed:
 1. Types of gifts. It was generally agreed by the group that cash and broadly traded appreciated property were excellent gift vehicles. Discussions were held concerning the possible problems concerning gifts of stock in a closely held corporation, real estate, ordinary income property and 170(e) capital gain property.

2. Timing of gifts. The matter of the receipt of a gift in between quarterly admission dates was discussed. Also, the problem of possible dilution of the fund by the receipt of a large gift in between regular admission dates was discussed.
3. Investment policies. It was pointed out that there are two factors to be considered in connection with the establishment of an investment policy for a Pooled Income Fund, the first of these being the desirability of a reasonable return to income beneficiaries; the second being the potential for growth which accrues to the benefit of the charitable organization to help defray the problems of inflation.
4. Estate and gift tax consequences. A broad, general presentation/discussion took place on this subject. It was generally agreed that, as individuals seeking support for our charitable organizations, we have a moral obligation to present information concerning gift tax and estate tax consequences of a Pooled Income Fund gift transfer. Further, that the matter of gift and estate taxes is adequately discussed in a number of the tax services and should be used in the presentation of a proposal.
5. Q-Tip rules. Recent information in the tax services was discussed concerning the qualified terminable income property and its effect on estate matters in regard to a Pooled Income Fund gift.
6. Death taxes. Revenue ruling 82-128 was discussed. It was generally agreed that, at the present time, this may only apply to the Unitrust and the Annuity Trust, however, future IRS regulations should be monitored.
7. More than one Pooled Income Fund. The matter of a charitable organization administering more than one Pooled Income Fund was presented and discussed. The advisability and desirability in regard to reduced charitable contribution deduction where the highest rate in the last three years reaches a high level was discussed. Also, the matter of maintaining a Pooled Income Fund with a primary emphasis on income and a second for

primary emphasis on growth was discussed.

8. Offering brochure. In response to the 1972 SEC No Action letter, the matter of providing an offering brochure (prospectus) was presented and discussed. Reference should be made to each organization's attorney for legal opinion on this matter.
9. Use of the computer. Use of word processing and/or computer equipment was presented and discussed. Three main areas can provide valuable assistance. These include the preparation of the Pooled Income Fund Declaration of Trust and Instrument of Transfer for the donor; preparation of income tax contribution deduction gift and estate tax factors; and storage of information concerning prospects, including birth date, sex, marital status, family, etc.

WORKSHOP SESSION — CHARITABLE REMAINDER TRUSTS-BASIC

Kathryn E. Baerwald

General Secretary

The American Lutheran Church

I. IN GENERAL

- A. Many individuals would like to make a gift to a charitable organization; in many cases, an outright gift or bequest is the best type of gift for the donor and his/her family.
- B. In some cases, the use of an inter vivos or testamentary charitable remainder trust or other arrangement may provide significant tax, income, and management advantages to the donor and/or other income beneficiaries.
- C. Most charitable trusts or remainder agreements provide for an income interest (or life estate) for the income beneficiary(ies) followed by a gift to charity. The donor is entitled to a charitable contribution deduction for the value of the remainder interest at the time the gift is established. Charitable income (lead) trusts provide for an income interest to charity and a remainder interest to non-charitable beneficiaries.

II. CHARITABLE REMAINDER UNITRUST IRC SEC. 664; REG. SEC. 1.664-3.

- A. *Payment of Unitrust Amount.* The governing instrument must provide for payment, at least annually, of a "unitrust amount" equal to a fixed percentage, at least 5%, of the net fair market value of the trust corpus valued annually. IRC Sec. 664(d)(2)(A).
- B. *Alternative Payments.* The trust may provide that only trust income, up to the unitrust amount percentage, will be paid out ("income only" unitrust) or that excess income can be used to catch up for underpayments in prior years ("income plus make-up" unitrusts). IRC Sec. 664 (d)(3); Reg. Sec 1.664-3(a)(1)(i)(b).

- C. *Term of Trust.* The term of the income interest can be for the life or lives of the income beneficiaries or for a term of not more than 20 years. IRC Sec. 664(d)(2)(A). It is also possible to have a life interest followed by an interest measured by life or a term of years, whichever is shorter. Reg. Sec. 1.664-3(a)(5).
- D. *Additions to Trust.* Additions to the trust corpus can be made if permitted by the governing instrument. Reg. Sec. 1.664-3(b).
- E. *Payments from Trust.* No payment, other than the unitrust amount, can be made except to charity. Reg. Sec. 1.664-3(a)(4).
- F. *Distribution of Income.* Income is distributed under a "four-tier" system:
 - 1. Current and accumulated ordinary income;
 - 2. Capital gain (short-term gain is distributed before long-term gain) on a cumulative net basis;
 - 3. Other income, such as tax-exempt interest; and
 - 4. Corpus.IRC Sec. 664(b).
- G. *Charitable Contribution Deduction.* At the establishment of the trust, the donor is entitled to a charitable contribution deduction for the actuarial value of the remainder interest passing to charity. IRC Sec. 170(f)(2)(A); Reg. Sec. 1.664-4.
- H. *Contribution of Appreciated Property.* In most cases, the donor will not be taxed on the capital gain resulting from a gift of appreciated property, nor will the contribution deduction be reduced by the amount of the gain. The donor may be found to have entered into a bargain sale if mortgaged property is contributed. IRC Sec. 1011(b); Reg. Sec. 1.1011-2(a)(3); IRC Sec. 170(e).
- I. *Fluctuation of Payments.* The unitrust offers the possibility of increased annual payments to the income beneficiaries as well as the risk of lower payments should the net fair market value of the trust decrease.
- J. *Gift Tax Consequences.* If the donor is not an income beneficiary, or if the donor does not reserve the right to

revoke the interest of a succeeding beneficiary, the donor has created a taxable gift for the present value of the income beneficiary's interest at the time of the gift. IRC Sec. 2511; Reg. Secs. 1.664-3(a)(4); 25.2511-2(b). The income interest of a spouse qualifies for the marital deduction. See also IRC Sec. 2522(c)(2)(A).

- K. *Estate Tax Consequences.* If the donor is the sole or surviving income beneficiary, the value of the trust will be included in his/her estate. However, the estate will then be entitled to a charitable deduction for the value of the trust. If the donor predeceases the other income beneficiary(ies) and does not revoke the succeeding interest(s), the actuarial value of the income interest(s) will be included in the estate, with the estate entitled to a contribution deduction for the remainder interest passing to charity. IRC Secs. 2036; 2055; Reg. Sec. 20.2055-2(e)(2)(iv). A surviving spouse's interest qualifies for the marital deduction. IRC Sec. 2056(b)(8).

III. CHARITABLE REMAINDER ANNUITY TRUST

IRC SEC. 664; REG. SEC. 1.664-2

- A. *Payment of Annuity Amount.* The trust must provide for the payment, at least annually, of a sum certain (the annuity amount) that is at least 5% of the initial fair market value of the trust. IRC Sec. 664(d)(1)(A). The annuity amount can be expressed as a fixed dollar amount or as a percentage. Reg. Sec. 1.664-2(a)(1)(ii) and (iii).
- B. *Term of Trust.* As with the unitrust, payments may be for a period of life (lives), a term of not more than 20 years, or for life followed by a period measured by a period of years or life, whichever is shorter. IRC Sec. 664(d)(1)(A); Reg. Sec. 1.664-2(a)(5).
- C. *Additions to Trust.* There can be no additions to the trust after it has been funded. Reg. Sec. 1.664-2(b).
- D. *Payments from Trust.* No payment, other than the annuity amount, can be made except to charity. Reg. Sec. 1.664-2(a)(4).
- E. *Income Distributions.* The income is distributed in the same manner as for the unitrust. IRC Sec. 664(b).

- F. *Tax Consequences to Donor.* The estate, gift, income, and capital gain tax consequences to the donor are substantially the same as in the establishment of a unitrust. See also Reg. Sec. 1.664-2(a)(4).
- G. *Charitable Deduction "5%" Rule.* At the establishment of the trust, the donor is entitled to a charitable contribution deduction for the actuarial value of the remainder interest passing to charity. Reg. Sec. 1.664-2(d). In Rev. Rul. 77-374, IRB 1977-40, 17, the IRS took the position that no deduction would be allowed if the probability exceeds 5% that a non-charitable beneficiary of the trust will survive to the exhaustion of the trust. A recent tax court decision, *Moor* (TC Memo 1982-299, 5/27/82), eased compliance somewhat with the "5%" rule.
- H. *Constant Payment.* The annuity trust provides a constant, unchanging flow of income to the income beneficiary(ies). There is no increase or reduction in the annuity payment as the result of a change in the fair market value of the trust, unless the principal of the trust is reduced to zero.

IV. UNRELATED BUSINESS TAXABLE INCOME (UBTI)

- A. *In General.* In most cases, income received by tax-exempt charitable organizations and trusts is not taxed. Under certain circumstances, however, income received by such entities is subject to the regular income tax as well as the alternative and add-on minimum taxes. The purpose of UBTI is to "eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete." Reg. Sec. 1.513-1(b).
- B. *Definition of UBTI.*
1. Generally, income from property owned by a charitable organization is exempt from federal income tax. One exception is "unrelated business taxable income" (UBTI) as defined in IRC Sec. 512(a)(1):
"Except as otherwise provided in this subsection,

the term 'unrelated business taxable income' means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter..."

2. An "unrelated trade or business" is defined as:
"...any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501..." IRC Sec. 513(a).
3. Certain items of income are not generally UBTI, such as dividends; interest; payments with respect to securities loans; annuities; royalties; rents; gains or losses from the sale, exchange, or other disposition of property; and other specific items. IRC Sec. 512(b).
4. However, even the above-listed items of income can be considered UBTI if:
 - a. The interest, annuity, royalty or rent comes from a "controlled organization" [IRC Sec. 512(b)(13)], i.e., the income comes from an organization which is 80% or more owned by the entity receiving the income, or
 - b. The income is "debt-financed property" [IRC Secs. 512(b)(4) and 514], i.e., "any property which is held to produce income and with respect to which there is an acquisition indebtedness..." IRC Sec. 514(b)(1).
5. "Acquisition indebtedness" is defined as:
 - a. An indebtedness incurred by the organization in acquiring or improving property;
 - b. An indebtedness incurred prior to the acquisition or improvement of the property if such would not have been incurred but for the acquiring or improving of the property; or
 - c. An indebtedness incurred after the acquisition or

indebtedness which would not have been incurred but for such acquisition or improvement and which was reasonably foreseeable at the time of the acquisition or improvement. IRC Sec. 514(c)(1).

6. Acquisition indebtedness also includes property subject to mortgage unless:

- a. The mortgage was placed on the property more than five years before the gift;
- b. The donor owned the property for more than five years before the gift;
- c. The charity does not assume the mortgage; and
- d. The debt will not be considered acquisition indebtedness for 10 years following the date of the gift. IRC Sec. 514(c)(2).

Acquisition indebtedness also includes property subject to a lien for taxes or similar assessments. IRC Sec. 514(c)(2)(C).

7. If a charitable remainder trust has even \$1 of UBI, then it is fully taxed.

C. *Entities to Which UBTI Applies*

1. UBTI does not apply to charitable lead trusts because they are taxable trusts.
2. UBTI does apply to charitable remainder annuity trusts and unitrusts.

V. PRIVATE FOUNDATION RULES

A. *In General.* Under IRC Sec. 508(e) and 4947(a)(2), certain private foundation rules apply to split-interest trust, "not all of the unexpired interests in which are devoted to" charitable purposes. Thus, the rules apply to charitable remainder annuity trusts and unitrusts. The rules are contained in IRC Secs. 4940 through 4948 and the regulations promulgated thereunder. Substantial penalties can be assessed for violation of these rules.

B. *Self-Dealing, IC Sec. 4941*

1. Self-dealing is defined as "any direct or indirect:
 - A. sale or exchange, or leasing, of property between a private foundation and a disqualified person;

- B. lending of money or other extension of credit between a private foundation and a disqualified person;
- C. furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- D. payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
- E. transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
- F. agreement by a private foundation to make any payment of money or other property to a government official [as defined in section 4946(c)], other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period."

IRC Sec. 4941(d)(1). The payment of the annuity or unitrust amount is not an act of self-dealing. IRC Sec. 4947(a)(2)(A).

2. There are certain exceptions to the self-dealing rules, the most common of which are:
 - "A. the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer. [NOTE: Thus, if the foundation does not assume the mortgage and if the mortgage was placed on the property outside the 10-year period, it is not self-dealing.]
 - B. the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other

charge and if the proceeds of the loan are used exclusively for purposes specified in Section 501(c)(3).

- C. the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in Section 501(c)(3).
- D. the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public...
- E. except in the case of a government official (as defined in Section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive..."

IRC Sec. 4941(d)(2).

C. *Excess Business Holdings. IRC Sec. 4943*

1. Generally, a private foundation may not hold more than 20% of the voting stock of an incorporated business (35% in some cases). Restrictions are also applicable to partnerships. IRC Sec. 4943(c)(2); 4943(c)(3).
2. The excess business holdings rule will not apply to charitable lead trusts if the income interest is not more than 60% of the fair market value of the trust. IRC Sec. 4947(b)(3)(A).
3. Similarly, the excess business holdings prohibition will not apply to a remainder trust if none of the annuity amount or unitrust amount (prior to termination) can be distributed to a 170(c) organization. IRC Sec. 4947(b)(3)(B).

D. *Jeopardizing Investments. IRC Sec. 4944*

1. Sec. 4944 prohibits a private foundation from investing in investments which "jeopardize the carrying out of any of its exempt purposes." IRC Sec. 4944(a)(1). Such investments are not defined in the code or regulations and are reviewed on a case by case basis. Certain items which will be "closely scrutinized" are margin tradings in securities; trading in commodities; working interests in oil and gas wells; the purchase of puts, calls, and straddles; the purchase of warrants and selling short. Reg. Sec. 53.4944-1(a)(2)(i).
2. As with excess business holdings, IRC Sec. 4944 will not apply to certain lead trusts and to remainder trusts from which no charity receives income prior to termination of the trust. IRC Sec. 4947(b)(3)(A) and (B).

E. *Taxable Expenditures. IRC Sec. 4945.* Taxable expenditures are defined as any amount paid or incurred by a private foundation:

1. To carry on propaganda or otherwise influence legislation;
2. To influence the outcome of an election or carry on a voter registration drive except under certain circumstances;
3. To provide grants for travel or study except under certain circumstances;
4. To give a grant to another organization except under certain circumstances; and
5. To carry on any purpose other than one specified in IRC Sec. 170(c)(2)(B). IRC Sec. 4945(d).

VI. CHARITABLE INCOME (LEAD) TRUST

- A. *In General.* Whereas other types of gift plans provide an income interest to individual beneficiaries with a remainder interest over to charity, a charitable income or lead trust pays the income interest to charity with the remainder going to individual beneficiaries. Such trusts are most often established as a part of a testamentary

plan because of the significant estate tax benefits that are available.

- B. *Form of Income Interest.* The payment to charity must be in the form of a guaranteed annuity or unitrust (fixed percentage) payment. IRC Secs. 170(f)(2)(B); 2522(c)(2)(B); 2055(e)(2)(B). No minimum percentage is required nor is there a limit (other than the Rule Against Perpetuities) on the number of years for the term of the trust.
- C. *Amount of the Deduction.* Depending on the manner in which the trust is established, a deduction may be available at the time the trust is established for the income interest going to charity. By using various combinations of annual payout requirements and the length of the term of the trust, it may be possible to obtain a deduction for 100% of the value of the trust. If excess business holdings are in the trust, the deduction should not exceed 60%.
- D. *Inter Vivos Lead Trusts.* Inter vivos lead trusts are rarely useful because of the limitations on the charitable deduction. Only if the trust is established as a grantor trust, requiring the donor to take into account all trust income into his/her taxable income, will the donor be entitled to a contribution deduction in the year the trust is established. IRC Secs. 671 and 170(f)(2)(B). The deduction is limited to 20% of the donor's contribution base and is not eligible for a carry over. IRC Sec. 170(b)(1)(B). If the trust is not a grantor trust, i.e., over 10 years in length of term, then the donor is not taxed on the income of the trust but no deduction is available. IRC Sec. 671. If the donor is not the remainder beneficiary, the donor may be liable for payment of a gift tax on the value of the remainder as a future interest.
- E. *Testamentary Lead Trust.* The estate is entitled to an estate tax deduction for the actuarial value of the income interest passing to charity. IRC Sec. 2055(a); 2055(e)(2)(B). The estate tax savings can be significant, as the estate can receive an unlimited charitable deduction for up to the full value of the trust. Caution is required if

the trust is funded with excess business holdings. Reg. Sec. 20.2055-2(e)(2)(v)(c).

- F. *Taxation of Lead Trust.* The lead trust is taxed as a complex trust unless it is a grantor trust. IRC Secs. 641-44; 661-63; 665-67. Inter vivos, nongrantor trust may be subject to the minimum tax. IRC Sec. 57(b). Section 664 relating to the sale of appreciated property also applies to inter vivos trusts.
- G. *Testamentary Plan With Unitrust.* Because no property can be made available to noncharitable beneficiaries during the term of the trust, a donor may deem it unwise to place a large portion of the estate in the trust so as to deprive family members or other beneficiaries from needed assets during the term of the trust. One planning option is to "match" a lead trust with a charitable remainder trust or QTIP with a charitable remainder. Thus, during the term of the lead trust, the income beneficiary(ies) will receive income payments from the remainder trust and the charity will receive income from the lead trust. At the termination of both trusts, the income beneficiaries will receive the remainder interest of the lead trust and the charity will receive the remainder interest in the remainder trust.

WORKSHOP SESSION — CHARITABLE REMAINDER TRUSTS — ADVANCED

Dr. Alva R. Appel

Director, Trust Services

General Conference of Seventh-day Adventists

Mr. Terry L. Simmons

Associate Counsel

Baptist Foundation of Texas

This paper is not intended to give final answers or legal opinions on the development of, management of, or documentation of charitable remainder trusts. Rather, the purpose of this paper is to explore in a general way the types of charitable remainder trusts and their application in the fund-raising activities of charitable organizations. Each organization should have its own legal counsel to guide and direct its participation in such activities, and should look to that counsel for advice in specific situations.

Before one promotes any program dealing with charitable planned giving, the organization involved should first be sure that the appropriate expertise is possessed to properly fulfill the obligations involved, and further, should be certain that the organization involved has the legal authority to operate such a program. It is at this point that the "KISS" (Keep It Simple, Stupid) principle is a very valid one. It is always advisable to do what one can do well and to use only those tools for planned giving that are reasonably essential to accomplish a profitable gift.

All details involved should be carefully studied in preparation for knowledgeable decisions. "A patient pursuit of facts, and cautious combination and comparison of them, is the drudgery to which man is subjected by his Maker, if he wishes to attain sure knowledge."—Jefferson, Thomas, *Notes On The State of Virginia* (Philadelphia: Prichard and Hall, 1788) page 71, n.

In looking at potential gifts, there are several factors which should be given particular consideration:

1. All possible details concerning the assets to be transferred should be obtained. These include, but are not

limited to, the following:

- a. Is the asset involved difficult to value?
 - b. Is the asset readily convertible to liquid assets?
 - c. What encumbrances are involved, including liens, rentals, leases, etc.?
 - d. Has a title search been conducted?
 - e. What is the status of the insurance on the property?
 - f. What are the maintenance costs in relation to the property?
 - g. What is the land use and zoning status of the property?
 - h. Is the property income producing?
 - i. Is the land landlocked, and are there right of way problems?
2. Would it be a profitable arrangement to all concerned? In other words, is it best for both the charitable organization as well as the potential donor? Will the charitable giving arrangement be able to accomplish the intent or the desire of both the donor and the charitable organization? Can the donor live irrevocably with the plan?
 3. Is there a less complicated or more cost effective way to accomplish the basic reasonable desires of both the donor and the charitable organization?
 4. Is it the desire of the donor or is it the salesmanship of the charitable organization that has had the greatest influence on the donor's potential gift?

An analysis of these points, together with any others which one would be prudent to consider, may indicate that the donor involved would best be served by making the gift through his or her will. Likewise, the analysis may indicate that a charitable gift annuity or pooled income fund gift might be most appropriate. However, if we assume that the analysis indicates that a remainder trust fits the situation best, it must be determined which remainder trust best fits the particular situation. To make this judgment, one must not only have basic knowledge of each type of trust but must also be knowledgeable as to what qualifies or disqualifies a certain type of trust for the favorable tax benefits which are sought. The type of assets, the desired results, the

ability to perform the functions of that agreement and the provision of proper authority to do so are all important factors in the process of choosing the proper remainder trust.

This paper will examine the common characteristics of the charitable remainder annuity trust and the charitable remainder unitrust, as well as the characteristics unique to each of those trusts. Various problem areas which are typically encountered in dealing with these trusts will be examined, as well as possible solutions to them.

Realizing that annuity trusts or unitrusts will not always fit every situation, alternatives such as the irrevocable nonqualifying trust and the qualified terminable interest property trust will be discussed.

The charitable lead trust, while not a remainder trust, is a charitable split interest trust which offers many advantages in its various forms and can often complement a remainder trust in an overall estate plan. This trust will be examined briefly.

Throughout the course of the paper, practical examples will be presented depicting the use of the various trusts and the trouble spots involved with them.

REMAINDER TRUSTS: STATUTORY REQUIREMENTS AND CHARACTERISTICS

While a basic knowledge of remainder trusts is assumed on the part of those attending the advanced workshop, a review of a few definitions and requirements in regard to these trusts should be helpful throughout the remainder of the paper.

The statutory framework for both the charitable remainder annuity trust and the charitable remainder unitrust is found in §664 of the Internal Revenue Code and the related regulations.

A charitable remainder annuity trust is a trust which provides for the payment of a sum certain not less often than annually to a beneficiary or beneficiaries, at least one of which is not an organization described in §170(c) of the Code. The regulations provide that the payments may be expressed as a fixed dollar amount or as a percentage of the initial fair market value of the trust corpus. In either case, the amount payable each year must be an amount no less than five percent of the initial fair market

value of the trust corpus. Individual beneficiaries must be living at the time of the creation of the trust, and the payments must continue for the lives of the beneficiaries or for a term of years not to exceed 20 years.

A charitable remainder unitrust is a trust which provides for the payment, not less often than annually, of a fixed percentage of the net fair market value of the trust assets, as valued annually, to a beneficiary or beneficiaries at least one of which is not an organization described in §170(c) of the Code. The fixed percentage must be at least 5 percent. As with the annuity trust, payments may be for the lives of the beneficiaries or for a term of years not to exceed 20 years.

The Code provides for two variations upon the standard unitrust described above. The first variation allows the Trustee to pay the net income of the trust or the unitrust percentage, whichever is less, in any given year. The second variation contains the net income language and also has a makeup provision allowing the Trustee to pay out excess income in any given year over the unitrust percentage for that year equal to past deficiencies, i.e., the amounts by which the net income of the trust in prior years fell below the amount determined by applying the unitrust percentage to the trust value for that year.

Typically, cash or other liquid assets will be used to fund charitable remainder annuity trusts or standard charitable remainder unitrusts. For gifts of unimproved real estate, either version of the unitrust containing the net income provision is ordinarily preferable.

PROBLEMS AREAS

Points of difficulty which may be encountered in dealing with remainder trusts depend both upon the experience of the individual and the peculiar facts of a certain situation. However, certain problem areas are common and recurring in the area of charitable remainder trusts. This section examines some of those areas and suggests methods of avoiding or dealing with them.

Unrelated Business Taxable Income

Reg. §1.664-1(a)(1)(i) provides that a charitable remainder trust is exempt from income tax for any taxable year of the trust

except a taxable year in which it has unrelated business taxable income. Reg. §1.664-1(c) provides that if a charitable remainder trust has any unrelated business taxable income, as defined in §512 of the Code and its regulations, for any taxable year, the trust is subject to income taxation for that year as a complex trust, i.e., a trust which may accumulate income or which may distribute corpus. Unrelated business taxable income is income derived from a trade or business unrelated to an organization's exempt function. While intended to govern the taxation of exempt organizations, the provisions of the Code and regulations relating to unrelated business taxable income are made applicable to charitable remainder trusts by the regulations cited above. An "unrelated trade or business" is any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting its basis for its exemption ... §513. §512 defines unrelated business taxable income as being the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed by the Internal Revenue Code which are directly connected with the carrying on of such trade or business.

While a detailed analysis of unrelated business taxable income is beyond the scope of this paper, this section of the paper is intended to raise the awareness of the reader to the serious consequences of incurring unrelated business taxable income in a remainder trust, thereby encouraging the reader to investigate himself or through professional counsel whether the possibility of unrelated business taxable income is present in a given situation.

While a bit simplistic, the difference between nontaxable income and unrelated business taxable income can be thought of in terms of passive income and active income, respectively. Dividends from stock are not unrelated business taxable income. Royalties from mineral properties are not unrelated business taxable income, but income from a working interest in a mineral property is unrelated business taxable income. Interest and annuities are not unrelated business taxable income.

Rents from real property, as defined in the regulations under

§512, do not constitute unrelated business taxable income. Rents from personal property are unrelated business taxable income unless they are incidental (i.e. 10% or less of the total rent) to the rental of real property.

The above provisions notwithstanding, interest, royalties or rents paid to the exempt organization or trust from another organization controlled by the exempt organization or trust do constitute unrelated business taxable income.

Where substantial services are rendered in addition to providing the use of real property, the rental payments do not constitute payments from the rental of real property, and do constitute unrelated business taxable income. Payments for the use or occupancy of rooms or other spaces where services are also rendered are examples of activities producing unrelated business taxable income, Reg. §1.512(b)-1(c)(5).

Another form of unrelated business taxable income is unrelated debt-financed income, which is income earned from property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year, but does not include income from any properties substantially all the use of which is substantially related to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption, §514(b)(1). Acquisition indebtedness includes the indebtedness incurred by the organization in acquiring or improving the property as well as the indebtedness where the organization receives property and either assumes or takes subject to an existing indebtedness.

The application of these basic principles of unrelated business taxable income to remainder trusts is illustrated in the following examples:

1. Tom Jones donates an office building owned by him to Alpha University in a charitable remainder unitrust. The unitrust continues to own and operate the office building for the remainder of the taxable year. The only income received by the unitrust from the office building is in the form of lease payments and the only services provided by the unitrust to the tenants of the office building are the furnishing of heat and light, the

cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, and similar services. Under Reg. §1.512(b)-1(c)(5), the income earned by the unitrust will not be unrelated business taxable income.

2. Tom Jones donates a motel to a charitable remainder unitrust for Alpha University. The only income to the unitrust is income from the rent of rooms in the motel. Among other services, the motel provides maid service to its patrons. Under the same regulation cited in example one, the income payable to the unitrust will be unrelated business taxable income.
3. Tom Jones donates AT&T debentures to a charitable remainder annuity trust for Alpha University. The interest received by the annuity trust from these debentures will not be unrelated business taxable income, Code §512(b)(1).
4. Tom Jones donates Acme Company debentures to a charitable remainder unitrust trust for Alpha University. The unitrust already owns all of the common stock in Acme Company. Under Code §512(b)(13), the interest paid to the unitrust by a wholly owned subsidiary will constitute unrelated business taxable income.
5. In 1979, Tom Jones purchases a tract of unimproved real estate for \$500,000 with a \$100,000 down payment and a \$400,000 note payable in equal annual installments over a period of ten years. In 1981, Tom Jones donates the property to a unitrust for Alpha University. The unitrust takes the property subject to the outstanding indebtedness. Any income earned from the real property in the unitrust during the time the indebtedness is outstanding will constitute unrelated debt-financed income under Code §514 and, as a result, unrelated business taxable income under Code §512.
6. Assume the same fact situation as in the preceding example, except that Tom Jones purchased the property in 1975 and transferred the property to the unitrust for Alpha University in 1981. Since the mortgage was placed on the property more than five years before the

date of its transfer, and since the property was held by the donor for more than five years prior to the date of transfer, any income from the property will not constitute unrelated debt-financed income or, in turn, unrelated business taxable income during a period of ten years following the date of the gift. Code §514(c)(2)(B).

7. Assume the same facts as in example 6, except that Tom Jones dies in 1979 soon after purchasing the property and that his will gives it to a unitrust for Alpha University. Under §514(c)(2)(B), the same 10-year grace period will apply, and because the gift is testamentary, the 5-year waiting period will not be a prerequisite.

To reiterate, in any year in which a remainder trust has one penny of unrelated business taxable income, the entire trust will be taxable on all of its income as a non-exempt complex trust.

Applicability of Private Foundation Excise Taxes To Remainder Trusts

Section 4947(a)(2) renders charitable remainder trusts subject to four of the five private foundation excise taxes described in Chapter 42 of the Code. Included are the taxes on self-dealing described in §4941, the tax on excess business holdings described in §4943, the tax relating to investments which jeopardize charitable purposes described in §4944, and the taxes on taxable expenditures described in §4945. However, §4947(b)(3) provides that §4943 and §4944 will not apply to remainder trusts for which a deduction was allowed for income, gift or estate tax purposes. As a result, this paper will restrict its coverage to the taxes imposed by §4945 and §4941.

Section 4947(a)(2) also requires that the pertinent private foundation governing provisions found in §508(e) of the Code be incorporated in remainder trust instruments.

Section 4945 sets out the tax on taxable expenditures for private foundations, made applicable to remainder trusts as set out above. This tax is assessed against expenditures by a remainder trust for certain activities including lobbying expenditures, expenditures for voter registration drives, and certain grants to individuals and organizations. Taxes may be assessed

ranging from 2½ percent to 10 percent of the amount involved against both the foundation (or trust) and the foundation management (or trustee). Second tier taxes of 50 percent to 100 percent of the amount involved can be assessed if the taxable expenditure is not corrected within the taxable period as defined in §4945. Obviously, the trustee of a remainder trust should be certain that expenditures of the trust are limited to those necessary for the functioning of the trust and the distribution of income to the beneficiaries as provided in the trust. Other expenditures should be avoided so as not to risk taxation under this private foundation excise tax rule.

Section 4941 assesses a tax on self-dealing transactions between a remainder trust and a disqualified person. Disqualified persons include the donor, various members of his family, and other persons and entities specified in §4946(a). Self-dealing encompasses transactions such as sales, exchanges, leases, loans, and various similar other categories of interaction between remainder trusts and disqualified persons. Under §4941, the merits of a particular transaction, or the fact that it is negotiated in an arms length manner, have no effect on the assessment of the tax. Section 4941 establishes an objective standard for all such transactions. In other words, the mere fact that such a transaction occurs constitutes self-dealing, regardless of how advantageous the transaction may be to the charity, and a tax potentially results on both the self-dealer and the trustee. The initial tax is 5 percent on the amount involved for the self-dealer and 2½ percent on the amount involved for the trustee. Additional second tier taxes are also potentially applicable. Some activities, such as sales and exchanges, leases and loans, between disqualified persons and remainder trusts clearly result in self-dealing with few apparent exceptions. Most probably, a transfer of mortgaged property to a remainder trust by a disqualified person would result in self-dealing, unless the disqualified person placed the mortgage on the property more than ten years before the transfer. Generally, payments of compensation by a remainder trust to a disqualified person would also result in a self-dealing tax.

Fortunately, certain exceptions apply to some of the situations

described above. For instance, a transaction which causes a person to become a disqualified person is not a transaction resulting in a self-dealing tax under §4941 according to Reg. §53.4941(d)-1(a). As a result, a transfer of mortgaged property to a remainder trust by a donor in a transaction which creates the remainder trust will not result in a taxable act of self-dealing.

An additional exception is found in regard to payments of compensation. Section 4941(d)(2)(E) provides that compensation paid to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purposes of the [remainder trust] shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive. The application of these provisions to remainder trusts is illustrated in the following examples:

1. Tom Jones purchases a tract of unimproved real estate and executes a mortgage as a portion of the purchase price. Soon thereafter, and while the mortgage is still outstanding, Tom Jones establishes a charitable remainder unitrust for Alpha University and transfers to it, as the initial funding, the property subject to the mortgage. Since the transfer of the mortgaged property was the transaction which rendered Tom Jones a disqualified person, the transfer will not constitute an act of self-dealing. However, the remainder trust may have unrelated debt-financed income problems as described above, and Tom Jones will quite probably have taxable income resulting from a bargain sale as described below.
2. Tom Jones transfers a farm to a remainder trust for Alpha University. The trustee of the remainder trust immediately decides to put the farm on the market for sale. In the interim, to produce some income, the trustee decides to lease the farm to Tom Jones. While the going market rate for the leasing of identical land in the area is \$100 per acre per year, Tom Jones agrees to pay the trust \$150 per acre so as to avoid any appearance of impropriety. Nonetheless, this transaction constitutes an act of self-dealing under the objective

standard of §4941. Regardless of the fairness of the transaction to the trust, the leasing of the property to a disqualified person, Tom Jones, results in self-dealing, and the amount involved, \$150 per acre, will be subject to the self-dealing tax.

3. Tom Jones transfers an office building to a charitable remainder unitrust for Alpha University. The trustee of the unitrust enters into an agreement with Tom Jones whereby Tom Jones will manage the office building for the trust. The going rate for such management services on similar buildings is 10 percent of rentals collected. The trustee agrees to compensate Tom Jones at that rate. Since management services of the office building would typically be necessary to the trust, and since the compensation paid Tom Jones is reasonable, this transaction will not constitute an act of self-dealing under §4941.

Bargain Sale Implications of Transfer of Property Subject to Indebtedness

Reg. §1.1011-2(a)(3) and Rev. Rul. 81-163 set out the IRS rule that a transfer of property to charity where the charity assumes or takes the property subject to an existing indebtedness against the property results in a bargain sale transaction in which the transferor is deemed to have received in the transaction an amount of money equal to the indebtedness existing against the property. While neither the regulation nor the revenue ruling specifically addresses a situation involving a remainder trust, it seems that the result would clearly be identical. As a result, in all transfers of debt-encumbered property to a charity, including a remainder trust, the bargain sale implications for the donor must be considered. These implications for remainder trusts are illustrated in the following example:

Tom Jones transfers a tract of unimproved real property to a remainder trust for Alpha University. At the time of the transfer, the property had a fair market value of \$1 million and had an existing indebtedness against it of \$500,000. Tom Jones' basis in the property was \$750,000. The bargain sale consequences to Tom Jones are as follows:

$$\text{Step One: } \frac{\text{Sales Price } \$500,000}{\text{Fair Market Value } \$1,000,000} \times \$750,000 \text{ Basis} =$$

\$375,000 Basis in Portion of Property Sold

Step Two:	Sales Proceeds (the debt)	\$ 500,000
	Basis in Portion of Property Sold	- 375,000
		\$ 125,000 Gain

Whether the gain is long term or short term will depend upon the holding period of the donor.

Application of the Partial Interest Rule to Remainder Trusts

Section 170(f)(3)(A) denies a deduction for a contribution to charity of an interest in property that consists of less than the donor's entire interest in the property. However, §170(f)(3)(B) provides that §170(f)(3)(A) does not apply to a contribution of an undivided portion of a donor's entire interest in property. For instance, a donation of a $\frac{1}{3}$ undivided interest in a tract of real estate to charity, even though the donor owns the entire tract, will qualify as a charitable gift entitled to a deduction. Revenue Ruling 76-331 addresses the situation of a conveyance of property to charity with a retention of mineral rights or timber rights. Under the holding of that ruling, such a retention results in the conveyance of an interest in property consisting of less than the donor's entire interest in the property. As a result, the ruling denies an income tax charitable deduction in such a situation. While the Ruling and the cited Code sections specifically involve an outright gift not in trust, the position taken by the Service should be equally applicable to similar gifts to remainder trusts. Institutions who are potential recipients of such gifts should bring this ruling to the attention of their donors and their donors' tax advisors.

Recent Rulings of Substantial Significance to Remainder Trusts

Before leaving the subject of charitable remainder trusts, a brief mention of two recent rulings affecting these trusts is in order.

In Rev. Rul. 72-395, the Internal Revenue Service set out a permissible provision for retroactively determining the pay-

ments due from a testamentary remainder trust upon final funding of the trust. In Rev. Rul. 80-123, this previously optional language was made mandatory. Now, in Rev. Rul. 82-165, the IRS has announced new mandatory language for the retroactive determination and ruled that the language announced in Rev. Rul. 72-395 is inadequate. Existing wills or trusts which will receive testamentary pourovers establishing or adding to remainder trusts should be reviewed with competent legal counsel to determine if changes are in order.

A new requirement of even greater significance was announced by the Service in Rev. Rul. 82-128. Effective for remainder trusts established after October 3, 1982, charitable remainder trust instruments must contain appropriate language making a successor income beneficiary's interest in the trust contingent upon that beneficiary's paying any estate tax for which the remainder trust may become obligated by virtue of the death of the Grantor of the trust. No new remainder trust providing for a successor or survivor beneficiary should be entered into without an appropriate provision complying with this ruling, and additions to existing unitrusts with successor or survivor beneficiaries should be made only upon advice of counsel.

ALTERNATIVES TO CHARITABLE REMAINDER TRUSTS

Charitable remainder trusts are excellent vehicles for enabling those who otherwise would not be able to make gifts to charity during their lifetimes to do so, since an income interest in the property transferred can be retained. However, the inflexibility of these trusts, as well as the inability to reach the principal of such a trust for the income beneficiary's unforeseen needs, renders these trusts unsuitable in some situations. In those situations, deferred giving, as a result of the Economic Recovery Tax Act of 1981 (ERTA), now offers two additional tools, one of which is new with ERTA and one which has always been with us but has had new life breathed into it by ERTA. These vehicles are the qualified terminable interest property trust (QTIP trust) and the irrevocable nonqualifying charitable remainder trust, respectively.

Qualified Terminable Interest Property Trust

ERTA, of course, made revolutionary changes in the Federal gift and estate tax system. One of the fundamental changes wrought by the Act was the allowance of an unlimited marital deduction for gift and estate tax purposes for gifts made and decedents dying after December 31, 1981, subject to certain exceptions not relevant here. Prior to the Act, not only was the marital deduction limited to the greater of \$250,000 or one-half of the adjusted gross estate, subject to adjustments, but a gift to a surviving spouse terminating with her death would not qualify for the marital deduction. ERTA, along with the unlimited marital deduction, enacted §2056(b)(7) which provides an exception to this "terminable interest rule". That section allows life interests and gifts in trust to a surviving spouse to qualify for the unlimited marital deduction, even though they terminate at her death, provided that she is entitled to receive all of the income from the property at least annually during her lifetime, and provided further that no person has the power to appoint any part of the property to any person other than the surviving spouse during her lifetime. This section was clearly intended to give flexibility to a spouse who has had multiple marriages and who desires to provide both for his surviving spouse and his children by a prior marriage. In such a situation, the decedent can provide for his wife's security while being sure that the property remaining after her death will ultimately pass to his children. An added advantage of a QTIP trust, in this situation and others, is that the Trustee can be authorized to invade the principal of the trust for the benefit of the surviving spouse.

While the QTIP trust from the outset possessed significant potential for deferred giving, the realization of that potential depended greatly upon whether the surviving spouse, who would be taxed in her estate upon all property in the QTIP trust, would be entitled to an estate tax charitable deduction upon her death for the property passing from the QTIP trust to a charitable remainderman. Fortunately, Congress clarified this question in the Technical Corrections Act of 1982. Section 2044(c) now provides that property qualifying for the marital deduction in the QTIP trust format will be treated as passing from the beneficiary spouse's estate for purposes of the charitable deduction.

The effect of these new provisions of the Code are obvious and dramatic. In the situation where a spouse is considering the establishment of a testamentary remainder trust for his surviving spouse, or in a situation where a spouse would consider such a trust if it were not for the restrictive nature of the trust and the prohibition on the invasion of principal, the QTIP trust will be a much more acceptable alternative. For instance, a husband can provide in his will that all or a portion of his estate will pass upon his death to a QTIP trust for his wife. He can further provide that upon her death, the remaining assets in the trust will pass to Alpha University. His will will also provide that during his wife's lifetime, the net income of the trust will be paid to her in convenient installments no less often than annually. In addition, he will typically provide that the Trustee will be authorized to invade principal to provide for his wife's needs.

Taxwise, such an arrangement will have the effect of removing all property flowing into the trust from the husband's estate for purposes of determining his taxable estate through application of the unlimited marital deduction. After his death and for the remainder of his wife's life, all property in the QTIP trust will be available for the wife's support. In addition, the couple will have the peace of mind and satisfaction ordinarily inherent in a remainder trust, i.e., professional trust management of the property for the surviving spouse and the knowledge that an irrevocable charitable gift has already been made to the institution of their choice for the purposes they have designated. Finally, while all property in the trust will be included in the wife's gross estate at its fair market value at the time of the wife's death for Federal estate tax purposes, her estate will receive a charitable estate tax deduction for the same amount. In effect, all property passing into the QTIP trust, regardless of amount, will have escaped taxation in both the husband's estate and the wife's estate while being fully available to the wife during her lifetime. Obviously, the assumption above that the husband will be the first to die is for the purpose of explanation only, and the same benefits will be available to a wife leaving a surviving husband.

A similar amendment to §2056 applicable specifically to remainder trusts is also of great significance. The provision applies only to trusts in which either or both spouses are the only

beneficiaries and entitles the deceased spouse to a marital deduction in his estate for the value of the surviving spouse's interest in the trust property for which the deceased spouse is the grantor. In summary, this provision, when combined with the gift and estate tax charitable deduction provisions, completely excludes remainder trust property in a covered remainder trust from transfer taxation in either spouse's estate.

The Irrevocable Nonqualifying Charitable Remainder Trust

Prior to the Tax Reform Act of 1969, the typical charitable split interest arrangement took the form of an irrevocable trust which provided that the net income of the trust would be paid to the income beneficiary for life, and further provided that upon the death of the income beneficiary, all remaining assets would pass to the charitable institution involved. Often, the Trustee would possess the right to invade principal for the beneficiary's needs. After the Tax Reform Act of 1969, such trusts ceased to qualify for income, gift and estate tax deductions, and, understandably, fell into disuse.

However, ERTA has dramatically increased the amount of property which can pass free of tax for gift and estate tax purposes. This year, \$275,000 can pass free of tax. Next year, that amount will be \$325,000, in 1985 it will be \$400,000, in 1986 it will be \$500,000 and in 1987, a total of \$600,000 will pass free of gift and/or estate taxes. This much wider window for transfers free of tax has made the irrevocable non-qualifying charitable remainder trust attractive again in limited circumstances.

For instance, assume that an individual has an estate of \$200,000. Assume further that he has no children. The individual desires to establish a trust which will ultimately pass to Alpha University and which will be funded with the bulk of his estate. During his lifetime, he wishes to receive the income from the trust, and further, he wishes the trust to be revocable. Alpha University, as many institutions do, has a policy against accepting purely revocable trusts. While a portion of the assets could be placed in the qualifying remainder trust with the remaining assets being placed in a revocable trust, the donor, quite understandably, wants the entire estate available to him for his care

and support. While banks typically manage revocable trusts in situations like this, the donor may have an aversion to bank trust departments, or more probably, bank trust departments may be unwilling to manage a trust of that size. As an alternative, and assuming no fiduciary problems are present, the donor and his tax advisors might consider transferring the assets to Alpha University or a third party in an irrevocable nonqualifying charitable remainder trust. The trust would provide that the net income would be paid to the donor for life, and that the Trustee would have authority to invade principal for the donor's needs. Typically, the Trustee's invasion power would be limited to an ascertainable standard, such as that portion of principal necessary to provide for the health, maintenance and support of the beneficiary. Such a format would provide security for the donor while meeting the charitable remainderman's requirement that all or a portion of the trust be irrevocable.

Taxwise, such an arrangement would result in a taxable gift for the donor in the entire amount transferred by him to the trust. However, assuming the transfer is made on or after January 1, 1982, and assuming further that the donor above has made no previous taxable gifts, his unified credit for 1982 and succeeding years will fully cover the \$200,000 gift, with the result that no actual tax will have to be paid. Since this trust is a trust in which the Grantor has retained the right to income for life, §2036 of the Code will bring the entire trust back into his estate. However, unless the appreciation of the trust property outpaces the increase in the unified credit between the date of gift and 1987, his estate tax unified credit will preclude the actual payment of any tax. More importantly, since the entire trust estate will vest in a qualified charity upon his death, the entire gift should qualify for the estate tax charitable deduction. For income tax purposes, the trust will be taxed as a noncharitable trust, and the donor will be taxed as a beneficiary of a noncharitable trust.

Obviously, the circumstances in which the use of the irrevocable nonqualifying charitable remainder trust will be advantageous will be limited. In addition, because the gift will be a taxable gift, even if no tax is actually paid, the donor's tax advisors should be involved at every step of the transaction. However, in the right situation, utilization of this trust may be

the only alternative enabling the donor to accomplish his goals.

The Third Split Interest Trust: The Charitable Lead Trust

While this workshop is devoted to charitable remainder trusts, it would be unfortunate if the third form of charitable split interest trust, the charitable lead trust, did not receive mention along with the charitable remainder annuity trust and the charitable remainder unitrust. This trust is a very valuable planning tool, and although often forgotten by both the deferred giving professional and the professional estate planner, it can offer enormous benefits in the area of transfer tax savings in the proper situation.

A charitable lead trust is merely a remainder trust in reverse. With a lead trust, income is paid to a charitable beneficiary or beneficiaries for a period of years, after which time the property either reverts back to the Grantor or is passed out of trust to his designated beneficiaries, typically the Grantor's children or grandchildren.

To qualify for income, gift and estate tax deductions, the income interest for charity must be in the form of an annuity or unitrust interest. Additionally, §170(f)(2)(B) of the Code requires that the Grantor of the trust be treated as the owner of the trust as a condition of receiving an income tax deduction for his gift of an income interest. In other words, the trust must be a Grantor trust, and the Grantor must be taxed on the trust income even though it is paid to charity. In return for this burden, the Grantor receives a benefit in the form of an income tax charitable deduction equal to the present value of the charity's right to receive the income over the term of years specified. The gift is treated as one "for the use of" a charity, and as a result, the income tax deduction can only be used to offset up to 20 percent of the donor's adjusted gross income, and no carry forward of unused deduction is allowed.

The Grantor trust requirement for obtaining an income tax deduction makes a lead trust impractical in most cases where the purpose of the trust is obtaining the income tax deduction. When the trust produces taxable income, the only plausible situation for its use in obtaining an income tax deduction would be a situation in which a donor has a large amount of income in the year the trust is established and expects a much lower level of income for

the remainder of the trust term which would be taxed at lower rates. Another alternative which would make the income tax deduction attractive would be an election (a voluntary and unrestrained election) by the Trustee to invest the trust assets so as to produce tax-free income. In such a case, although the Grantor would be taxed upon the income of the trust, that income would be tax free.

Because of the limitations on the income tax deduction set out above, a lead trust typically will be utilized best in the area of estate planning as a tool for reduction or elimination of transfer taxes. A lead trust meeting the requirements of §2522(c)(2)(B) for gift tax purposes and §2055(e)(2)(B) for estate tax purposes can reduce or eliminate the transfer taxes imposed on a transfer of the remainder interest in the trust from the Grantor to others, typically his children or grandchildren. These sections allow a gift and/or estate tax deduction for the present value of the income interest passing to charity which is deductible from the gross gift in determining the net taxable gift. If the income interest is large enough, and if the term of years for which the trust is established is long enough, this deduction can equal or exceed the gross value of the gift with a result that all transfer taxes will be avoided. To obtain these benefits, it is not necessary that the Grantor be taxed on the trust income. As a result, a trust established at death, or a lifetime trust which does not otherwise run afoul of the Grantor trust rules and which has a term in excess of ten years, will have no adverse income tax consequences for the donor. He receives no income tax deduction and has no income to report.

Prior to January 1, 1983, the value of a lead trust for lifetime giving purposes was limited by the fact that the lead trust would be subject to the alternative minimum tax. Since charitable gifts were a tax preference item, the trust, by taking charitable deductions for income paid to charity in computing its own income, would eventually, if the deduction were large enough (and they typically were), find itself computing its tax under the alternative tax computation. The effective tax rate, in some situations, would reach 20 per cent. However, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) removed charitable deductions from the list of items of tax preference.

Beginning January 1, 1983, this disadvantage of lifetime lead trusts has been removed.

As a result of the TEFRA relief provision in regard to the alternative minimum tax, the primary detriment to the establishment of a lead trust during the Grantor's lifetime lies in the fact that his children or whoever receives the lead trust assets on termination of the trust will take the donor's basis in the property. On the other hand, a lead trust established through one's will receives a stepped-up basis to fair market value at date of death, and the assets will have that stepped-up basis when they pass out of trust at the end of the lead trust term.

For a trust established in the donor's lifetime, any capital gain reportable upon the sale of an asset in the trust will be taxed at the Grantor's tax rates for the first two years of the trust. After that two-year period, or for a testamentary trust, the capital gain will be taxed to the trust at the trust's rates.

The use of the charitable lead trust is illustrated in the following examples:

1. Tom Jones places \$1,000,000 of income-producing property in a charitable lead trust providing for an annuity payment of \$60,000 each year for a period of eight years to Alpha University. The present value of Alpha University's right to receive \$60,000 a year for eight years is \$380,860. This is Tom Jones' charitable income tax deduction available to him in the year of the trust's creation. However, in return for the deduction, Tom Jones will have to report the trust income each year as his own. For instance, if the trust actually earns \$80,000 annually, this amount will be reportable by Tom Jones each year. Furthermore, if Tom Jones' adjusted gross income in the year of the trust is only \$600,000, he may only take \$120,000 of his available charitable deduction ($20\% \times \$600,000$). The excess deduction in the amount of \$252,600 cannot be carried over to the next year and will be lost.
2. Tom Jones desires to give his daughter a property valued at \$1,000,000. If Tom Jones makes an outright gift of this property to his daughter, the gift tax on the transaction will be \$345,800 before consideration of the unified credit against gift and estate taxes available to Tom Jones at the time of the gift. As an alternative, Tom Jones could place the property in a

charitable lead trust for a period of 15 years with provision that an annuity of 10 per cent, or \$100,000, be paid to Alpha University during each year of the trust. The trust would provide that upon termination, the property in the trust would pass to his daughter. The present value of the daughter's right to receive the \$1,000,000 fifteen years after the creation of the trust is \$7,219. This is the amount reportable for gift tax purposes in lieu of the \$1,000,000 which would be reportable if the gift were made outright to the daughter. Obviously, the gift tax savings realized by creating a charitable lead trust in this situation would be sizeable. As an even better alternative, by making the annuity rate 10.1 per cent, the taxable gift to the daughter can be wiped out in its entirety.

3. Assume in the example above that Tom Jones' estate is valued at \$2,000,000. Assume further that he desires to leave half of his estate to Alpha University and half of his estate to his daughter. While he could accomplish this goal by leaving \$1,000,000 each outright to the daughter and to Alpha University, such a plan would result in \$345,800 in estate tax before consideration of the unified credit on the \$1,000,000 passing to the daughter. Of course, Tom Jones could leave \$1,000,000 outright to Alpha University and place \$1,000,000 in a charitable lead trust as described in the above example for his daughter. However, in that case, the daughter would receive no benefit from his estate for 15 years. As an alternative, the donor could establish a "credit shelter" provision in his will providing that the exemption equivalent to the unified credit in effect in the year of his death pass outright or in trust to his daughter upon his death. Assuming that Tom Jones has used no portion of his credit previously, and assuming that he dies on or after January 1, 1987, the amount of \$600,000 could pass free of tax upon his death to his daughter. The remainder of the \$1,000,000 designated for the daughter over and above the amount passing by means of the credit shelter provision could flow into a charitable lead trust for a period of 15 years during which an annuity of 10.1 per cent would be paid to Alpha University. At the end of the lead trust term, the lead trust assets would pass outright to the daughter free of transfer taxes.

The remainder of Tom Jones' estate, the \$1,000,000 intended for Alpha University, could pass outright to Alpha University at his death, or as an alternative providing additional security to the daughter, all or a portion of that amount could be placed in a remainder trust for a term of years equal to the term of years of the lead trust. This would provide income to the daughter pending termination of the lead trust and the subsequent distribution to her. To completely avoid transfer taxes in this case, the credit shelter gift should be reduced by an amount at least equivalent to the taxable amount of the unitrust.

A very important point to remember is that all appreciation of assets within a lead trust will pass free of transfer taxes to the noncharitable beneficiaries upon termination of the trust.

An additional use of the lead trust, although relatively rare in application, lies in the opportunity which it gives to donors who regularly exceed their percentage contribution limits in gifts to charity to make gifts over and above those limits with before-tax dollars. Typically, a donor would establish such a trust for a period of years in excess of 10 years so as to avoid being taxed on the income of the trust. Ordinarily, the trust would revert back to the Grantor after termination, although the assets could pass to family members. Without the trust, any donations of income from property which would otherwise be placed in trust would be made from after-tax dollars, assuming the donor has already reached his 50 per cent contribution ceiling. With the trust, since he is not taxed on the trust income, he has effectively raised his contribution ceiling. This concept is illustrated by the following example:

Tom Jones normally has a gross income of \$200,000. He also has substantial nontaxable income, and as a result, requires very little of the \$200,000 in gross income to maintain his standard of living. That being the case, he would like to donate a substantial portion of the \$200,000 to Alpha University. However, he may only deduct charitable donations up to 50 per cent of his adjusted gross income, in this case \$100,000. (In this example, we will assume that gross income and adjusted gross income are the same.) He will receive no tax benefit from donations over that amount.

By transferring \$500,000 to a charitable lead trust providing for a 10 per cent annuity to Alpha University, he will, in effect, be making charitable gifts of \$50,000 of income in each year that the trust is in existence. Since we can assume that the \$50,000 would have been in his gross income had the trust not been created, the effect of the trust is to reduce gross income by \$50,000. He may still give 50% of his remaining adjusted gross income, or \$75,000, to Alpha University or other charities and take a deduction for that amount. Therefore, through a combination of traditional giving and the charitable lead trust, he had increased his charitable giving from \$100,000 to \$125,000 per year and has reduced his gross income from \$200,000 to \$150,000.

Finally, it should be noted that lead trusts are also subject to the private foundation excise taxes, although the rules of their application are somewhat different for lead trusts than for remainder trusts. Care should be taken to comply with these rules when dealing with lead trusts.

CONCLUSION

While granted that the charitable remainder annuity trust and charitable remainder unitrust do not offer the flexibility that pre-1969 irrevocable charitable remainder trusts offered, this lack of flexibility is often exaggerated. Often, these trusts by themselves can meet all of the needs of the donor while assuring the availability of future endowment or capital assets for the charity involved. However, by combining these remainder trusts with other giving vehicles, the flexibility of the overall arrangement can be enhanced greatly. For an individual who is concerned both about protection against inflation and the certainty of income, a unitrust can be combined with a gift annuity to offer, in combination, a potential hedge against inflation and an income floor which will never change. For a donor who is concerned about the possibility that he or his spouse may need the principal conveyed for some future, unforeseeable eventuality, a remainder trust can be combined with a revocable trust, with an irrevocable nonqualifying trust or with QTIP

trust to meet that concern. In some cases, a remainder trust, a revocable trust and a charitable life estate may all be combined in an overall plan meeting the income, security and trust management needs of the donor while at the same time providing the assurance of future capital for the charitable institution of the donor's choice. Finally, as described in the examples under the lead trust section above, remainder trusts can be combined with lead trusts to soften the effects of the delay in receipt of property on family members who will ultimately benefit from a lead trust.

However, even with all the flexibility and tax advantages offered by charitable remainder trusts, these trusts remain very complex entities subject to strict construction by the Internal Revenue Service, and subject further to the application of private foundation rules and other provisions which can make their administration difficult if not hazardous. The responsible fiduciary or charitable institution which solicits and manages these trusts would do well to be informed both of the existence of these potential pitfalls and of the steps necessary to avoid them.

WORKSHOP SESSION — ADMINISTRATION AND REPORTING—SMALL INSTITUTIONS

Dr. Darold H. Morgan, *President* and
Harold D. Richardson, *Senior Vice President and Treasurer,*
Annuity Board of the Southern Baptist Convention

This workshop is designed to discuss the administration and reporting responsibility relating to gifts to charitable institutions. Specifically the session is geared to small institutions but the reporting responsibility really applies to all charitable institutions that solicit and receive gifts.

The types of gift arrangements that we will discuss today are:

1. Outright Gift
 - a. cash
 - b. property
2. Gift Annuities
3. Charitable Remainder Trusts
 - a. Unitrust
 - b. Annuity Trust
 - c. Revocable
4. Pooled Income Funds
5. Other

A review of each type of gift is appropriate to remind us of the type of information that needs to be kept and reported to the donor and Internal Revenue Service. Legal requirements are another subject and not part of this workshop.

A charitable deduction is available to the donor at the time the gift is finalized, therefore it is necessary to give to the donor the necessary information to file accurate and complete tax returns. If the gift is a type of deferred gift it will be necessary to record and report to the donor the proper income reporting information on an annual basis. We will discuss the requirements of each agreement as we walk through each type of arrangement.

Before we begin the detail requirements of administration and reporting it is probably a good time to discuss departmental responsibility within the institution along with other observations regarding an institution's commitment to a fund raising program.

A fund raising program that requires promotion, personal solicitation and detailed administration should be weighed carefully before implementation. A successful program requires professional expertise in soliciting, investments and administration as well as a commitment of financial resources.

A well conceived development program requires patience. A successful deferred giving program may take as long as ten years to produce cash flow sufficient to pay for expenses and furnish additional monies to the exempt organization's purposes.

Preparation should be made to develop and maintain a donor file that contains name, address, date of birth and a history of giving to your institution. Record of contacts and responses should also be kept. This will help develop prime prospects for gifts. The file will also become the source for periodic mailouts that keep donors or potential donors informed and interested.

A deferred giving program requires a great deal more administration than a program of soliciting current gifts. This is the point that may be the difference between a successful program and one that sputters from the start. Donors will be impressed with an accurate, timely administered program. I recognize that a commitment of personnel and finances are of highest priority.

The solicitation and development of gifts generally will begin with the development offices. Record keeping and good controls can and should begin with the development officer. Proper receipt of securities, deeds and other gifts should be given at the time the gift is received by the institution.

This receipt may be a temporary receipt until the gift is finalized and the appropriate value is placed on the gift, but it will give the donor proof of delivery of an asset to the institution.

I believe it will also impress the donor that the institution is well organized and on top of the administrative details.

It is at this time that complete information should be obtained from the donor. Forms should be developed that will capture all the appropriate information necessary to complete the agreement and allow for proper administration.

Some of the information necessary is:

- a. Name of donor and beneficiary
- b. Age of each donor and beneficiary
- c. Type of agreement desired

- d. Amount to be transferred
- e. Value of asset if determinable (appraisal, if property)
- f. List of remainder charitable institutions
- g. Rate of distribution desired
- h. Type of trust
- i. Date asset acquired, if not cash

When the instruments are finalized and the gift consummated, a gift receipt should be prepared and given to the donor. This receipt, I believe, should be prepared by the financial office. Separation of duties creates good internal control within the organization. Naturally, the receipt may be mailed or delivered by the development officer but the preparation and recording should be handled by the financial officer.

Any administration necessary during the term of the gift should be handled also by the financial office. This is a natural sequence since all income, expenses, investments and reporting is normally the responsibility of the financial office. Again, I emphasize that actual donor contact may be the responsibility of the development office if the institution so desires.

In summary, the internal organization is to be decided by the institution involved, however, I encourage that the proper internal controls be considered when the decision is made.

Now, let's begin our discussion of administration and reporting of each of the gift arrangements mentioned earlier.

Outright Gifts:

The receipt of cash requires the simplest and most straightforward reporting. Valuation is obvious, therefore a cash receipt documenting the cash gift should be prepared and forwarded to the donor for his/her records. Copies of these receipts should be kept and the gift added to the file created for historical purposes. This file, mentioned earlier, should contain all data relating to gifts or contacts with donor, may prove very beneficial in securing the large gift at some other time.

Gifts of property, except for securities traded on an exchange, present another problem—that of valuation. There are those who believe that an official receipt containing a dollar valuation should not be given to the donor. Justification and deduction of the gift is the responsibility of the donor and his/her tax advisor

and the only responsibility of the institution is to acknowledge the gift and inform the donor of the Internal Revenue Service requirements of reporting and deducting. A standard letter or form could be designed for this purpose. In any event the institution has the responsibility of aiding the donor in securing the proper and correct deduction.

Gift Annuities:

A gift annuity is defined as an irrevocable transfer of money or property to a charitable organization in return for the organization's agreement to pay designated donors and/or beneficiaries fixed payments for life.

The reporting requirements are governed by the nature of the agreement. The institution has a continuing reporting requirement annually during the term of the agreement. Some of the pertinent details are:

1. Part gift and part purchase of annuity
2. Payment is fixed — never varies
3. Generally 60-70% of payment is tax free
4. Exclusion ratio necessary for reporting — never changes

The gift annuity arrangement is designed with a remainder gift built into the rates paid. A charitable deduction is allowed for the present value of the remainder interest after the annuity payment requirement is met. This is determined by using appropriate actuarial tables provided by the Internal Revenue Service. The donor has an investment in the contract, therefore part of the payment is considered return of principal and is tax free.

The donor must be provided the amount of deduction available in the year the gift is made as well as the amount paid on an annual basis. The amount not reportable as income due to return of principal must also be reported. A form W2-P is to be furnished to the Internal Revenue Service and the donor.

Administration of gift annuities during their term of existence, require that assets supporting the payment of gift annuities be segregated. Even though the annuitant may look to the general assets of the institution for payments, the gift portion of the annuity should not be recognized until the final payment has been made to the donor and/or beneficiary. Separation will

protect the integrity of the liability to pay and help to keep liabilities and gifts separate.

Some institutions fund the gift annuity through insurance companies in order to receive the gift up front. They are able to recognize the gift because the liability is transferred to the insurance company.

Charitable Remainder Unitrusts:

A charitable remainder unitrust is a trust that provides for payment, not less often than annually, of a fixed percentage of the net fair market value of the trust assets, as valued annually. Payments may be for the lives of the beneficiaries or for a term of years not to exceed twenty (20) years.

There are two variations of the standard unitrust mentioned above. The first variation allows the Trustee to pay the net income of the trust or the unitrust percentage, whichever is less, in any given year.

The second variation contains the same net income language and also has a makeup provision allowing the Trustee to pay out excess income in any given year over the unitrust percentage for that year equal to past deficiencies, i.e., the amounts by which the net income of the trust in prior years fell below the amount determined by applying the unitrust percentage to the trust value for that year. The purpose of the unitrust is to allow a donor to receive income during his/her lifetime and for the charitable institutions to receive the remainder as a gift.

A charitable deduction is available the year the property or cash is transferred to the trust. The unitrust will recognize any capital gain upon the sale of the property and may distribute this gain to the donor in future years if conditions warrant. We will discuss this possibility later as we discuss distributions. Capital gain is bypassed on appreciated property.

The administration of the unitrust is further complicated by the fact that income distributed retains the same character that it had in the trust. There is also a hierarchical system that the trust must follow in distributing the income. Income is distributed as follows:

1. Ordinary income
2. Capital gains — losses

3. Other income

4. Return of corpus (principal)

You can see that the nature of the unitrust requires that complete accurate records be kept to assure that the donor has the correct information to file his/her tax return on a timely basis. In the first year of the unitrust the donor must report to the Internal Revenue Service all the pertinent data relating to asset transfer along with a copy of the unitrust. The institution must provide the donor with this information.

The institution is also required to report to the Internal Revenue Service annually the operations of the trust. This is accomplished by filing form 5227 and, generally, a 1041-A fiduciary tax return. A form should also be furnished the donor that informs him/her of the type and amount of income reportable.

In summary, Trustee will:

1. Obtain taxpayer identification number
2. Report annually on form 5227 and 1041-A within 3½ months after close of fiscal year
3. Attach copy of unitrust to form 5227 the first taxable year with written declaration
4. Obtain each beneficiary's social security number
5. Send letter or form annually to beneficiary informing him/her of amount of income and type under the 4-tier provisions.

Charitable Remainder Annuity Trust:

A charitable remainder annuity trust is a trust which provides for the payment of a sum certain not less often than annually to the donor and beneficiaries. The regulations provide that the payments may be expressed as a fixed dollar amount or as a percentage of the initial fair market value of the trust corpus. In either case the amount payable each year must be an amount no less than five percent of the initial fair market value of the trust corpus. The payments must continue for the lives of the beneficiaries or for a term of years not to exceed twenty years.

The donor receives a charitable deduction in the year the annuity trust is created, therefore, all pertinent information relating to the transfer of assets must be furnished the donor. In

addition there are the same requirements that the unitrust carries regarding reporting to the Internal Revenue Service.

Distributions are treated in the same manner as unitrust distributions in that they keep the same characteristic as they had in the annuity trust. The hierarchical application of types of income also applies thereby requiring records that identify the type of income received by the trust.

The following summarizes the reporting requirements. The Trustee will:

1. Obtain taxpayer identification number
2. File form 5227 and 1041-A annually to the Internal Revenue Service
3. Attach a copy of annuity trust to the first form 5227 filed along with a written declaration
4. Obtain each beneficiary's social security number
5. Send letter or form to beneficiary informing him/her of amount of income and the type under the 4-tier provision

Revocable Trusts:

This is a trust that can be revoked anytime prior to donor's death. The institution may create this type of trust for the donor in order to bypass probate or to manage the assets in exchange for a remainder interest in the trust. Proper administration of this type of trust may be used to instill confidence on the part of the donor, thereby leading to more and larger gifts. A large number of institutions will not write revocable trusts.

Reporting requirements would include a letter or form informing the donor of the type and amount of income received during the year. Form 1041 - Fiduciary Income Tax Return must also be filed.

Pooled Income Fund:

A pooled income arrangement allows a donor to irrevocably transfer money, securities or both to qualified charities separately maintained pooled income fund, where it is invested together with transfers of others who make similar life income gifts. Donor, during his/her lifetime will receive his/her share of the pooled income fund earnings each year. On donor's or designated beneficiary's death the charity removes from the pool assets

equal to the value of donor's units in the fund and uses the assets for charitable purposes.

This type of gift arrangement is sometimes difficult for small institutions due to the minimum amount needed to begin a pooled income fund. If an institution desires to begin a pooled income fund it is possible to commingle with endowment funds. It is necessary however to maintain records which sufficiently identify the portion of the fund owned by the pooled income fund.

It is important to consider possible Securities and Exchange Commission implications and state "blue sky" implications. Other state laws may be involved in establishing a pooled income arrangement, therefore, precaution should be taken when considering this type of arrangement.

There are many complications in administering a pooled income arrangement. Computation of unit value funds yearly rate of return, and separation of detail reports may require that a financial institution be engaged as trustee. Most likely, the cost of staffing and programming and internal program would exceed a trustee's fee incurred by the small institution. Using an outside trustee would also provide the expertise to provide another tool in the arsenal of the development offices. Reporting of Institution would require:

1. Filing Form 1041 within 3½ months after the close of fiscal year of fund. Form 5227 is also required
2. Obtain employer identification number for funds
3. Copy of pooled income fund agreement should be attached to Form 1041
4. Attach support for calculating annual rate of return
5. Send letter or form to donor containing the amount and type of income to be reported on his/her tax return

General Observations:

We have discussed only some of the gift arrangements available to donors who have the desire to support your program at your institution. There are others that you may want to investigate. Your institution will need to decide what types of gifts it is going to solicit and administer.

Securing the gift, if it is a deferred gift, is the beginning of a

continuing relationship, with the donor. How the gift is invested, recorded and reported becomes very important in this relationship. Good administration with timely and accurate reporting will impress the donor and open the door for more gifts in the future. He/she will also become an ambassador for your institution and provide good leads to solicit other gifts. Naturally the reverse will undo a lot of the efforts put forth to raise further gifts.

Remember that trustees other than the charitable institution are available and qualified to handle the administrative responsibilities required to achieve good results. It is possible a small institution is not able to staff adequate professional people to administer the more complicated agreements. Because of the expertise available, this should not prevent the solicitation of these gifts that will ultimately support the program of your institution.

Gifts from deferred arrangements are not recognized by the institution until the final payment is made to the donor or beneficiary. It is for this reason assets of deferred gifts should be segregated from general assets of the institution.

Is there a minimum amount or percentage that an institution should receive before you will accept the responsibility of administering a deferred gift? Some institutions do not charge an administrative charge if the donor agrees to leave an adequate amount to the charitable institution. Administering deferred gifts does incur expense, therefore, an institution must examine its policy in regard to accepting deferred gifts without adequate remainder value.

WORKSHOP SESSION — ADMINISTRATION AND REPORTING — SMALL INSTITUTIONS

Jane Stuber, *Director*
Deferred Gifts and Bequests
Smith College

I. REVIEW THE PLANS

BEQUESTS

However great your admiration for Abraham Lincoln and others who died intestate, you do not want members of your constituency to follow in their footsteps. Nor do you want prospective donors to follow the example of Horatio Nelson, Lord of the British Admiralty who—before his death at Trafalgar—bequeathed his beloved mistress, Lady Hamilton, to King and Country that they might “make ample provision to maintain her rank in life.” Considering that Emma Hamilton died in abject poverty, it is obvious that King and Country did not choose to accept this particular testamentary offering.

To avoid such extremes and because, historically, bequests have been the greatest single source for increasing endowment, prospective donors and their advisors should be made aware of appropriate testamentary provisions which will enable a governing board to carry forward the work of a particular organization. At the very least, prospective donors and their attorneys should be provided with suitable bequest wordings (approved by your institution’s counsel), which indicate the legal name of the organization (e.g., Smith College is legally incorporated as The Trustees of The Smith College). Bequest information should include suggested wording for (1) unrestricted bequests permitting the Trustees at their discretion to use the income, principal, or both, for immediate needs, for endowment, or to place it in reserve; (2) bequests which will establish permanently endowed, named funds (possibly as a memorial) with the use of income unrestricted; (3) those which create permanently endowed funds with the use of income restricted to a particular purpose such as scholarship assistance, salaries, or instruction in a particular field; (4) residuary bequests which result in an institution re-

ceiving all or part of the rest, residue, and remainder of an estate; and (5) a contingency clause so that those with commitments to family and friends may provide that if an individual named in a Will as a beneficiary predeceases the testator, his or her share of the estate will pass to your institution.

Generally, governing boards favor unrestricted bequests because needs change. Therefore, when discussing a restricted bequest, urge that the purpose be stated as a preference so that if, in succeeding years, circumstances change to the extent that it would be impractical to continue using the funds for the original objective, the income, principal, or both, may be used for a purpose which in the opinion of the then governing board most nearly carries out the intention stated in the Will.

Properly drawn Wills can set up life income gift arrangements to the benefit of individual beneficiaries, as well as to your institution. Through testamentary provisions it is possible also to increase a previously established life income gift arrangement paying income to the survivor named in the agreement, or which has paid income to another from the outset. An institution's bequest program can and should be carefully coordinated with the life income gift options being promoted.

CHARITABLE GIFT ANNUITY:

(Immediate Payment)

The Charitable Gift Annuity is a contractual agreement between the donor and the issuing institution which provides a guaranteed fixed income. Rates followed generally are those recommended by the Committee on Gift Annuities. The fixed percentage return is based on the annuitant's age at the starting date of the agreement. A Charitable Gift Annuity is part gift and part purchase of an annuity, but payments are based on the entire amount transferred to the issuing institution. A large part of each payment is received tax free. The remaining portion of the payment is taxed for Federal income tax purposes as ordinary income.

No more than two beneficiaries may be named in a Charitable Gift Annuity contract. If the Committee on Gift Annuities' recommended rates are followed, the fixed percentage for an annuity covering two lives will be smaller than the percentage

provided for a single life contract. Under no circumstance should an annuity be issued which does not result in a charitable contribution of at least 10% of the amount transferred.

(Deferred Payment)

The Deferred Payment Gift Annuity is a variation of the standard or "immediate" Charitable Gift Annuity. Although the gift is made now (and the charitable contribution deduction claimed in the year of the gift), payments do not begin until a date specified in the agreement.

Payments are based on the original transfer plus interest earned on that amount. The portions of annual income from a Deferred Payment Gift Annuity which will be taxable and non-taxable depend on the age of the annuitant at the time the gift is made, the age of the annuitant at the date payments begin, and life expectancy tables and tax laws in effect at the time.

POOLED INCOME FUND

A Pooled Income Fund is a charitable remainder trust managed by a Trustee which may be the institution itself. Gifts are commingled with the gifts of others who have made similar contributions. Each contribution purchases a share of the total units in the Fund, and each income beneficiary is entitled to a pro rata share of the Fund's earned income.

The number of units originally assigned to each Pooled Income Fund gift will not change, but the income earned by the Fund and the value of the Fund's assets will fluctuate. Payments to the beneficiary are fully taxable as ordinary income. There can be no guarantee that a specific rate of return will be achieved but the Fund should be invested so that reasonable stability results.

CHARITABLE REMAINDER UNITRUST

Under a separately drawn unitrust agreement, cash, marketable securities, or both, are transferred to a trustee. The assets used to invest the unitrust and all receipts are managed and invested by the trustee as a single fund. (Under Revenue Ruling 73-531, a unitrust may be invested in a bank's common fund.)

Unitrust income is determined by multiplying the percentage specified in the unitrust agreement (which cannot be less than 5%) by the fair market value of the trust, revalued each year.

Although the percentage used to compute the payout can never change once the unitrust is created, fluctuating market conditions will cause the dollar amount of payments to vary in size.

One variation of the standard unitrust provides that the beneficiary receives the stated percentage or the actual income earned by the trust, whichever is lower. For years in which trust income is less than the stated percentage, deficiencies in distribution will be made up if the income earned by the trust in later years is greater than the stated percentage. Another variation of the unitrust provides that the beneficiary receives the lesser of the stated percentage or actual income earned by the trust, with no make-up provision for deficiencies in payments.

Unitrust income is taxed to the beneficiary under a four-tier structure and payments reflect the nature of the trust assets (ordinary income, capital gain, tax-exempt income, return of principal for the current year and any undistributed ordinary income, capital gains or tax-exempt income from previous years). For Federal income tax purposes the Trustee advises the beneficiary each year of the way in which trust income is deemed to have been distributed.

CHARITABLE REMAINDER ANNUITY TRUST

The Charitable Remainder Annuity Trust provides a fixed income, stated in the separately drawn agreement as a dollar amount or a percentage totaling at least 5% of the initial fair market value of the trust. There is no annual valuation of Annuity Trust assets for the purpose of determining the payout. Unlike the Charitable Gift Annuity, an Annuity Trust is not backed by the assets of an issuing institution. Annuity Trust beneficiaries turn only to the transferred property and its reinvestment for annual payments. Therefore, it is important that the stated dollar amount or payout percentage not be set so high that it is possible to deplete the trust. Otherwise, payments will cease and, ultimately, there will be no remainder for charity. Additionally, if the probability that the income beneficiary will outlive the funds is greater than 5%, the charitable deduction may be in jeopardy.

Income received by the beneficiary is taxed in the same manner as for a Charitable Remainder Unitrust.

LIFE ESTATE IN A PERSONAL RESIDENCE OR FARM

In addition to gifts which provide income for the life of the beneficiary or for a term not to exceed 20 years, a charitable organization may accept the gift of a personal residence or farm in which the life tenancy is retained for the donor and/or other persons. The irrevocable transfer is made by deed with a retained life estate agreement. An appraisal must be obtained at the time the gift is made in order to support the donor's claim for the charitable deduction. Fees paid to appraisers by the donor are not deductible as part of the charitable contribution, but may be deducted for Federal income tax purposes as an itemized expense.

A charitable deduction is allowed for the charity's interest in the property and is based on Treasury Tables and the life expectancy of the tenant(s). The fair market value of the structure is reduced by depreciation, then discounted at 6% per annum for the life interests. The appraised value of the property is subject to acceptance by the Internal Revenue Service.

II. TAX IMPLICATIONS OF LIFE INCOME GIFT PLANS

CHARITABLE CONTRIBUTION DEDUCTION

Each irrevocable life income gift arrangement generates a charitable contribution, deductible by the donor for Federal income tax purposes up to the applicable percentage of adjusted gross income ceiling (50% for contributions of cash; 30% for contributions of long-term appreciated property), and qualifies for the five-year carryover period.

The deduction is based on the initial fair market value of the assets transferred, on Treasury Tables, the age, sex, and number of beneficiaries, and on the payout specified in the agreement. (The Pooled Income Fund is an exception to this general rule. In computing the charitable portion of the transfer to a Pooled Income Fund, the highest rate of return earned by the Fund in the previous three years is substituted, in lieu of a stated payout. If the Fund has not achieved a three-year history, the computation of the charitable deduction is based on an assumed return of 6%.)

CAPITAL GAINS CONSEQUENCES

Charitable Gift Annuity:

The use of long-term appreciated securities for funding a Charitable Gift Annuity (either immediate or deferred payment) generates capital gains tax. Computed under the bargain sale rules, the gain is smaller than it would be on a direct sale of the same stock. Additionally, if the donor is the sole annuitant (or one of two in a joint and survivor agreement) and the annuity is nonassignable, the smaller gain is proratable over his or her actuarially computed life expectancy. If the donor is not one of the annuitants but names another person to receive annuity income, the capital gain (still computed under the bargain sale rules) cannot be prorated but must be reported in the year of the gift. If, in a two-life agreement, the donor-annuitant dies during the period in which the capital gain is being prorated, the survivor continues reporting the gain in the amount previously reported each year by the donor.

The donor-annuitant begins the ratable reporting of the capital gain at the time annuity payments begin, even though the first payment may not fall within the same tax year as the transfer, or the year in which the charitable contribution deduction is being claimed. In a one-life agreement, if the donor-annuitant dies during the period in which the capital gain is being reported, the unreported capital gain is "forgiven." In a two-life agreement, the unreported gain also is forgiven in the event both the donor-annuitant *and* the survivor annuitant die during this period of time.

Pooled Income Fund:

The transfer of long-term appreciated securities to a qualified Pool Income Fund totally avoids capital gains tax on the appreciated value of the stock. Therefore, by transferring low-cost, low-yield stock, it is possible to change investments and enjoy the benefit of greater diversification — possibly increasing the overall rate of return — without paying capital gains tax.

Gains on sales of long-term appreciated securities by the Trustee of the Fund will not be taxed to the Fund. There can be a capital gain only on the sale by the Trustee of short-term assets but, in this case, capital gains tax is paid by the Fund itself.

(Internal Revenue Code restrictions on Pooled Income Funds prohibit acceptance or investment in securities producing tax-exempt income.)

Charitable Remainder Unitrust and Charitable Remainder Annuity Trust:

The contribution of long-term appreciated securities to either form of charitable remainder trust does not generate capital gains tax at the time of transfer. Gains on sales made by the Trustee are not taxed to the trust. Capital gains are taxed only as deemed distributed to the beneficiary of trust payments.

GIFT TAX

A gift of a charitable remainder interest is not subject to Federal gift tax, although a gift tax return must be filed for all Pooled Income Fund, Charitable Remainder Unitrust and Charitable Remainder Annuity Trust gifts. A gift tax return also must be filed for the gift of a personal residence or farm in which a life tenancy has been reserved. The gift tax return is required for one-life charitable gift annuity agreements (in which the donor is the annuitant) only if the charitable portion of the agreement exceeds \$10,000.

The designation of an income beneficiary other than the donor may create a gift subject to tax on the actuarial value of the beneficiary's life interest. But, if the beneficiary is the donor's spouse, his or her interest may qualify for the unlimited gift tax marital deduction. Whether the gift will be taxable also depends on the availability of the \$10,000 annual exclusion, the possibility of gift splitting with a spouse, and the extent to which the credit against the gift tax has been used. In the case of a survivor beneficiary, the donor can reserve the right, exercisable by Will, to revoke the survivor's life interest and, in that instance, no taxable gift is made to the beneficiary.

FEDERAL ESTATE TAX

If the agreement is for the donor's life alone, the full amount of the life income gift arrangement (as of the date of death or alternate valuation date) is free from Federal Estate Tax. If there is a survivor beneficiary (and the donor is the first to die), only the value of the survivor's life interest (computed at the death of the donor) is subject to tax in the donor's estate. If the survivor

beneficiary predeceases the donor, no part of the life income gift arrangement is taxed to the donor's estate.

However, if the survivor beneficiary is the donor's spouse, the full amount of the life income gift can be removed from the taxable estate of both spouses. The value of the charitable remainder interest qualifies for the estate tax charitable deduction and is never taxable.

Appreciation is expressed to Mr. Philip T. Temple, Prerau and Teitell, 375 Park Avenue, New York, New York, who reviewed *Section II. Tax Implications of Life Income Gift Plans*.

III. ADDITIONAL SOURCES OF ASSISTANCE

A. Conferences:

1. Committee on Gift Annuities
1865 Broadway
New York, New York 10023
2. Council for the Advancement and Support of Education
Eleven Dupont Circle
Washington, D.C. 20036

B. Training Programs

1. Philanthropy Tax Institute
13 Arcadia Road
Old Greenwich, Connecticut 06870
2. R and R Newkirk
P.O. Box 1727
Indianapolis, Indiana 46206
3. Kennedy-Sinclair, Inc.
524 Hamburg Turnpike
Wayne, New Jersey 07470
4. Robert F. Sharpe & Company, Inc.
White Station Tower
5050 Poplar Avenue
Memphis, Tennessee 38157
5. Planned Giving Specialists
36 Hawthorne Place
Montclair, New Jersey 07042
6. The Pentera Group, Inc.
608 North Keystone
Indianapolis, Indiana 46220

7. Pictorial Publishers, Inc.
P.O. Box 67520
Indianapolis, Indiana 46268

C. Manuals providing computation forms and information relating to life income gift programs:

1. Philanthropy Tax Institute
 - a) Managing a Deferred Giving Program
(Conrad Teitell)
 - b) Deferred Giving Tax Techniques
(Conrad Teitell)
2. Committee on Gift Annuities
 - a) Tax Implications of an Annuity Gift
 - b) Guide for Computing the Federal Tax Implications of Charitable Gifts Subject to Life Income Agreements under Pooled Income Fund Plans
 - c) Deferred Gift Annuities
(Guide for Calculation of Rate and Gift Value under Revenue Ruling 72-438)
3. Council for the Advancement & Support of Education
 - a) Revised Guide to the Administration of Charitable Remainder Trusts
(Edited by David Clark, Robert Kaiser, and John Holt Myers, updated 1978)
 - b) An Introduction to Annuity, Life Income, and Bequest Programs
(William Dunseth, 1978)
 - c) Planned Giving Ideas (The Best of CASE CURRENTS)
4. Government Printing Offices
 - a) Actuarial Values I: Valuation of Last Survivor Charitable Remainder
 - b) Actuarial Values II: Factors at 6% Involving one and two Lives

D. Publications

1. Taxwise Giving
(13 Arcadia Road, Old Greenwich, Connecticut 06870)

2. Trusts and Estates, The Journal of Estate Planning and Administration
(461 Eighth Avenue, New York, New York 10001)
- E. Miscellaneous
 1. The Deferred Gifts Program
Northwest Area Foundation
W-975 1st National Bank Building
St. Paul, Minnesota 55101
 2. The Costs and Benefits of Deferred Giving
Norman S. Fink and Howard C. Metzler, for the
Lilly Endowment, Inc. Columbia University Press,
New York, New York
 3. Tax Economics of Charitable Giving
Arthur Anderson and Company
69 West Washington Street
Chicago, IL 60602
 4. The Educator (bi-monthly publication for prospects/
donors)
McKenney and Thomson
17th Floor — Munsen Building
Baltimore, MD 21202
 5. Amicus (quarterly publication for prospects/donors)
Taxwise Giving
13 Arcadia Road
Old Greenwich, Connecticut 06870

WORKSHOP SESSION — ADMINISTRATION AND REPORTING — LARGE INSTITUTIONS

Frank J. Mayo

Planned Gifts Consultant

The Salvation Army Western Territory

A planned gift is defined as, "one which is legally provided for during the donor's lifetime and generally regarded as having been made at a particular date, but whose principal benefits are not received by the object of his charity until a later date, usually the death of the donor or that of a survivor beneficiary if one is named."

In the case of charitable gift annuities and charitable trusts, a planned gift is referred to as, "the gift that gives back to you."

Assuming that the larger institution is entering a planned gifts program surfaces some considerations worthy of our time; not the least of which is the matter of administrative responsibilities assumed by the charity.

The experience of The Salvation Army in the West over a seven-and-one-half year period has told us that most donors establishing a charitable trust "expect" The Salvation Army to serve as trustee. The average donor does not distinguish between the charitable remainderman and the trustee, or between a gift made to the institution and a gift made to a trust. We are often told to serve or they will take the gift elsewhere. They are making a gift to The Salvation Army, and as far as they are concerned, it's The Salvation Army paying them, and they do not distinguish this and the function of a trustee. This, then, commits our organization to a serious administrative responsibility, namely trusteeship. This is an extended term responsibility for which we must prepare wisely. We must also be aware of the fact that we are dealing with people and in a people-oriented function and not dealing just with dollars and instruments. I see the administration of planned giving as being basically divided into four categories:

1. People
2. Money
3. Selling and Marketing

4. Internal Systems and Reporting

Administration, according to the dictionary, is "the management of any institution." It's taking charge, directing affairs and submitting to authority; it's control and discipline.

PEOPLE

The primary concern in this administrative process is people. Your planned giving program will only be as good as the people you bring to it, and they will only be as good as you let them. The director of the program must come to you with experience, training, technical know-how and concern for people. Those whom you put in the field should be self-starters, motivated, knowledgeable and people oriented. All our concerns over automated equipment and computers, legitimate as they are, are nonetheless secondary and contributory to our concerns for our donors. The art of estate planning/planned giving is the art of helping people. It is not simply the mechanical process of rearranging dollars, but rather the planning of a life's work and a distribution of assets which have been accumulated over that life span.

MONEY

Money is also of great concern to us. Perhaps first of all is the internal problems of money which are created by the need for the budget to start and operate the planned giving program. The Salvation Army in the Western Territory a number of years ago adopted a policy of setting aside 7½ percent of the monies received from planned giving for the funding of the planned giving program. They very wisely decided that the money received this year would fund the program next year so they constantly stay a year ahead of themselves. This is wise financial planning and good budgeting process. This planned giving budget must be adequately funded and should be part of the general budgeting concept of the institution and not be treated as an orphan child. A commitment must also be made to fund this program over an extended period of years and not be done on a one or two year trial basis. The obligations created by your planned giving people will be ongoing, and will require attention regardless of whether you continue the solicitation process. This budget must include such things as salaries, benefits, expense accounts, tra-

vel, equipment, advertising, literature and training. It generally takes an amount equal to a person's annual salary to keep him in the field annually.

The managing of money belonging to others is also a continuing responsibility when we are writing annuities or serving as trustee. Unless the annuities are reinsured and we divest ourselves of the management responsibility, we must maintain a segregated fund, produce income and send checks to annuitants in an accurate and timely manner. It is our opinion that a check from The Salvation Army periodically means that every other mail piece sent to that donor will be opened by him and probably be read. It is to our advantage to manage our own fund, serve as trustee and mail the checks ourselves on our own check form and in our own envelopes with a letter from us.

The degree of sophistication in the managing of trust and annuity assets is of course related directly to the attitudes of the institution. Our experience is teaching us that we often are holding assets that have been used as initial funding for trusts and we do not need to do a great deal of management decision making. There are, however, other occasions when it is necessary to change a trust asset because of the needs of the donor changing. We have set up a trust committee which meets periodically and makes these decisions. The changing moods of the market place will demand that this committee meet on a regular basis and be alert to the trust demands for income.

SALES/MARKETING

A number of years ago I saw a plaque in a newspaper office which said, "Doing business without advertising is like winking at someone in the dark. You know what you're doing, but they don't." Ringing our hands and hoping that donors will beat down our planned giving door will not surface leads. I was told when I first came into this work that I would never get gifts for my institution by sitting in the office and shuffling the prospect cards. We must let people know that we want and can receive this kind of gift. Strangely enough, we receive frequent inquiries from attorneys and donors as well asking if The Salvation Army is capable of receiving these gifts. Though we may assume people understand we can receive these gifts, we are not correct in doing so. We must educate our public.

It is also important to determine what you are marketing. Our experience has taught us that if we have to begin selling The Salvation Army when we are in the home of the donor, that it is really too late. The institution, by its own production of good, works over the years and by the literature which it disseminates must say to the public who they are and what they're doing and convince people that the institution is worthy of receiving the gifts.

We do, however, have products that we are marketing. We are marketing wills, outright transfers in kind, annuities, irrevocable trust, revocable trusts, pooled income fund trusts, life estate agreements and lead trusts and many others. These are the things we need to talk about and educate our public to. We also believe that the periodic addition of a new product or a variation of an existing product will help in marketing the planned giving effort of our institution. About three years ago, we began a new revocable savings account trust program which, at the time, seemed to us to be just another nice tool to add to our kit. We did discover, however, that the soaring interest rates were making gift annuities much less attractive and this revocable trust program began at that point to pick up the slack. We have also discovered that revocable trusts written to hold assets and convert to an irrevocable trust or some other kind of instrument at the occurrence of some event or a point in time have been very useful. The revocable life estate agreement which converts to a trust has been most helpful. We are also currently working on the possibility of putting together what we would like to call a "life care trust" which would make it possible for people to place assets with us and then allow us to pay bills for them when they become incapacitated. We also feel a very strong and ongoing responsibility to those with whom we have worked and completed agreements. In order to keep the calling program on these people current, we are now hiring retired Salvation Army officers to take direction from the Director of Planned Giving in their division and make these "pastoral" type of calls on our existing donors. To date this program is functioning well and has been well received by the donors.

In all of our marketing concepts, we must not forget the importance of getting out on the road and telling people what we are

doing. To accomplish this, we can hold seminars and group meetings, meet with people for breakfast, lunch and dinner, visit in homes, inform our internal staff, talk with attorneys, accountants and trust officers and generally keep up an ongoing educational program.

To back this up should be a good presentation of appropriate literature. I recommend a printing of one general brochure which briefly covers or touches on the various kinds of instruments that you will write, and then a specific brochure on each of the subjects talked about in the general brochure. The brochure should be easy to read, should be on paper that does not in any way reduce the visibility of the ink, they should not be on slick or shiny paper, and I recommend against trying to do it all in one 8½ x 11 brochure. You should have in your supply of brochures some very complicated and heavy material, but for general distribution and especially for use in sending these brochures through the mail, I recommend very simple brochures that talk to the issue but do not try to answer all of the questions. The point is to encourage the donor to invite us to come and sit down with them and talk about their problems. If we answer or endeavor to answer all of their questions in our letter or brochure, they will not need us.

Advertising in public media has been good to The Salvation Army throughout the United States. The old axiom that the best place to advertise is in your own publications still remains true, and if you have an organizational publication, I would encourage you to have a planned giving ad with a return coupon in every issue. In addition to this, you will be wise to experiment with various publications and see what you can do to draw in coupon responses from the general public. These ads that are placed should be kept simple and should be as large as you can afford to run and should be run in a periodical only as long as it remains effective. Placing an ad and just letting it run issue after issue is not necessarily effective. You should be trying new markets and always put a coupon on the ad, and don't worry about changing the ad since that is generally for our benefit and has little meaning to the reading public. At the end of the year the ad responses should be analyzed and those responses that are too expensive would dictate terminating that publication. Our policy has been

that when it costs more than \$50.00 to get a coupon back, we drop the publication.

The use of direct mail in soliciting planned gifts is also a valid concept. Experience has taught us and other organizations that this is a rather expensive way of getting leads, and that the direct mail should be sent to a selected market and not to a general mailing list.

The best marketing tool that we have at our disposal is a trained and experienced field man who gets out on the road and sees people.

INTERNAL SYSTEMS AND REPORTING

With responsibility must come accountability. To turn a planned giving person loose and not provide for adequate evaluation of the work, time, use and production does the person and the program an injustice. The governing board that authorized and funded the program must receive back an accounting of what has been done. The most vital elements in that report will be how many planned gifts you have secured and the dollar total of those expectancies.

This does surface the whole matter of how to value the gift. Howard Metzler and Norman Fink have written a book entitled, "The Costs and Benefits of Deferred Giving." This study was sponsored by the Lilly Foundation and applies the cost accounting, benefits analysis and actuarial and econometric forecasting to the planned giving effort to determine if it's worth it. Their conclusion seems to be that it is a worthwhile effort. Obviously, your institution cannot embark on an effort that will only produce a negative cash flow over an extended period of years, albeit we expect that in the early years of the program. This, however, does not appear to happen when the organization keeps up its good work for which it was originally conceived. Most people never change their wills once written, but because of the campus riots in the 1960's, some did go to the trouble, and today bequests are going to other institutions as a result.

In reporting your expectancies internally, you must adapt a realistic criteria. If a donor family, husband age 47, and wife, 45, designate \$100,000 for you in their wills, you must determine what you think that is worth. If that family were 77 and 75, it

would be worth a good deal more and have less chance of ever being revoked and changed. The gift, however, from the younger family will have many years to grow if it is a percentage or residual bequest.

When reporting internally, it is important to show the ages of the donors, the gross amount of the gift, how much is designated, the type of agreement and give as much backup verification with calling records, copies of documents, etc., as possible. There should be a separate report for each gift, showing the above information for confidential reporting. The summary for publication to the Board should show summaries only with no names or other information which would reveal who or where the gift was originated.

The persons doing the donor contacting must keep accurate records of calls in great enough detail that a new person could take over the file with little or no difficulty. Duplicate files should also be kept if the donor contact person is stationed away from the main office or files are carried out into the field.

The reports by the donor contact person should show the number and type of calls made, the results of those calls, the number of miles traveled, the expenses, public presentations given, contacts with other professionals such as attorneys, accountants, trust officers, etc. I would recommend staying away from the essay type report because they are seldom read. The statistics I have given here will be very useful at the end of a quarter, the end of a year, or the end of several years for determining the direction of the program in the years ahead.

This reporting, done at least monthly, will make it possible to evaluate the performance of the donor contact person and the program as a whole. For example, The Salvation Army contact people in the Western Territory make about five calls for every completed agreement, and it costs about 2½ cents for every dollar committed through a gift agreement. This will include some outright gifts and all deferred gifts.

In an article in a recent issue of "Fundraising Management" magazine, Norman Fink says, "...charitable fundraising is more of an art than a science..." I agree with this, and would add to it the consideration that when raising the deferred dollar, we have also been of considerable help to our donor/constituents in all or

some of the following ways:

1. We have helped them make a gift they wanted to make but didn't think they could.
2. We have helped them make a larger gift than they ever thought they could.
3. We have helped them get an estate plan, or parts of a plan together which will be a greater benefit to their heirs.
4. We have helped them save on death taxes.
5. We have helped them increase their lifetime income.
6. We have helped them achieve peace of mind through good, thoughtful planning and charitable giving.

All in all, planned giving is a merging of the helping hand, the giving hand and the receiving hand. It is both ministry and monetary in nature and really should not be valued solely on any one element.

INVESTMENT & MANAGEMENT OF GIFT PROPERTIES — LARGE INSTITUTIONS

Earl F. Schneider, *Controller*

Thomas R. Vogeley, *Assistant Treasurer,*
American Bible Society

When we were asked to conduct a workshop on *Investment and Management of Gift Properties for Large Institutions*, our initial reaction was — What could we possibly say to such a group of informed people that they haven't already heard or read about in prior conferences?

The Chairman then advised us that the attendees at these meetings vary greatly from conference to conference and there may be many persons attending this conference for the first time. We then agreed that since the last conference, there have been many changes in the way investments are handled due to the economic situation, new tax laws, new investment instruments, new methods of transferring cash and so forth. So we agreed to proceed.

We do not profess to be experts on this topic, however, we are involved in the investment and management of gift properties, and we work for an organization which is classified by most people in the non-profit field as a large institution.

During this session we will be sharing with you some of the ways that gift properties are handled at the American Bible Society and we are hopeful that you will raise questions either during or at the conclusion of this presentation.

We interpret the words "Gift Properties" to cover property given to tax-exempt organizations under deferred gift programs such as Gift Annuities, Pooled Life Income Agreements, Revocable Trusts, Annuity Trusts or Unitrusts and Lead Trusts.

Gift Properties may take the form of cash, securities, land, farms, houses or commercial buildings. Personal property such as jewelry or automobiles is not usually accepted for deferred gift agreements.

Our understanding of "Investment and Management" covers the decisions as to what to do with the property when it is received (investment) and the periodic reviews of those decisions (Management).

Gifts of Cash—Cash is the most simple method of charitable giving. Cash received by an organization should be deposited immediately preferably in an interest-bearing checking account which non-profit organizations are permitted to keep in most banks. The agreements are issued as of the date the cash is received with the exception of pooled life income agreements which are issued as of the next determination date after receipt of the cash. At month end (or the next determination date) the cash is transferred to the proper investment fund and investments are purchased in accordance with the organization's investment policy for each specific fund.

It may be helpful if we are explicit about the steps taken at the ABS in investing cash received.

1. Cash is deposited immediately—on the day of receipt.
2. The account is an interest bearing checking account.
3. When the funds are ready for investment, the cash is wired to the Custodian Bank.
4. The Investment Department is advised of all such transfers and selects appropriate investment instruments within established policies.

You may be interested to know that for many years cash generated as income on the Society's general investments remained with the custodian until the end of the month. Only then would it be invested. As interest rates increased, this process was increased to twice a month.

During the period of very high interest rates it became imperative for institutions to earn higher levels of income on all possible cash. In the case of the American Bible Society, an arrangement was instituted with the custodian bank to sweep income balances in excess of \$5,000 into a money market fund on a daily basis.

In 1982, the income from this sweep process was substantial. One caveat, however, good cash managers must recognize that banks may react to sweep programs in the form of higher bank fees. This must be analyzed carefully before initiating any program. If the number of transactions increase at the same time your bank balances decline, it is only fair for the bank to increase its charges. Since it is now possible for the banks themselves to pay these higher interest rates, it may no longer be necessary to

move cash out of the banks into money market funds in order to gain this higher interest.

Gifts of Property—Donors owning property which has appreciated in value can gain considerable tax advantages by giving the property to a qualifying tax-exempt organization. Contributing appreciated property held more than twelve months to a charitable organization for a pooled income fund can save the donor from paying capital gains taxes on the appreciated value. Property which has depreciated in value should be sold by the donor and the proceeds given to the charitable organization. The donor may then have a deductible loss to offset against taxable income. Contributing appreciated property for a gift annuity agreement does not entirely save the donor from paying capital gains taxes. Such transactions are treated as "bargain sales" and the donor escapes the capital gains taxes only on the gift portion of the principal given.

Securities—are valued on the date they are received in negotiable form. For instance, if a stock or bond power is not received with an unendorsed security, or the stock or bond power is incomplete, the organization is not in a position to value the security or issue an agreement. Listed securities are normally valued at the average of their highs and lows on the day the gift is complete. When valuing unlisted securities, the organization should obtain a current realistic appraisal from a qualified source. Securities must be added to a pooled fund before they are sold. The fund pays no capital gains taxes on securities sold which are held more than twelve months including the donor's holding period. Some organizations hold all securities received in their pooled income fund for at least twelve months before selling them in order to be sure that no taxes are incurred by the pooled fund. This is the Society's practice.

Real Estate—Transfers of appreciated real estate property such as land, farms, houses or commercial buildings require careful handling by the receiving organization. Donors who transfer appreciated real estate property encumbered by debt to a pooled income fund are subject to the "bargain sale" rule and they may find that taxable income was realized as a result of the transfer. Many organizations will not accept encumbered real estate property for a pooled income fund.

Most organizations that receive real estate are not equipped to manage this type of asset and prefer to sell it as soon as possible. It is extremely important that the donor should never be involved in the negotiations with a prospective purchaser. The organization receiving the property should have complete control over the sale. If the donor negotiates with the buyer prior to the transfer, the donor risks paying taxes on the capital gain.

It is recommended that an organization accept appreciated property only after one or two appraisals have been made. The organization advises the donor that an attempt will be made to sell the property for at least the appraised value. When the donor agrees, a real estate broker is contacted by the organization to initiate a search for a buyer. It is prudent also (especially in distant areas) for the organization to hire a local attorney to coordinate the receipt of the deed to the property from the donor and to represent the organization at the closing when the property is sold. The estimated net proceeds after payment of real estate commissions and closing costs becomes the principal amount of the pooled life income agreement and the agreement is issued on the next determination date after receipt of the property. The property is received into the pooled income fund and either sold immediately or may be transferred to another of the organization's funds so that the pooled fund is not "saddled" with a low income-producing asset.

Investment Policies — Investment policies will differ for each type of deferred agreement issued.

In formulating the specific investment policies consideration must be given to both legal constraints and fiduciary obligations placed on the institution. Many state regulations specifically restrict the types of instruments which may be held. The fiduciary obligations to holders of agreements necessitates the generation of certain income levels while assuring conservation of the capital. Let's discuss the implications of these considerations on various types of agreements.

Revocable Agreements — Many donors are not in a position to give an irrevocable gift to an organization. They fear that they may need the principal for a later emergency. To accommodate this type of donor, most organizations offer revocable trust agree-

ments where the principal of the agreement can be withdrawn in whole or in part if an emergency arises. The donors receive fully taxable income during their lifetime and, if no emergency arises, the remaining principal reverts to the organization at the donor's death.

At the ABS, when cash is received for these revocable agreements, appropriate trust fund investments (bonds and mortgages) are purchased.

Since the principal received is subject to withdrawal at a future date, many organizations invest in readily marketable high-grade bonds in order to produce the income for the periodic payments and to have a security that can be easily sold in the event the principal must be returned.

In many cases, donors give specific securities and request that they be held. The securities are recorded in the Society's name and are entered on the ABS books at \$1.00. The donors receive the exact income generated by the securities during their lifetime. The income is fully taxable to the donor. At the donor's death, the securities are sold or added to other Society holdings at market value.

Gift Annuities — Most state insurance departments prescribe the types of securities that must be invested for annuity funds. The ABS annuity funds are regulated by the New York State Insurance Department and an actuarial valuation is made each year to determine the legal reserve required by this regulatory body. This "legal" reserve normally amounts to a figure between 50% and 60% of the face value of annuity agreements in force. Therefore, 60% of the principal received by the Society is invested in fixed income securities in the form of bonds or mortgages approved by the New York State Insurance Department. Because only a small percentage of stock is permitted for investments (5% of assets) the Society holds no stock in its Annuity Legal Reserve Fund. The remaining 40% of the principal received is invested in the Annuity Fund portion of the Society's General Fund which is pre-dominantly invested in equities. When the annual actuarial valuation is received, the Annuity Legal Reserve Fund is adjusted accordingly.

We should note that the total of the Society's two annuity funds, the 60% legal reserve and the 40% portion that is in the

General Fund, exceeds the face amount of agreements in force. Very simply, this is done in order to:

- produce the necessary income to provide for payments to annuitants which can be as high as 14% and
- pay for the promotion and administration expenses of the annuity program

These General Fund investment holdings normally reflect the following guidelines:

- Contain a broad diversification of industries
- Consist of good/high quality issues
- Include both income-producing and growth-potential securities
- Be limited to a manageable number of issues
- Be divided between fixed income and equity issues with established percentage relationships (5/95-35/65)
- Purchase no single stock with an initial purchase value in excess of 2% of the equity portfolio
- Contain no single stock with a market value in excess of 10% of the equity portfolio
- Contain no options, or futures

Your own guidelines may differ from these in specifics but each of these areas should be reviewed before setting policies.

Pooled Income Agreements—Most organizations have a portfolio which contains a mixture of high quality, high yielding investments as well as some growth potential investments. Growth investments, however, which pay no dividends are rarely found in a pooled income fund's portfolio. Donors frequently "shop around" for a pooled income fund with a high yield and your organization's payment history may have an influence on whether or not a donor will participate in your organization's fund.

Here again several broad guidelines for investments can be applied:

- Diversification of industries
- Good/high quality issues
- Mix of high income issues plus some items which afford future growth of both Income and Principal
- Maximum percentage limits on size of any one issue in the portfolio

—No options, futures, or venture capital securities

One final point regarding real estate gifts which are part of pooled funds. It was mentioned before that when securities are received, they are held for at least twelve months to assure that there is no question about the total holding period. Yet in the case of real estate the Society sells it as soon as possible because the holding period is a known factor.

Unitrusts—A unitrust agreement must pay a fixed percentage of income to the beneficiary so the investments must be capable of providing that income each year. Since the investments must be valued annually to determine the payment, it is wise to select investments that can be easily valued.

Annuity Trusts—An annuity trust agreement requires a fixed sum to be paid to the beneficiary each year even if the principal is consumed in so doing. It would be prudent to invest the principal for this type of agreement in high quality bonds which are not subject to changes in income from year to year.

Who formulates investment policy?—Small organizations which have small staffs and relatively small amounts of funds to invest are more likely to use the services of a bank or other financial institution to invest the principal, prepare and mail the periodic payments, and prepare and mail the tax statements to the donors. Although some large organizations also use outside financial institutions to handle their investments many of them are staffed to do this work themselves with the help of members of their governing boards.

The American Bible Society is indeed fortunate to have a Finance Committee comprised of twelve distinguished members of the Board of Managers who are active in the financial area. Each of them brings his special expertise to the monthly meeting. Their backgrounds cover banking, brokerage houses, insurance companies, financial consultants, economics, and manufacturing companies. There are specialists in stocks, in bonds, and in mortgages included in this group. In addition to the Finance Committee, the President of the ABS is a retired banker and contributes greatly to the work of the Committee.

The ABS employs an Investment Manager who is responsible for carrying out the instructions of the Committee. Although the Manager has the authority to act within certain dollar limitations

between meetings, he usually confers by telephone with Committee members on any unusual or fast-moving situations. The Committee reviews all transactions at their regular monthly meetings and the entire portfolios of all funds are reviewed in depth at the close of each quarter. The Society's securities are held at one of the large New York banks. Records of the entire portfolio are maintained on the Society's in-house computer and sales and purchases are updated daily so the portfolio is always current.

The performances of the major funds are compared with the Dow Jones Industrial and the S&P 500 averages.

Investment Manager—As mentioned previously the American Bible Society employs its own Investment Manager. You may ask how one really determines whether to utilize an in-house investment advisor versus turning that function over to an outside resource.

In the Society's case the single most important factor was the availability of talent. The current Investment Manager was involved in the Society's investment program when he was a broker and decided to join the Society after a long distinguished career on Wall Street.

Other factors which argue for use of in-house management include: low cost, when compared to outside fees; absolute control over the investment activities, selection of individual securities and trading activity consistent with the fund's investment objective; and not the least in our case is the lively interchange of points of view on investments between the Finance Committee members and the Investment Manager. All of these have convinced the ABS, that in-house management is appropriate.

Security Loans—The Society has been lending securities for over ten years and earns substantial additional income from this source. Some securities are loaned in exchange for cash, some are loaned in exchange for other securities, and some are loaned under a letter of credit issued by the broker's bank. The Society retains the dividends or interest income on the borrowed securities and receives additional income by investing the cash received in short term paper, money market funds, or other instruments approved by the Finance Committee. The Finance

Committee only permits the purchase of commercial paper issued exclusively by Companies rated P-1 by Moody's and A-1 by Standard & Poor's.

In the case of collateral loans the Society receives negotiated fees based on the principal amount, the length of the loan and the current interest rates. The Society uses an independent loan agent to handle its security loans.

As mentioned previously, the ABS is presently operating under a very tight policy on short term investment of cash. During 1982 and so far this year the Finance Committee's policy has been to invest only in money market funds holding US Government securities and top rated commercial paper. Only paper which is rated A-1 or P-1 by Standard & Poor's and Moody's may be held.

By restricting short term cash investments to more secure items we have traded off higher interest income. But, this is a balance that the Committee has deemed as prudent in these times.

One final subject we would like to mention is the influence that the investment and management of funds will have on policy decisions related to your deferred giving programs.

Two specific examples of this influence at ABS regard establishing minimum dollar limits for particular programs. In the case of Life Income Agreements (the pooled fund), the ABS has set a minimum limit of \$1,000 and of \$10,000 for agreements where a second beneficiary's age is below 20. In the case of Gift Annuities, \$500 is now the minimum available.

These policy decisions were specifically influenced by comparing the cost of administering the programs to the income derived from the investment of the funds.

We mention this factor simply to highlight the direct influence your investment and management practices must have on the actual Gift programs offered.

During the past few minutes we have covered a number of areas related to the Investment and Management of Gift Properties and the funds generated by charitable gifts. We trust that at least a portion of these comments have touched on aspects which are of interest to you and your institutions.

MINUTES

Eighteenth Conference on Gift Annuities Denver Hilton Hotel, Denver, Colorado

Wednesday, May 4, 1983

First Plenary Session

The Conference was called to order at 9:05 a.m. by Chairman, Charles W. Baas. The place of meeting was the Grand Ballroom of the Denver Hilton Hotel.

Invocation was delivered by Dr. Chester A. Myrom, Former Director, Lutheran Church in America Foundation and former Secretary of the Committee on Gift Annuities.

Welcoming remarks were made by Dr. Baas. The full text is set forth in this booklet beginning on page 5.

Chairman Baas proposed the following persons to constitute the Resolutions Committee:

Chairman: MR. CHARLES W. SPICER, JR., CLU, Vice President, Development, OMS International, Inc.

MR. JOHN M. DESCHERE, Comptroller, Bard College

MR. PETER LAFFERTY, Director of Deferred Giving, University of Miami

DR. DAROLD H. MORGAN, President, Annuity Board, Southern Baptist Convention

MR. MICHAEL MUDRY, Actuary, Senior Vice President & Secretary, Hay/Huggins

MR. ED SAVAGE, Planned Giving Director, Sacred Heart League

MS. CLAIRE M. TEDESCO, Director, Lutheran Church in America Foundation

DR. CHARLES W. BAAS, Treasurer, American Bible Society
— Ex Officio

MOTION was made and seconded that the proposed committee be approved.

MOTION CARRIED

Dr. Lacy H. Hunt, Executive Vice President and Chief Economist of CM&M Group, Inc. was then introduced to discuss the topic "Economic and Financial Outlook." A compilation of tables had been distributed to participants in the hall. Dr. Hunt referred to the tables frequently. The text of his remarks and the tables are set forth in this booklet beginning at page 9.

Dr. Hunt analyzed positive and negative factors influencing economic recovery. On the positive side he mentioned money growth in non-inflationary terms, housing and inventory liquidation. Negative factors included the Federal financial budget imbalance and upward pressure on interest rates as indication that Federal spending is out of control, absorbing an ever increasing percentage of the Gross National Product. He forecast that the Consumer Price Index would return to level of 8 to 9% and unemployment would remain above 9%. A most appreciative audience applauded his talk enthusiastically.

A coffee break recess took place from 10:15 to 10:30 a.m.

When the conference reconvened, Mr. Michael Mudry, Actuary, Senior Vice President & Secretary, Hay/Huggins, was called upon to present the "Actuarial Basis for Immediate and Deferred Gift Annuity Rates." His paper and supporting schedules are set forth in this booklet beginning at page 31. A new rate schedule based on increased interest and new mortality assumptions was proposed. He described the need for both of these assumptions in a clear, detailed analysis. A brief period of questions followed his remarks.

Dr. Roland C. Matthies then presented a report on State Regulations. He listed four questions that have been raised in this connection:

- a. Is a gift annuity a security?
- b. Is a pooled income fund a trust?
- c. Are "Blue Sky" laws relevant?
- d. Is SEC oversight involved?

Dr. Matthies recommended that all questions pertaining to State Regulations be directed to the New York office of the Committee on Gift Annuities. A roster of Monitors for State Regulations was distributed to participants and is reproduced in this booklet along with the full text of Dr. Matthies' remarks, beginning at page 51.

The first plenary session was declared in recess at 11:50 to resume at 12:00 noon in the Junior Ballroom and Assembly Rooms for luncheon.

Luncheon Session

Grace was offered by The Reverend Robert M. Bartlett, Director of Annuities, United Church of Canada.

Dr. Robert B. Gronlund, President, Northwood Institute and Chairman of the Program Committee for this Conference served as Master of Ceremonies in honoring Dr. Charles W. Baas, Dr. Roland Matthies and Dr. Chester Myrom for their dedicated service to the Committee on Gift Annuities over many years. Each received a special plaque commemorating the occasion. In addition, Dr. Baas was presented with a gift certificate. Each of them received a standing ovation.

The Conference recessed from luncheon to designated locations to participate in Workshop Sessions.

Workshop Sessions

The following workshops convened at 1:30 p.m.

- 1) *Gift Annuity & Deferred Annuity - Basic*
MISS AGNES CLAIRE REITHEBUCH - Accounting Manager, The Society for the Propagation of the Faith
DR. CHESTER A. MYROM - Former Director, Lutheran Church in America Foundation
- 2) *Gift Annuity & Deferred Annuity - Advanced*
MR. WILLIAM E. JARVIS - Treasurer & Business Manager, American Baptist Foreign Mission Society
MR. JON HEINTZELMAN - Senior Estate Planning Officer, Northwestern University
- 3) *Pooled Income Fund - Basic*
MR. JAMES B. POTTER - Assistant Vice President, United Presbyterian Foundation

- 4) *Pooled Income Fund — Advanced*
MR. JAMES G. MARSHALL, JR. — Executive Director,
Methodist Hospital Foundation, Inc.
- 5) *Charitable Remainder Trusts — Basic*
MRS. KATHRYN E. BAERWALD — General Secretary,
The American Lutheran Church
THE REVEREND LEONARD CLOUGH — Director of
Bequests & Life Income Gifts Program, United Church of
Christ
- 6) *Charitable Remainder Trusts — Advanced*
DR. ALVA R. APPEL — Director, Trust Services, General
Conference of Seventh-day Adventists
MR. TERRY SIMMONS — Associate Counsel, Baptist
Foundation of Texas
- 7) *Administration & Reporting — Small Institutions*
DR. DAROLD H. MORGAN — President, Annuity
Board, Southern Baptist Convention
MISS JANE STUBER — Director, Deferred Gifts & Be-
quests, Smith College
- 8) *Administration & Reporting — Large Institutions*
MR. FRANK J. MAYO — Consultant for Planned Giv-
ing, The Salvation Army
COLONEL FLOYD K. HOOPER — National Treasurer,
The Salvation Army
- 9) *Investment & Management of Gift Properties — Small Institutions*
MR. MYLES WALBURN — Director, United Church
Board for World Ministries, United Church of Christ
RICHARD OSTERBERG, ESQ. — Partner-Weston,
Patrick, Willard & Redding
- 10) *Investment & Management of Gift Properties — Large Institutions*
MR. EARL F. SCHNEIDER — Controller, American
Bible Society
MR. THOMAS R. VOGLEY — Assistant Treasurer,
American Bible Society

The first workshops (Session "A") concluded about 3:00 p.m. for a coffee break of approximately fifteen minutes. The second workshops (Session "B") followed, lasting until about 5:00 p.m. At their conclusion, the Conference recessed for dinner.

Optional Evening Sessions

The following optional sessions convened in the evening:

Canadian Taxation

THE REVEREND ROBERT M. BARTLETT — Director of Annuities, The United Church of Canada

Designing an Income Stream Program to Meet Donor's Family Goals

MR. JOHN RYAN — Director of Planned Giving, University of Minnesota Foundation

Responding to Special Gift Situations

CLINTON SCHROEDER, ESQ. — Partner-Gray, Plant, Mooty, Mooty & Bennett

Thursday, May 5, 1983

The Conference was reconvened at 8:30 a.m. in the Grand Ballroom by Chairman Baas.

The Chairman of the Resolutions Committee, Mr. Charles W. Spicer, Jr.; submitted the following Resolutions:

- I. BE IT RESOLVED, that gift annuity rates based on the 1983 Table A — Female Mortality Assumptions with ages rated one year younger, interest assumption of 6½%; 50% residuum; expense loading of 5%; with tabular rates modified at younger ages and older ages extending to age 90 and above as 14%, be adopted by the Eighteenth Conference on Gift Annuities as the maximum uniform rates.
- II. BE IT RESOLVED, that interest rates used to calculate interest factors for Deferred Gift Annuities be increased by ½ of 1% as follows:
 - from 4% to 4½% first ten years of deferred period;
 - from 3½% to 4% next ten years;
 - from 3% to 3½% next ten years; and
 - from 2½% to 3% for remaining years of deferred period.

Mr. Spicer moved adoption of these Resolutions which were promptly seconded and ADOPTED unanimously.

The Conference recessed to previously designated locations to resume participation in Workshop Sessions "C" and "D".

Following these sessions at 12:15, luncheon was served in the Junior Ballroom and Assembly Rooms. Grace was offered by Father Donald LeMay, O.S.B., Director of Planned Giving, Saint John's University.

Second Plenary Session

The Conference reconvened at 1:30 p.m. in the Grand Ballroom. The Chairman of the Resolutions Committee, Mr. Spicer, presented the report of that committee. The full text of the Resolutions Committee Report is printed beginning at page 250. Mr. Spicer read the entire report and moved its adoption. It was seconded and ADOPTED unanimously. The final Resolution recognizing the contributions of Dr. Charles W. Baas, Dr. Roland C. Matthies and Dr. Chester A. Myrom was ADOPTED by acclamation with a standing ovation.

Dr. Baas then introduced the speaker for the final session of the Conference, Conrad Teitell, Esq., Partner, Prerau & Teitell and Editor of *Taxwise Giving*. His topic was "Federal Tax Legislation." Mr. Teitell reported on recent Regulations and Internal Revenue Service Rulings affecting Gift Annuities and Charitable Remainder Trusts. He described various tax reform proposals. He informed and entertained the audience with his unique style of presentation and received an enthusiastic ovation. At the conclusion of his remarks, he answered several questions from the audience.

The conference adjourned at 3:00 p.m. with benediction by Dr. Alva R. Appel, Director, Trust Services, General Conference of Seventh-day Adventists.

Respectfully submitted,
John M. Deschere, *Secretary*

REPORT OF THE RESOLUTIONS COMMITTEE

- I. BE IT RESOLVED, that gift annuity rates based on the 1983 Table A — Female Mortality Assumptions with ages rated one year younger, interest assumption of $6\frac{1}{2}\%$; 50% residuum; expense loading of 5%; with tabular rates modified at younger ages and older ages extending to age 90 and above as 14%, be adopted by the Eighteenth Conference on Gift Annuities as the maximum uniform rates.
- II. BE IT RESOLVED, that interest rates used to calculate interest factors for Deferred Gift Annuities be increased by $\frac{1}{2}$ of 1% as follows:
 - from 4% to $4\frac{1}{2}\%$ first ten years of deferred period;
 - from $3\frac{1}{2}\%$ to 4% next ten years;
 - from 3% to $3\frac{1}{2}\%$ next ten years; and
 - from $2\frac{1}{2}\%$ to 3% for remaining years of deferred period.
- III. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities note with special interest the information set forth in Chairman Baas' opening statement regarding the number of sponsors that have been developed for this Conference, now 1,174, and give recognition to the fact that this growth could not have come about without the active personal promotion and support of individuals attending this and prior conferences.
- IV. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express its sincere appreciation to Dr. Lacy Hunt, President of CM&M Asset Management Company and Executive Vice President and Chief Economist for CM&M Group, Inc., for his timely and authoritative address on the subject "Economic and Financial Outlook".

- V. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express appreciation to Mr. Michael Mudry, Actuary, Senior Vice President and Secretary of Hay/Huggins, for his study on the rate structure for both standard and Deferred Gift Annuities.
- VI. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express deep appreciation to those other persons who made plenary session presentations on matters of continuing concern, namely:
- Dr. Roland C. Matthies, Vice President and
Treasurer Emeritus, Wittenberg University
"Report on State Regulations"
- Conrad Teitell, Esq., Partner-Prerau & Teitell;
Editor, *Taxwise Giving*
"Federal Tax Legislation"
- VII. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express gratitude to the leaders of the various workshop sessions who graciously shared their knowledge and expertise during this Conference, namely the following:
- Miss Agnes Claire Reithebuch, Accounting Manager,
The Society for the Propagation of the Faith
- Dr. Chester A. Myrom, Former Director, Lutheran
Church in America Foundation
- Mr. William E. Jarvis, Treasurer and Business
Manager, American Baptist Foreign Mission
Society
- Mr. Jon Heintzelman, Senior Estate Planning Officer,
Northwestern University
- Mr. James B. Potter, Assistant Vice President,
United Presbyterian Foundation
- Mr. James G. Marshall, Jr., Executive Director,
Methodist Hospital Foundation, Inc.
- Mrs. Kathryn E. Baerwald, General Secretary, The
American Lutheran Church

The Reverend Leonard Clough, Director of Bequests & Life Income Gifts Program, United Church of Christ

Dr. Alva R. Appel, Director, Trust Services, General Conference of Seventh-day Adventists

Mr. Terry Simmons, Associate Counsel, Baptist Foundation of Texas

Dr. Darold H. Morgan President, Annuity Board, Southern Baptist Convention

Miss Jane Stuber, Director, Deferred Gifts and Bequests, Smith College

Mr. Frank J. Mayo, Consultant for Planned Giving, The Salvation Army

Colonel Floyd K. Hooper, National Treasurer, The Salvation Army

Mr. Myles Walburn, Director, United Church Board for World Ministries, United Church of Christ

Richard Osterberg, Esq., Partner-Weston, Patrick, Willard & Redding

Mr. Earl F. Schneider, Controller, American Bible Society

Mr. Thomas R. Vogeley, Assistant Treasurer, American Bible Society

VIII. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express special gratitude to those persons conducting optional sessions, namely:

The Reverend Robert M. Bartlett, Director of Annuities, The United Church of Canada

Mr. John Ryan, Director of Planned Giving, University of Minnesota Foundation

Clinton Schroeder, Esq., Partner-Gray, Plant, Mooty, Mooty & Bennett

IX. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities recommend to the various societies, agencies, boards, institutions, colleges, homes and hospitals, that for the purpose of uniformity and a better understanding of gift annuity agreements:

1. the agreement between the donor and the issuing agency be referred to as a "gift annuity agreement";
2. the periodic payment under gift annuity agreements be referred as "annuity payments"; and
3. in discussing, promoting or advertising gift annuity agreements, such terminology as "bonds," "interest," "investment," "principal" which apply to other forms of financial transactions be carefully avoided.

- X. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities recommend that organizations issuing gift annuity agreements maintain the funds related to their gift annuity program as "segregated funds" to make certain that all required annuity payments can be made.
- XI. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities recommend that religious, educational, health, and charitable groups which cooperate with the Committee on Gift Annuities be requested to send to the Chairman of the Committee copies of new rulings by Federal or State authorities dealing with gift annuities or life income agreements.
- XII. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities strongly urge and encourage all organizations issuing gift annuity agreements to adopt the Uniform Gift Annuity Rates as maximum rates.
- XIII. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities send greetings to Mr. Forrest Smith, Honorary Treasurer; and to Dr. J. Homer Magee and Dr. R. Alton Reed, Honorary Members, remembering their many contributions to the work of this Committee.

- XIV. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express its appreciation for the special helpfulness extended to this group in connection with the arrangements for it to Miss Mary Lou Ruegg, Administrative Assistant to the Treasurer of the American Bible Society, Miss Patricia A. Blankenship, Secretary to the Treasurer of the American Bible Society, Mrs. Charles W. Baas, and the staff and management of The Denver Hilton.
- XV. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express its warm thanks and hearty commendation to Mr. Tal Roberts and Dr. Robert B. Gronlund, respectively, for their leadership as convenors of the Arrangements Committee and Program Committee for this Conference.
- XVI. BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities express to Dr. Charles W. Baas, Chairman; Dr. Roland C. Matthies, Dr. Darold H. Morgan, Vice Chairmen; Mr. John Deschere, Secretary; Mr. William E. Jarvis, Treasurer, and to the other members of the Committee on Gift Annuities, its appreciation for this outstanding Conference and for their many services since the last Conference.

Charles W. Spicer, Jr., Chairman

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SPECIAL RESOLUTION

WHEREAS, DR. CHARLES W. BAAS has served as a member of the Committee on Gift Annuities, representing the American Bible Society, for 35 years, including distinguished service as Chairman for 25 years and

WHEREAS, DR. ROLAND C. MATTHIES has served as a member of the Committee, representing Wittenberg University, for 27 years, including distinguished service as Vice Chairman for 22 years, and

WHEREAS, DR. CHESTER A. MYROM has served as a member of the Committee, representing Lutheran Church in America Foundation for 25 years, including distinguished service as Secretary for 18 years,

BE IT RESOLVED, that the Eighteenth Conference on Gift Annuities in Denver, Colorado express its deep gratitude and sincere appreciation for the devotion and dedication to the Committee on Gift Annuities rendered consistently and continuously over many years by Dr. Baas, Dr. Matthies and Dr. Myrom.

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 Shriners Hospitals for Crippled
 Children
 Shults-Lewis Child and Family
 Services, Inc.
 Sierra Club Foundation
 Sierra View Homes, Inc.
 Simmons College
 Simpson College
 Sioux Falls College
 Sky Ranch Lutheran Camp
 Smith College
 Society for the Propagation of the Faith
 South Dakota Children's Aid
 South Dakota United Methodist
 Foundation
 South Miami Hospital
 Southeastern Baptist Theological
 Seminary
 Southeastern Bible College
 Southern Baptist College
 Southern Baptist Convention
 Annuity Board
 Foreign Mission Board
 Radio & Television Commission
 Southern Baptist Foundation
 Southern California College of
 Optometry
 Southern Methodist University
 Southwest Baptist College
 Southwest Estate Services, Inc.
 Southwest Texas State University
 Southwestern at Memphis
 Southwestern Baptist Bible College
 Southwestern College
 Spring Arbor College
 Spring Hill College
 Springfield College
 Stanford University
 Starr Commonwealth Schools

State University of New York
 Harry Steinberg
 Stephens College
 Sterling College
 John B. Stetson University
 Stewards Foundation
 Don Stewart Evangelistic Association
 Barton W. Stone Christian Home
 Cardinal Stritch College
 Sudan Interior Mission
 Summit Ministries
 Suncoast Family YMCA's Foundation,
 Inc.
 Sunnyside Presbyterian Home
 Suomi College
 Jimmy Swaggart Evangelistic
 Association
 Sweet Briar College
 Swiss Village, Inc.
 Sword of the Lord Foundation

 Tabitha Home
 Tabor College
 Taylor University
 Temple University
 Texas Christian University
 Texas Methodist Foundation
 Texas Presbyterian Foundation
 Texas Tech University Health Sciences
 Center
 Three Crosses Ranch, Inc.
 Thy Kingdom Come, Inc.
 Toccoa Falls College
 Tressler-Lutheran Service Associates,
 Inc.
 Trevecca Nazarene College
 Trinity College
 Trinity University
 Trumpet Associates, Inc.
 Trustees of Methodist Health and
 Welfare Services
 Tucson Medical Center
 Tulane University
 Twelveacres, Incorporated
 Twinwells Indian School

 UCLA Public Affairs - Fund
 Management
 US Committee for UNICEF
 Uevangelized Fields Mission
 Union Theological Seminary
 Unitarian Universalist Association

 United Church Board for Homeland
 Ministries
 United Church Board for World
 Ministries
 United Church Homes, Inc.
 United Church of Canada
 United Church of Christ
 Arizona Conference
 Commission on Development
 Connecticut Conference
 Illinois Conference
 Illinois South Conference
 Massachusetts Conference
 Ohio Conference
 Pension Boards
 United Church of Religious Science
 United Indian Missions, Inc.
 United Methodist Children's Home
 United Methodist Church
 Board of Discipleship
 Board of Higher Education &
 Ministries
 Central Pennsylvania Conference
 General Board of Global Ministries
 General Council on Finance
 Northern New York Conference
 Pacific & Southwest Annual
 Conference
 Preachers' Aid Society
 of the Central Illinois Conference
 Preachers' Aid Society Southern
 New England Conference
 South Indiana Ministers Pension
 Endowment Fund, Inc.
 United Methodist Church Foundation,
 Inc.
 United Methodist Foundation
 Detroit Annual Conference
 Endowment Fund, Inc.
 Iowa Annual Conference
 The Kansas Area
 United Methodist Foundation of
 Louisiana
 United Methodist Foundation
 Northern Illinois Conference
 Southern Illinois Conference
 Texas Annual Conference
 Western Pennsylvania Conference
 United Methodist Homes for the Aged
 United Methodist Homes for the Aging
 United Methodist Homes of New
 Jersey

United Presbyterian Foundation
 United Theological Seminary
 United Way of America
 United Way of Central Iowa
 United Way of Delaware
 United Way of Orange County
 Unity School of Christianity
 University Hospitals of Cleveland
 University of Alabama in Birmingham
 Medical & Educational Foundation
 University of California
 Berkeley Foundation
 University of Chicago
 University of Cincinnati Foundation
 University of Colorado Foundation,
 Inc.
 University of Delaware
 University of Denver
 University of Florida Foundation, Inc.
 University of Georgia
 University of Hartford
 University of Miami
 University of Minnesota Foundation
 University of North Carolina
 University of Oregon Development
 Fund
 University of Portland
 University of Puget Sound
 University of Redlands
 University of Richmond
 University of San Diego
 University of Santa Clara
 University of Scranton
 University of South Dakota Foundation
 University of Vermont
 University of Washington
 Up With People
 Uta Halee Girls Village

 Valparaiso University
 Jack Van Impe Ministries
 Vassar College
 Vennard College
 Virginia Polytechnic Institute &
 State University
 Visiting Nurse Service of New York
 Voice of China and Asia Missionary
 Society, Inc.
 Voice of Prophecy

 WEF Ministries

 Warner, Norcross & Judd
 Warner Pacific Endowment, Inc.
 Warner Press, Inc.
 Warner Southern College, Inc.
 Wartburg College
 Wartburg Seminary
 Washington Bible College
 Washington State University — YMCA
 Washington University
 Wayland Academy
 Wellesley College
 Wentworth Institute of Technology
 Wesley Gardens
 Wesley Medical Endowment
 Foundation
 Wesley Theological Seminary
 Wesleyan Church
 Wesleyan University
 West Nebraska General Hospital
 Foundation
 West Virginia Baptist Foundation, Inc.
 Westbrook College
 Western Wyoming College Foundation
 Western Illinois University
 Western Maryland College
 Western Pennsylvania Christian
 Broadcasting
 Westmar College
 Westminster Ministries
 Westmont College
 Wheaton College
 Wheaton, Illinois
 Wheaton College
 Norton, Massachusetts
 White Plains Hospital Medical Center
 Whitman College
 Whitworth Foundation
 Wichita State University
 Endowment Association
 Widener College
 Willamette University
 Willamette View Manor Foundation
 Emma Willard School
 Wills Eye Hospital
 Wilmington College
 Winebrenner Theological Seminary
 Wingate College
 Wings of Healing
 Winthrop College
 Wisconsin Evangelical Lutheran Synod
 Wisconsin United Methodist
 Foundation, Inc.

Wittenberg University
Philip G. Wojtalewicz
Woodward and Slater, Inc.
Words of Hope
World Evangelism, Inc.
World Gospel Mission
World Home Bible League
World Literature Crusade
World Mission Prayer League
World Missionary Press, Inc.
World Neighbors
World Radio
World Radio Missionary Fellowship,
Inc.
World Vision, Inc.
Worldteam, Inc.
Worldwide Evangelization Crusade
Wycliffe Bible Translators, Inc.

YMCA of Austin, Minnesota
YMCA of Greater St. Louis
YMCA of Metropolitan Minneapolis
YMCA of Olympia
YWCA of Minneapolis Area
YWCA National Board
Yale University
Yankton College
Yellowstone Boys & Girls Ranch
York College
York College of Pennsylvania
Young Life
Youth for Christ

CONSTITUTION of the COMMITTEE ON GIFT ANNUITIES

ARTICLE I

The Committee on Gift Annuities, hereinafter referred to as the Committee, shall continue the activities of the Committee on Annuities organized in 1927 as a Sub-Committee on Annuities of the Committee on Financial and Fiduciary Matters of the Federal Council of the Churches of Christ in America.

The Committee shall study and recommend the proper range of rates for charitable gift annuities and the accepted methods of yield computations for pooled income fund agreements.

The Committee may also study and recommend the form of contracts, the amount and type of reserve funds, and the terminology to be used in describing, advertising, and issuing charitable gift annuities, pooled income fund agreements, and such other deferred gift agreements as the Committee shall decide.

The Committee may ascertain and report as to legislation, taxability, and related matters regarding charitable gift annuities, pooled income fund agreements, and such other deferred gift agreements as determined by the Committee.

The Committee shall call a conference on charitable gift annuities at least once each four years and invite those who contribute to its activities to attend.

ARTICLE II

The membership of the Committee shall consist of not more than 25 persons. These members shall be chosen by a majority vote of the Committee from important religious, educational, charitable and other organizations or from groups of such organizations issuing and experienced in gift annuities and/or life income agreements. In electing members to the Committee, the Committee shall secure representation from the member groups,

but such member is not the agent of the organization or group from which he or she comes, nor is the organization or group bound by any decisions reached by the Committee.

As a general rule, only one representative shall be selected from each organization or group of related organizations unless for special reasons an additional member is selected by the Committee.

Membership on the Committee shall not continue beyond the time the member terminates service with the organization or group of organizations with which he or she was associated at the time of election to the Committee.

Persons who are not affiliated with organizations or groups of organizations above defined may be elected by the Committee present and voting by unanimous vote only.

ARTICLE III

In order to finance its activities and its research in actuarial, financial, and legal matters, and the publication and dissemination of information so obtained, the Committee will collect registration fees from those who attend its Conferences and fees from those who make use of its findings and services. It may set a periodic membership fee and may request gifts from those groups that cooperate with it to cover the expenses of its various activities, such amounts to be decided by the Committee. The Committee will also sell its printed material to pay for its out-of-pocket expenses.

ARTICLE IV

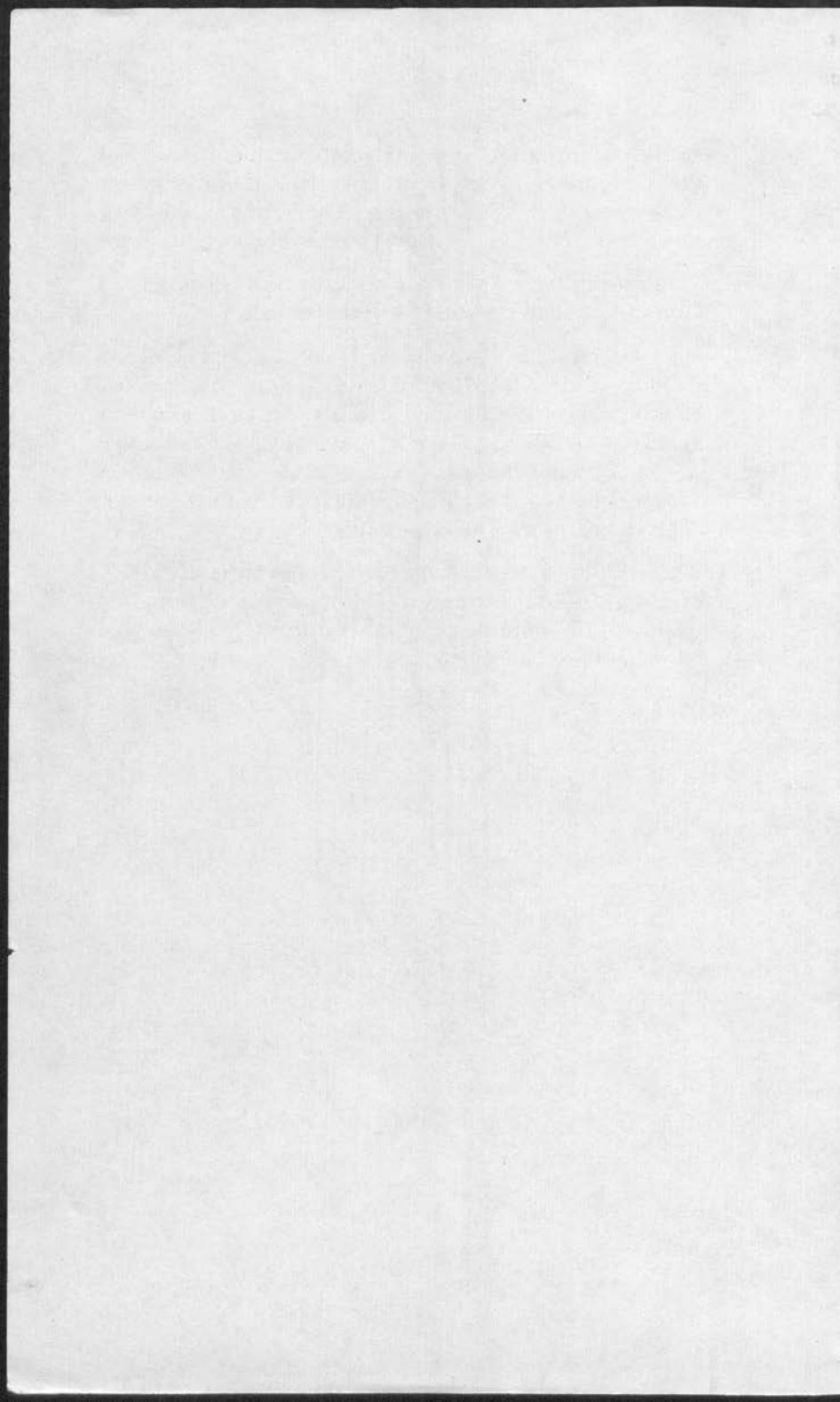
This Constitution may be changed, provided the proposed changes are presented at one meeting of the Committee and voted upon at the next meeting. Any proposed changes shall be provided to every member of the Committee, prior to the meeting at which it shall be voted upon, and approval by two-thirds of the members present and voting shall be necessary for final approval.

BY-LAWS COMMITTEE ON GIFT ANNUITIES

- I. The Officers shall be a Chairman, one or more Vice Chairmen, Treasurer, Secretary, Assistant Treasurer, and Assistant Secretary, who shall be elected at the Committee meeting next following the Charitable Gift Annuity Conference and shall serve until the first meeting after the next such Conference or until their successors have been elected and installed. Officers may be elected to one or more successive terms and a majority vote of Members present will elect.
- II. Vacancies in the offices of the Committee shall be filled by the Committee at any meeting. A vote of a majority of those present will elect.
- III. The Chairman, Vice Chairmen, Treasurer, Secretary, Assistant Treasurer, and Assistant Secretary of the Committee shall fulfill the usual duties of those offices during their term of office. The Treasurer shall keep the accounts, and the Secretary shall keep the Minutes of the meetings of the Committee and each shall perform such other duties as may be assigned them by the Chairman or the Committee.
- IV. The Chairman, or in his absence a Vice Chairman, shall call the meetings of the Committee at such time and place as seems desirable either to the Committee if it is in session or to the Chairman if the Committee is not in session. At least two weeks' notice of the forthcoming meeting should ordinarily be given.
- V. Conferences on Gift Annuities shall be called periodically as required by the Constitution of the Committee on Gift Annuities. A majority vote of Committee Members shall be required to call a Conference.
- VI. A membership nominating committee shall be appointed by the Chairman. It may submit nominations for

consideration at any meeting when the membership of the Committee consists of less than the maximum established in the Constitution. A vote of a majority of those present will elect as provided in the Constitution.

- VII. A quorum necessary for the conduct of business of the Committee shall consist of seven Members.
- VIII. The Committee shall carry Directors and Officers liability insurance to protect its Members from any claims that might be filed against the Committee or against a Member in his or her capacity as a Committee Member, and it shall provide indemnity to its Members for any costs or other liability incurred with respect to such claims to the extent permitted by law.
- IX. These By-laws may be amended at any regularly called meeting of the Committee, provided the proposed changes are approved by a two-thirds vote of the Members present and voting.



COMMITTEE ON GIFT ANNUITIES

Chairman

CHARLES W. BAAS
Treasurer, American Bible Society

Vice Chairmen

ROLAND C. MATTHIES
Vice President & Treasurer Emeritus
Wittenberg University
DAROLD H. MORGAN
President, Annuity Board
Southern Baptist Convention

Secretary

JOHN M. DESCHERE
Comptroller, Bard College

Treasurer

WILLIAM E. JARVIS
Treasurer & Business Manager
American Baptist Foreign
Mission Society

Actuary

Hay/Huggins

Other Members

ALVA R. APPEL
Director, Trust Services
General Conference of
Seventh-day Adventists
ROBERT M. BARTLETT
Director of Annuities
The United Church of Canada
CHARLES L. BURRALL, JR.
Consultant
Hay/Huggins
K. JOAN COLE
Assistant General Secretary
General Council on Finance
& Administration
The United Methodist Church
ROBERT B. GRONLUND
President
Northwood Institute of Florida
FLOYD K. HOOPER
National Treasurer &
Business Administrator
The Salvation Army
RICHARD A. JAMES
Legal Counsel
Loma Linda University
DAVID E. JOHNSON
Senior Vice President
Saint Olaf College

JAMES G. MARSHALL, JR.
Executive Director
Methodist Hospital Foundation, Inc.

JOHN METZLER, JR.
Treasurer, General Board
Church of the Brethren

MICHAEL MUDRY
Senior Vice President & Secretary
Hay/Huggins

JOHN D. ORDWAY
Executive Vice President
The Pension Boards
United Church of Christ

JAMES B. POTTER
Assistant Vice President
United Presbyterian Foundation
AGNES CLAIRE REITHEBUCH
Accounting Manager
The Society for the Propagation
of the Faith

TAL ROBERTS
Executive Vice President
Baptist Foundation of Texas

CLINTON A. SCHROEDER
Partner—Gray, Plant, Mooty,
Mooty & Bennett

JANE STUBER
Director, Deferred Gifts & Bequests
Smith College

CLAIRE M. TEDESCO
Director, Lutheran Church
in America Foundation

EUGENE L. WILSON
Controller
American Leprosy Missions, Inc.

Honorary Treasurer

FORREST SMITH
American Baptist Foreign
Mission Society

Honorary Members

J. HOMER MAGEE
The United Methodist Church
CHESTER A. MYROM
Lutheran Church in
America Foundation
R. ALTON REED
Southern Baptist Convention