

# NOTES

## GIFT ANNUITIES AND LIFE INCOME CONTRACTS ISSUED BY CHARITABLE ORGANIZATIONS UNDER THE FEDERAL INCOME TAX LAWS

The use of annuity agreements by charitable organizations to raise funds is not of recent origin. History reveals that churches used a form of life annuities to raise capital as early as the eighth century.<sup>1</sup> Throughout the medieval period annuities had an important role in both church and government financing,<sup>2</sup> and in 1554, Holland raised half the expenses of a war with France by the sale of life annuities.<sup>3</sup> In the United States, however, while one charitable organization has been issuing life annuity agreements since 1867,<sup>4</sup> it has been only in the past thirty years that charitable organizations have generally employed this device.<sup>5</sup> Possibly the reason for this recent impetus is the recognition that the "era of large gifts" for charitable purposes is over, and that an appeal must be made to the average citizen who desires to support charity but cannot afford to relinquish the income from his capital during his lifetime.<sup>6</sup>

There are two basic types of charitable gift agreements which preserve or increase the income of the donor—the "gift annuity" and the "life income contract." The purpose of this note is to review the federal income tax effects of these agreements on both the donor and the charitable organization, to examine the problem of state regulation, and to consider the right of charitable organizations to enter into such agreements.<sup>7</sup>

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1. MURPHY, *SALE OF ANNUITIES BY GOVERNMENTS* 2 (1939).

2. *Ibid.* See also CROBAUGH, *ANNUITIES AND THEIR USES* 12 (1933); AMERICAN COUNCIL ON EDUCATION STUDIES, *FUNDS SUBJECT TO ANNUITY AGREEMENTS* 1 (1939).

3. MURPHY, *op. cit. supra* note 1, at 3.

4. The American Bible Society was the pioneer in issuing gift annuities. Anthony, *Annuity Agreements Among Colleges*, 16 ASS'N OF AM. COLL. BULL. 473, 474 (1930). Pomona College in California, the Salvation Army, and the Methodist, Baptist, and Presbyterian Churches have been particularly active in the solicitation of gift annuities. See Moorhead, *Annuity and Life Income Plans Offered by Charitable Organizations*, 10 J. AM. SOC'Y C. L. U. 157, 158 (1956).

5. Anthony, *supra* note 4, at 473.

6. Weld, *Donors' Annuities and College Security*, 30 ASS'N OF AM. COLL. BULL. 539 (1944).

7. This note covers only those charitable organizations exempt under INT. REV. CODE OF 1954, § 501(c), contributions to which are deductible by the donor under INT. REV. CODE OF 1954, § 170(c).

## I. THE GIFT ANNUITY

*(a) Nature of the Agreement*

The "gift annuity," or as it is sometimes referred to, "annuity bond," is the older, more widely used type of agreement. It is a contract whereby the charitable organization, in consideration of receiving a principal sum, binds itself to pay a specific amount of money annually to the donor during his lifetime.<sup>8</sup> The charitable organization is under no contractual obligation to isolate the sum received for a gift annuity or to retain it until the donor-annuitant's death.<sup>9</sup>

An ordinary commercial life annuity repays to the annuitant a portion of the principal in every payment, so that theoretically at the end of the annuitant's life expectancy the entire principal will have been returned.<sup>10</sup> However, in the usual charitable gift annuity, it is intended that the charitable organization retain a substantial portion of the principal.<sup>11</sup> Hence, for the same principal sum, annuity payments made by charitable organizations are ordinarily smaller than those paid by commercial annuity companies.<sup>12</sup> Studies indicate that most charitable organizations attempt to retain a "residuum" of seventy to eighty per cent of the original principal at the annuitant's death.<sup>13</sup>

*(b) Tax Effects on the Donor-Annuitant*

Since a portion of the principal sum transferred to a charitable organization subject to an annuity agreement will inure to the benefit of the organization, the donor has made a charitable contribution<sup>14</sup>

8. The annuity agreement may cover two or more lives with payment ceasing at the death of the last survivor—a "joint-life-and-survivor annuity." See LASER, *HOW TAX LAWS MAKE GIVING TO CHARITY EASY* 38 (1948); AMERICAN COUNCIL ON EDUCATION STUDIES, *op. cit. supra* note 2, at 3-5.

9. However, there may be certain restrictions under state insurance laws. See notes 79-85 *infra*, and text supported thereby.

10. CROBAUGH, *op. cit. supra* note 2, at 51.

11. AMERICAN COUNCIL ON EDUCATION STUDIES, *op. cit. supra* note 2, at 3, 12; Anthony, *supra* note 4, at 473.

12. The following table compares the return of one charitable life annuity (Pomona College, Claremont, Calif., see POMONA COLLEGE, ANNUITY AND LIFE INCOME PLANS—1957, at 4), with a commercial non-refund life annuity (Union Central Life Ins. Co., 721 Olive, St. Louis, Mo.):

Age of Annuitant	Charitable Annuity	Commercial Annuity
	Male or Female (per cent)	Male (per cent)
40	3.50	4.02
45	3.70	4.45
50	3.90	5.00
55	4.20	5.70
60	4.50	6.61
65	5.00	7.83
70	5.50	9.49
75	6.30	11.78

13. See note 11 *supra*.

14. See Anna L. Raymond, 40 B.T.A. 244 (1939), *aff'd*, 114 F.2d 140 (7th Cir. 1940).

and is entitled to a deduction in the year that the sum is transferred,<sup>15</sup> subject to the statutory limitations on charitable deductions.<sup>16</sup> The amount of the deduction is the difference between the sum transferred to the charitable organization and the present value of the annuitant's right to receive payments, such value computed with the factors used by reputable commercial insurance companies.<sup>17</sup>

For example, assume a donor-annuitant—male and age fifty—pays \$1,000.00 to a charitable organization, and receives a four per cent life annuity:<sup>18</sup>

Amount paid to the charitable organization .....	\$1,000.00
Present value of the annuity .....	800.64
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Charitable deduction .....	<u>\$ 199.36</u>

The charitable deduction decreases the donor's income tax and thereby decreases the actual cost of the gift annuity.<sup>19</sup> Therefore, the effective yield on the annuity, *i.e.*, the after-tax-cost return, is raised.<sup>20</sup> Assuming the donor in the above example was in the 50 per cent tax bracket, the \$199.36 deduction decreases his income tax by \$99.78, making the actual cost of the gift annuity \$900.32, rather than \$1,000.00. The after-tax-cost return is \$40.00 on \$900.32, or 4.44 per cent,—not \$40.00 on \$1,000.00, or 4 per cent.

The payments received by a donor-annuitant under a gift annuity contract are taxed as an annuity payment, and therefore are only partially includible in taxable income.<sup>21</sup> Taxable income includes only the amount received in excess of the annual exclusion, *i.e.*, the cost of the contract (the present value of the annuity) divided by the number of years of life expectancy.<sup>22</sup> In the above illustration the present value of the annuity contract was \$800.64; life expectancy for a male, age fifty, is twenty-two years; the annual exclusion is \$36.39 ( $800.64 \div 22$ ). Therefore, of the \$40.00 annual payment, only \$3.61 is taxable to the recipient. This annual exclusion is available throughout the annuitant's life, even though he outlives his life expectancy.<sup>23</sup>

Special caution should be used when one transfers property other than money for a gift annuity. Ordinarily a donor can transfer low-cost property, which has appreciated in value in his hands, to a

15. 4 P-H 1956 FED. TAX SERV. ¶ 76,312 (letter ruling dated Sept. 9, 1955).

16. INT. REV. CODE OF 1954, § 170.

17. See note 15 *supra*. And if the present value of the annuity exceeds the amount transferred to the charitable organization, no deduction is allowed. Rev. Rul. 388, 1955-1 CUM. BULL. 233.

18. See note 15 *supra*.

19. See, *e.g.*, Piper, *How the Charitable Foundation Fits into the Investment Picture*, in N.Y.U. 12TH INST. ON FED. TAX. 1209, 1219 (1954).

20. *Ibid.*

21. See note 15 *supra*; 1 MERTENS, FEDERAL INCOME TAXATION § 6A.05 (1956).

22. INT. REV. CODE OF 1954, § 72(b).

23. 1 P-H 1956 FED. TAX. SERV. ¶ 8149(b).

charitable organization and receive a deduction for the fair market value of the property at the time of transfer—no taxable gain is realized by the donor.<sup>24</sup> However, when property is transferred to a charitable organization for a gift annuity, the donor-annuitant has purchased a right to receive payments which has a definite value. Therefore, if the property transferred has a lower adjusted tax basis in the donor's hands than the cost of the annuity contract (the present value of the annuity), the transaction is construed to be a taxable exchange combined with a gift, resulting in a taxable gain to the donor.<sup>25</sup> The amount of the gain is the excess of the present value of the annuity over the donor's basis in the property.<sup>26</sup> If the property is a capital asset held by the donor more than six months, the gain is a long-term capital gain.<sup>27</sup>

## II. THE LIFE INCOME CONTRACT

### (a) *Nature of the Agreement*

The "life income contract," or as it is frequently termed, a "living trust," is becoming an increasingly popular device employed by charitable organizations to solicit donations. Under this plan<sup>28</sup> a charitable organization accepts a principal sum and agrees to invest it with the organization's general endowment funds. The charitable organization then pays the donor, or his designee, an income for life, determined by the average yield on the organization's general endowment funds in the previous year.<sup>29</sup>

The life income contract differs from the gift annuity agreement in two basic respects. First, the return under a life income contract varies from year to year and bears no relation to the donor's age. The return on a gift annuity, however, is a fixed annual sum determined by the age of the annuitant at the date the annuity is purchased.<sup>30</sup> Second, under a life income contract, the charitable organi-

24. Rev. Rul. 410, 1955-1 CUM. BULL. 297. For the special rule applicable to a gift of agricultural or manufactured products, or property held for sale in the ordinary course of business, see Rev. Rul. 138, 1955-1 CUM. BULL. 223.

25. See note 15 *supra*.

26. *Ibid.*

27. *Ibid.*

28. AMERICAN COUNCIL ON EDUCATION STUDIES, *op. cit. supra* note 2, at 4; Piper, *supra* note 19, at 1218. This type of agreement is offered by Washington University, St. Louis, Mo. See *Gifts Subject to the Payment of a Life Income to the Donor*, Jan. 5, 1956 (unpublished memorandum, available on request from Treasurer, Washington University, St. Louis 5, Mo.).

29. An agreement very similar to the life income contract is the "retained life estate," where the charitable organization agrees to pay a life income to the donor determined by the earnings of the specific funds or property donated. This, in effect, is an irrevocable trust, the income reserved to the donor for life, with the remainder over at the donor's death to the charitable organization. The tax consequences of the retained life estate are similar to those of the life income contract. See Rev. Rul. 620, 1955-2 CUM. BULL. 56; Piper, *supra* note 19, at 1218-19.

30. See Rev. Rul. 275, 1955-1 CUM. BULL. 295; AMERICAN COUNCIL ON EDUCATION STUDIES, *op. cit. supra* note 2, at 4.

zation receives the entire principal on the donor's death, whereas under a gift annuity, a portion of the principal will generally have been repaid to the donor-annuitant.<sup>31</sup>

Generally, the rate of return on life income plans exceeds that paid on gift annuities, except in the case of a gift annuity where the donor-annuitant has a limited life expectancy because of advanced age.<sup>32</sup>

(b) *Tax Effects on the Donor*

The donor, under a life income contract, is entitled to a charitable deduction for the value of what the charitable organization actually receives in the year of purchase. Since the charitable organization receives the entire principal at some future date, the amount of the deduction is the present value of the remainder interest passing to the charitable organization.<sup>33</sup>

For example, assume a donor—male and age fifty—makes a gift of \$1,000.00 to a charitable organization, under a life income contract. At age fifty, the present value of \$1,000.00 is \$480.30,<sup>34</sup> which would be the donor's charitable deduction. The higher effective return, based on the after-tax-cost of the gift, pointed out in connection with a gift annuity, also applies to amounts donated under life income contracts.<sup>35</sup>

There are two important tax characteristics of the life income contract when compared with a gift annuity. First, the payments received under a life income contract represent income from a principal sum, and therefore are fully includible in the recipient's gross income—the annual exclusion applicable to annuity payments is not available to the recipient.<sup>36</sup> Second, when appreciated property is transferred to the charitable organization under a life income contract, the appreciation in the value of the property will not constitute a taxable gain to the donor.<sup>37</sup> The donor under a life income contract is not considered to have purchased a right of definite value, as in the case of a gift annuity where there is a guarantee of future payments.

31. *Ibid.*

32. See Piper, *supra* note 19, at 1219. The following schedule indicates the return paid by Washington University to donors under life income contracts during the past ten years (See *Gifts Subject to the Payment of a Life Income to the Donor*, *supra* note 28, at 1).

1946	3.90%	1951	6.67%
1947	3.93	1952	6.27
1948	4.37	1953	6.39
1949	4.78	1954	6.04
1950	5.36	1955	6.33

33. See Rev. Rul. 275, 1955-1 CUM. BULL. 295; Rev. Rul. 620, 1955-2 CUM. BULL. 56; I.T. 3707, 1945-2 CUM. BULL. 114; I.T. 1776, 2 CUM. BULL. 151 (1923); 5 MERTENS, FEDERAL INCOME TAXATION 526 (1953). *But see* problems raised in note 44 *infra* and text supported thereby.

34. For a table of present values, see 4-A P-H FED. TAX. SERV. ¶ 131006.4 (1957).

35. See text supported by notes 19-20 *supra*.

36. Rev. Rul. 275, 1955-1 CUM. BULL. 295.

37. *Ibid.*

(c) *Problem Raised by the 1954 Code on Life Income Contracts*

The "life income contract," or "living trust," has been treated in the rulings dealing with such agreements as an irrevocable trust.<sup>38</sup> This trust relationship is said to raise a question under the 1954 Code.<sup>39</sup> The Code permits an additional ten per cent charitable deduction for an individual, provided the contributions are made to churches, educational organizations, or hospitals.<sup>40</sup> The Code provides, however, that the additional deduction is available only for contributions made directly to the charitable organization;<sup>41</sup> gifts in trust for the use of the charitable organization do not qualify. The question posed is whether the life income contract as an irrevocable trust will qualify for the extra deduction.

The contribution under a life income contract is, however, not held in trust for the charitable organization, but is a present irrevocable gift.<sup>42</sup> The charitable organization promises to pay future variable sums, which are simply unsecured debts of the organization. Thus a strict trust relationship does not exist. Further, even if the courts should construe life income contracts to be trusts, the Senate Finance Committee Report indicates that the purpose of the statutory provision was to exclude payments to a trust only where the charitable organization is beneficiary.<sup>43</sup> It would seem that the life income contract should qualify for the extra ten per cent deduction.<sup>44</sup>

### III. FACTORS TO CONSIDER IN PURCHASING LIFE INCOME CONTRACTS AND GIFT ANNUITIES

It is apparent that from the donor's standpoint, the guiding consideration determining which type of agreement to select, depends

38. See note 33 *supra*.

39. See McClure, *Living Trusts for Charity*, 44 ILL. B.J. 140 (1955).

40. INT. REV. CODE OF 1954, § 170(b) (1) (A), (B).

41. *Ibid.*

42. McClure, *supra* note 39, at 145.

43. *Ibid.*

44. Mr. McClure, in his article (see note 39 *supra*), raises two other problems concerning "living trusts" under the 1954 Code.

First, INT. REV. CODE OF 1954, §§ 671, 677, treats the grantor as "owner" of that portion of a trust from which he receives income. The problem presented is, if the donor-grantor has transferred appreciated low-cost stock, will he realize a capital gain should the charitable organization sell the stock? After a detailed analysis of the congressional reports, Mr. McClure concludes, "such a consequence was never intended by the draftsman of this legislation," and "to try to apportion the life tenant's share of tax on such gains would be abortive."

Second, INT. REV. CODE OF 1954, § 170(b) (1) (D), denies a charitable deduction if "the grantor has a reversionary interest in the corpus or income of that portion of the trust with respect to which a deduction would . . . be allowable. . . ." The problem is whether this section would preclude a deduction for a "living trust." However, Mr. McClure points out that,

to apply the limitation against a reversionary interest to the present right to receive income appears to be a complete distortion of the language of the statute. The donor . . . never gave up the right to receive the income—so how could it be a reversion?

largely on the donor's individual tax status. There are several factors to consider:

First, the return from a life income plan will generally exceed that from a gift annuity.<sup>45</sup>

Second, the charitable deduction is generally higher on a life income plan.<sup>46</sup>

Third, the donor who wishes to avail himself of the additional tax feature obtained by transferring appreciated property to a charitable organization and receiving a charitable deduction based on the fair market value of the property, must use a life income contract or be subject to a capital gains tax.<sup>47</sup>

Fourth, the donor who is already in a high tax bracket may desire the partial taxability feature applicable to payments received from a gift annuity.<sup>48</sup>

Fifth, the cautious donor, who desires certainty of payment and a hedge against deflation, should employ the gift annuity.

A final factor, of course, is which type of agreement is acceptable to the charitable organization that the donor desires to benefit.

#### IV. TAX EFFECTS OF GIFT ANNUITIES AND LIFE INCOME CONTRACTS ON THE CHARITABLE ORGANIZATION

One of the most zealously guarded privileges of charitable organizations is their "tax-exempt status." To enjoy such a status the law for many years has imposed two requirements:<sup>49</sup>

First, the charitable organization must be organized and operated exclusively for charitable purposes.

Second, the organization's net earnings must not "inure to the benefit of any private shareholder or individual."

Congress, in the 1950 Revenue Act, added more definiteness to these requirements.<sup>50</sup> The Act provided that tax-exemption would be denied for those years in which a charitable organization "makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from" or "engages in any other transaction which results in a substantial diversion of its income or corpus to," the creator of, or a substantial contributor to, the organization. Such acts by a charitable organization are termed "prohibited transactions."<sup>51</sup>

45. See notes 12, 32 *supra* and text supported thereby.

46. See text supported by note 31 *supra*.

47. See text supported by notes 25, 37 *supra*.

48. See text supported by 21, 22 *supra*.

49. INT. REV. CODE OF 1954, § 501(c) (3).

50. Int. Rev. Code of 1939, § 3813(b), added by 64 STAT. 957 (1950) (now INT. REV. CODE OF 1954, § 503(c) (4), (6)).

51. These "prohibited transactions" apply to all charitable organizations exempt under § 501(c) (3) except certain "public" organizations, such as religious and educational organizations maintaining a regularly enrolled student body

The term "exclusively" in the first statutory requirement has been construed as *primarily* rather than *solely*.<sup>52</sup> A somewhat similar interpretation has been given to the second requirement;<sup>53</sup> the payment of private annuities by a charitable organization has been held not to affect its tax-exempt status where the annuity payments were *incidental* to the primary charitable activities.<sup>54</sup> Annuity payments have been justified as a condition upon a gift,<sup>55</sup> the consideration for a sale,<sup>56</sup> a charge upon specific assets,<sup>57</sup> and simply as a justified means of furthering charitable purposes.<sup>58</sup> As one recent circuit court decision stated:<sup>59</sup>

It is well established that when property is transferred to a charitable trust with a proviso that all or part of the income therefrom be paid to a private individual for a stated term, such payments are a charge upon the specific assets transferred, and the donee retains its tax exempt status . . . .

When the charitable organization has been found to operate for private benefit, the courts have held that the statutory requirements were violated and tax-exemption has been denied. For example, where the "annuities" were such that the charitable organization was simply acting as a "conduit" for the receipt and transmission of income to the donor,<sup>60</sup> or where only one-half of the income of the organization

(INT. REV. CODE OF 1954, § 503 (b)). Apparently Congress thought these organizations are not readily susceptible to being used for private benefit. However, it would certainly be dangerous for any charitable organization to engage in a prohibited transaction. See Brown, *The New Restrictions on Charitable Exemptions and Deductions for Federal Tax Purposes*, 13 U. PITT. L. REV. 623, 640 (1952).

52. Latham, *Private Charitable Foundations: Some Tax and Policy Implications*, 98 U. PA. L. REV. 617, 639-43 (1950); Jenks, *The Use and Misuse of Section 101(G)*, in N.Y.U. 7TH. INST. ON FED. TAX. 1051 (1949); 34 VA. L. REV. 225 (1948).

53. *Ibid.*

54. Emerit E. Baker, Inc., 40 B.T.A. 555 (1939) (private charitable foundation paid life annuity to wife of founder and educational expenses of her nieces and nephews). In addition to the *Baker* decision, the courts have held the payment of private annuities did not affect tax-exempt status in: *Lederer v. Stockton*, 260 U.S. 3 (1922) (hospital was a residuary beneficiary of a testamentary trust which was subject to payment of certain annuities); *Powell Foundation v. Comm'r*, 222 F.2d 68 (7th Cir. 1955), *reversing*, 21 T.C. 279 (1953) (founder of charitable foundation transferred bonds subject to the income therefrom being paid to his wife); *Comm'r v. Orton*, 9 T.C. 533, *aff'd*, 173 F.2d 483 (6th Cir. 1949) (widow of founder of charitable foundation renounced her statutory share in husband's estate which would have destroyed the foundation, and agreed to accept a life annuity).

55. See Eaton, *Charitable Foundations, Tax Avoidance and Business Expediency*, 35 VA. L. REV. 809, 861 (1949).

56. *Ibid.*

57. *Powell Foundation v. Comm'r*, 222 F.2d 68 (7th Cir. 1955).

58. See Emerit E. Baker, Inc., 40 B.T.A. 555 (1939).

59. *Powell Foundation v. Comm'r*, 222 F.2d 68, 73-74 (7th Cir. 1955).

60. *Scholarship Endowment Foundation v. Nicholas*, 25 F. Supp. 511 (D.C. Colo. 1938), *aff'd*, 106 F.2d 552 (10th Cir. 1939) (founder retained net income from charitable corporation).

was left to accomplish charitable purposes,<sup>61</sup> or where the amount paid to the donor was clearly excessive,<sup>62</sup> tax-exemption has been denied.

The decisions reveal that the courts have attempted to construe the statutory requirements in a "reasonable manner"<sup>63</sup> and the fundamental factor always is whether the court is satisfied that a bona fide charitable organization actually exists.<sup>64</sup>

There are certain factors inherent in granting annuity agreements which may endanger a charitable organization's tax-exempt status.<sup>65</sup> An annuity contract has been described as a "wager against death."<sup>66</sup> That is, when a charitable organization binds itself to pay an annuitant a fixed annual sum during his life, it is taking the risk that the annuitant might live long enough to exhaust the principal and income which the charitable organization received.<sup>67</sup> If the principal were exhausted, the payments would have to be met by diverting other charitable assets and income.<sup>68</sup> It is entirely probable that under such circumstances the Commissioner would argue that the organization's income was inuring to the benefit of a private individual, thereby violating the basic tax-exemption requirements.<sup>69</sup>

61. *The Davenport Foundation*, P-H 1947 T.C. Mem. Dec. ¶ 47341, *aff'd*, 170 F.2d 70 (9th Cir. 1948).

62. *Mabee Petroleum Corp. v. United States*, 203 F.2d 872 (5th Cir. 1953) (founder retained \$100,000 annual salary).

63. See *Powell Foundation v. Comm'r*, 222 F.2d 68 (7th Cir. 1955).

64. See Note, 25 CORNELL L.Q. 634, 636 (1940).

65. See Blackwell, *Annuity Funds May Endanger Tax Exemption*, Coll. & Univ. Bus., March 1954, p. 46-47.

66. See Tyler & Ohl, *The Revenue Act of 1934*, 83 U. PA. L. REV. 607, 632 (1935).

67. See notes 65, 66 *supra*; Blackwell, *Annuity Funds and Living Trusts*, Col. & Univ. Bus., Aug. 1951, p. 47; Welck, *The Acceptance of Funds Subject to Annuity*, 24 ASS'N OF AM. COLL. BULL. 370 (1938).

68. It is possible for charitable organizations to "reinsure" their annuity contracts, *i.e.*, use a portion of the sum turned over to the organization to purchase an annuity from a commercial insurance company. Thus, the insurance company would bear the risk of the annuity payments and the charitable organization would have the balance available for its immediate use. One disadvantage of reinsurance is that the insurance company takes a large portion of the gift if the annuitant is between fifty and seventy years of age. Reinsurance has been subject to criticism because the charitable organization, in effect, becomes an agent of commercial insurance companies, and further, donor-annuitants might not appreciate an insurance company obtaining part of the funds. However, it is clearly desirable when a charitable organization has large annuity contracts without the prerequisite safety in numbers. See FEDERAL COUNCIL OF THE CHURCHES OF CHRIST IN AMERICA, *METHODS AND PLANS IN USING ANNUITY AGREEMENTS* (3rd Conf. on Annuities 1930) 16-34 (1931); Anthony, *supra* note 4; Weld, *supra* note 6.

69. For example, in *William L. Powell Foundation*, 21 T.C. 279 (1953), evidence showed that the annuitant received more than the income earned by the charitable foundation's assets charged with the annuity. The tax court upheld the Commissioner in denying tax-exemption and stated: "By paying her a higher rate of interest than it actually earned on its mortgage investments [those assets charged with the annuity], a part of the income of its general assets inured to her benefit." *Id.* at 285. Mr. T. E. Blackwell, commenting on this decision, stated:

The import of the decision is clear. If the tax-exempt institution segregates the assets charged with the payment of a life income to the annuitants

The hazards of charitable organizations entering the life annuity business are entirely real, not theoretical. A number of charitable institutions have found that "gift annuities can be millstones rather than life-preservers."<sup>70</sup> There are several factors contributing to the danger that charitable organizations who grant annuities may find it necessary to divert other charitable assets to meet annuity obligations.

Charitable organizations spread their risk over too small a number of lives, with an uneven distribution on the lives covered, so that a major portion of the risk may rest on a small minority of the individuals insured.<sup>71</sup> Thus, a charitable organization does not receive the benefit of the "law of large numbers," which is necessary for successful insurance business—based on the use of mortality tables.<sup>72</sup> Many charitable organizations have prepared crude schedules of annuity rates which do not adequately reflect interest, mortality factors, and the overhead expense involved in soliciting, writing, and administering their annuity contracts.<sup>73</sup> Further, there is a tendency on the part of charitable organizations to merge annuity funds with other general funds, with a corresponding neglect in accounting practices and adequate maintenance of reserves.<sup>74</sup> And, rather than accepting cash or easily saleable securities for annuity agreements, some charities have accepted real property, which is particularly susceptible to value fluctuation.<sup>75</sup>

It is evident that if charitable organizations desire to enter annuity

and pays them not more than the actual net income earned by such segregated assets, it does not hazard its tax-exempt status by the acceptance of such gifts or contracts.

However many colleges have accepted gifts subject to the payment of a fixed life income to the donor, not merely the net income earned by his gift. If the donor should live long enough for these fixed periodic payments to exhaust both the corpus of his gift as well as the income therefrom, it is possible that the Commissioner of Internal Revenue might seek to apply the rule enunciated in the current case. This could mean that the college would lose its tax exempt status during the years payments to an annuitant were made from resources of the college other than that of his own gift.

Blackwell, *Annuity Funds May Endanger Tax Exemption*, Coll. & Univ. Bus., March 1954, p. 47.

On appeal, the seventh circuit held the record did not support the tax court's findings, and reversed the decision. *Powell Foundation v. Comm'r*, 222 F.2d 68 (7th Cir. 1955). However, the Commissioner's position is still significant.

70. Weld, *supra* note 6.

71. FEDERAL COUNCIL OF THE CHURCHES OF CHRIST IN AMERICA, *op. cit. supra* note 68, at 16.

72. See Blackwell, *Annuity Funds May Endanger Tax Exemption*, Coll. & Univ. Bus., March 1954, p. 46.

73. See note 71 *supra*.

74. *Ibid.*; see also U.S. OFFICE OF EDUCATION, DEP'T OF HEALTH, EDUCATION & WELFARE, BIENNIAL SURVEY OF EDUCATION IN THE UNITED STATES, 1950-52, c. 4, § 2, at 8 (1955).

75. Thus, it has been recommended that charities accept specific assets only under a living trust agreement and pay the actual net income of the assets to the donor. See Wellck, *The Acceptance of Funds Subject to Annuity*, 24 ASS'N OF AM. COLL. BULL. 370 (1938).

agreements, they must use particular care in the selection of risks and in determining rates of return<sup>76</sup> so as not to endanger other assets, which in turn might affect their tax-exempt status.

From the standpoint of the donee's tax-exempt status, the life income contract is undoubtedly the safer type of agreement. Under a life income contract the charitable organization binds itself to pay the donor only what is earned by the endowment fund assets.<sup>77</sup> Therefore, the charitable organization does not engage in any risk that part of its other income or corpus will "inure to the benefit of any private shareholder or individual."<sup>78</sup>

## V. RELATED PROBLEMS AFFECTING CHARITABLE ORGANIZATIONS ISSUING GIFT ANNUITIES

### (a) State Regulation

Two states, New York and California, have recognized the dangers involved when charitable organizations issue gift annuities, and specifically regulate the issuance of gift annuity contracts under their state insurance laws.<sup>79</sup>

The New York statute, which went into effect in 1940, requires:<sup>80</sup>

1. Charitable organizations granting annuity agreements must be licensed by the state superintendent of insurance, and copies of forms and schedules of rates must be approved by the state insurance department.

2. Rates must be calculated and specific reserves must be maintained so that a minimum "residuum" of fifty per cent of the original gift inures to the charitable organization at the annuitant's death.<sup>81</sup> Such

76. See *Questions—Annuity Contracts*, Coll. & Univ. Bus., Jan. 1951, p. 6.

Charitable organizations themselves have not been unmindful of the dangers (and advantages) of issuing annuity agreements. The Committee on Financial and Fiduciary Matters of the Federal Council of the Churches of Christ in America held a series of six annual conferences on annuities and the Financial Advisory Service of the American Council on Education has also studied the annuity problem (see note 2 *supra*). See Blackwell, *Annuity Funds and Living Trusts*, Coll. & Univ. Bus., Aug. 1951, p. 47. However, the concern of these charitable associations developed during the 1930's and was directed toward the endangering of other assets, and not the consequential effect on tax-exemption.

77. See text supported by note 29 *supra*.

78. Blackwell, *Annuity Funds May Endanger Tax Exemption*, Coll. & Univ. Bus., March 1954, p. 46-47. See also Anthony, *supra* note 4, at 473-76.

79. See Moorhead, *supra* note 4, at 162-63; Welck, *New York Regulates College Annuities*, 50 SCH. & SOC. 765-66 (1939). The state of Indiana authorizes state educational and charitable institutions to receive gifts subject to annuities, provided the annuities do not exceed the actual income from the property donated. IND. ANN. STAT. §§ 22-513, 514 (Burns 1950).

80. N.Y. INS. LAW § 45.

81. The revision note to the statute points out that the purpose of inserting this minimum residuum requirement was to prevent charitable organizations from competing with commercial insurance companies in the sale of annuities. N.Y. INS. LAW § 45, Revision Note. However, one author indicates that the purpose was to safeguard annuitants because so many institutions had defaulted on annuity agreements. Welck, *New York Regulates College Annuities*, 50 SCH. & SOC. 765 (1939).

reserves must be invested in securities approved by the state insurance department and may not be pooled with other assets.

3. Foreign institutions must comply with the statute in order to issue annuity contracts in New York.

California<sup>82</sup> since 1935 has similarly required a certificate of authority from the state insurance commissioner and the maintenance of reserve funds. The California statute, however, in addition prescribes the form of the annuity agreement and requires that a copy of each agreement entered into be filed with the insurance commissioner.

Apparently other states do not specifically regulate charitable annuity agreements; however, the definitions in most insurance statutes are broad enough to include a charitable organization which issues annuities.<sup>83</sup> Accordingly, it has been recommended that charitable organizations meet the statutory requirements of their respective states as to rates, reserves, and registration, before entering into annuity contracts.<sup>84</sup> This would seem sound advice and should provide no difficulty to the charitable organization granting rates of return based on retaining a seventy-eighty per cent residuum. In fact, one charitable organization points out in its advertising, as an additional security feature, that its annuity contracts are written in conformance with state insurance laws.<sup>85</sup>

Neither New York nor California regulate the "life income contract" where the donor receives a return based on the average yield of the charitable organization's general endowment funds. Since none of the principal sum transferred to a charitable organization for a life income contract is returned to the donor, the life income contract would not appear to be the proper subject of state insurance regulation.

#### (b) *Charter Power to Issue Gift Annuities*

A problem pertinent to both federal and state tax-exemption is whether a charitable organization which binds itself to pay an annuity is acting beyond its charter powers. Apparently only two cases have directly<sup>86</sup> considered this question.

82. 2 CAL. INS. CODE ANN. §§ 11520-11524 (1950).

83. See, e.g., MO. ANN. STAT. § 375.030(1) (Vernon 1952) (No individual or association shall be permitted to do insurance business without first complying with the state insurance laws). *But see*, MASS. ANN. LAWS c. 175, § 118 (1948) ("[C]orporations incorporated for any . . . charitable . . . purpose . . . shall not be subject to this [insurance] chapter").

84. Moorhead, *supra* note 4, at 163. *But see* Barger v. French, 122 Kan. 607, 253 Pac. 230 (1927) (discussed in text supported by notes 87, 88 *infra*), where the court held that a charitable corporation which granted an annuity did not need to qualify under the statute covering corporations dealing in annuities.

85. See POMONA COLLEGE, ANNUITY AND LIFE INCOME PLANS—1957, at 12.

86. In Booth v. Baptist Church, 126 N.Y. 215, 28 N.E. 238 (1891), a testator had bequeathed sums to various charities upon condition that the charities pay certain life annuities. It was contended that these bequests were invalid because

In a Kansas case,<sup>87</sup> an elderly woman transferred property to a church, for which the church granted her a life annuity. After her death, her executor sued the church to recover the value of the property, and alleged that since the church was incorporated under the statute pertaining to religious corporations and not under the statute pertaining to corporations dealing in annuities, the church had no corporate power to enter into an annuity contract. The trial court accepted the executor's contention and held the annuity contract was illegal. The Kansas Supreme Court reversed, and held, that even though the church had no corporate power to deal in annuities, the annuity contract was valid. The court stated:<sup>88</sup>

[T]he fact that the condition of the gift is a payment by the donee to the donor of a sum annually, or periodically, is but an incident of the gift, and does not make the donee "dealing in annuities," as that term is used in our statute. . . . The donee is dealing in gifts, or in accepting gifts—a function clearly within its corporate powers.

In an early first circuit decision,<sup>89</sup> it was contended that a charitable organization was without the necessary power under its charter to agree to pay an annuity which was a condition of receiving a substantial bequest. The court rejected this contention and stated: "The fact that the association has, by its charter, certain enumerated powers, does not bar it from the exercise of incidental functions

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the charities could not pay annuities without violating their charter, *i.e.*, applying charitable property to the benefit of persons not proper charitable beneficiaries. Further, it was contended that if the current rate of interest income should fall, since the annuity payments remain unchanged, the deficiency would have to be met from other charitable funds. However, the court was able to side-step these contentions because it found that the testator had provided that upon the failure of the sums he had transferred to the charities to meet the annuity payments, the charge was to be made to his residual legatees and not the charity.

Dictum in one decision states that the law will not allow a charitable institution to encroach upon its charitable funds to meet annuity payments. *Robb v. Washington and Jefferson College*, 103 App. Div. 327, 93 N.Y. Supp. 92, 111, *modified and aff'd*, 185 N.Y. 485, 78 N.E. 359 (1906). Generally, however, an annuitant has a valid right of action against a charitable institution for a default in annuity payments. See *University of Vermont v. Wilbur's Estate*, 105 Vt. 147, 163 Atl. 572 (1933); *Beatty's Estate v. Western College*, 177 Ill. 280, 52 N.E. 432 (1898). Where an annuity agreement with a small college gave the donor-annuitant the right to retake possession of the funds on the college's default, the court, after the subsequent insolvency of the college, allowed the donor a prior lien on all trust funds. *Word v. Sparks*, 191 Ark. 893, 82 S.W.2d 5 (1935) (criticized in Blackwell, *The Charitable Corporation and the Charitable Trust*, 24 WASH. U.L.Q. 1, 37 (1938)).

Advertisements of some charitable organizations soliciting gift annuities indicate annuity investments are protected by *all* their assets and endowment funds. See POMONA COLLEGE, ANNUITY AND LIFE INCOME PLANS—1957, at 12; Advertisement of Findlay College, Findlay, Ohio, in *The Wall Street Journal*, Mar. 19, 1956, p. 18, col. 2. A safer statement would seem to be that made by the American Bible Society, *i.e.*, adequate annuity reserves are maintained to meet annuity obligations. AMERICAN BIBLE SOCIETY, A GIFT THAT LIVES 3 (available on request from American Bible Society, 450 Park Ave., New York 22, N.Y.).

87. *Barger v. French*, 122 Kan. 607, 253 Pac. 230, 50 A.L.R. 290 (1927).

88. *Id.* at 611, 253 Pac. at 231.

89. *Sherman v. American Congregational Ass'n*, 113 Fed. 609 (1st Cir. 1902).

which relate to the accomplishment of the substantial purposes of its incorporation . . . ."<sup>90</sup>

These cases, enunciating an "incidental" test, involved isolated annuity agreements where there was no real problem of endangering charitable assets or competing with commercial insurance companies. The paucity of cases and the extensive use of gift annuities in many different jurisdictions would seem to indicate the non-existence of an *ultra vires* problem. Perhaps the "incidental" test is a sufficient answer for the conservative charitable organization engaging in issuing gift annuity contracts. However, should a bona fide charitable organization in its desire to solicit funds, grant rates of return which either endanger charitable assets or compete with commercial insurance companies,<sup>91</sup> it is likely that the state or the insurance companies would promote an ouster suit.<sup>92</sup>

Since it is well established that the reservation of income to a donor does not defeat a present gift,<sup>93</sup> and because under a life income contract the charitable organization does not endanger charitable assets, there would seem to be no problem that a charitable organization would exceed its charter powers by entering into life income contracts.

90. *Id.* at 613.

91. From the standpoint of rates of return, charitable organizations have a distinct advantage over insurance companies, *i.e.*, the earnings and interest on charitable funds are free from federal income tax, and the donor-annuitant receives a higher effective rate of return because of his tax deduction. See Moorhead, *supra* note 4, at 164.

92. Related problems under state law are whether a charitable organization has the power to accept and hold property subject to an annuity and whether such property qualifies for exemption from state taxation. The court in *State ex rel. Morris v. Westminster College*, 175 Mo. 52, 61, 74 S.W. 990, 992 (1903), considering these problems, stated:

The defendant was incorporated and granted these valuable rights for the sole purpose of establishing and maintaining an educational institution. It has no authority to carry on any other business nor to hold property for any other purpose. It cannot receive and hold property, under the shield of exemption from taxation, for any other than its corporate purpose. It may lawfully take property, burdened as this is said to be, if it is really designed for its own use in the end, but to the extent that the property is devoted to a purpose other than that for which the corporation was created it is not exempt from taxation.

The court went on to find that the annuity was not being paid out of income from the property sought to be taxed and granted tax exemption.

In *State v. Watkins*, 108 Minn. 114, 121 N.W. 390 (1909), real property given to a charity subject to an annuity was held tax-exempt because by state statute income of an annuity was taxed if the principal was not. The court rejected the argument that the annuity might be so large that the annuitant could receive the entire beneficial use of the property without taxation. See also *Masonic Lodge v. Board of Review*, 281 Ill. 480, 117 N.E. 1016 (1917) (real property subject to an annuity: tax exempt—"a charge in the nature of an encumbrance").

Indiana by statute requires that where property is transferred to a charitable institution and the income is reserved to the donor, such property is taxable unless actually occupied and used by the institution. IND. ANN. STAT. § 64-219 (Burns 1951).

93. See, *e.g.*, *University of Vermont v. Wilbur's Estate*, 105 Vt. 147, 163 Atl. 572 (1933).

## VI. CONCLUSION

Gift annuities and life income contracts serve worthy purposes for both the donor<sup>94</sup> and the charitable organization.<sup>95</sup> The donor receives the benefits of a life income and a charitable deduction, plus the added satisfaction of presenting a gift to charity during his lifetime. On the other hand, the charitable organization is able to attract a class of donors who otherwise might not make a gift. Further, the charitable organization receives the assurance of a present gift, compared with the mere possibility of a future bequest.

The life income agreements seem the most desirable for both the donor and the charitable organization. The donor generally receives a larger return on his contribution, plus a larger charitable deduction. The charitable organization receives a larger gift and does not endanger its tax-exempt status, nor subject itself to state regulation. Further, the life income agreements would not seem to provide a basis for possible ultra vires charges.

However, the gift annuity may be necessary to fit a donor's personal tax situation and provide the donor with a return on his capital during less prosperous times. The charitable organization must exercise caution in the issuance of annuities, not only to ensure the receipt of an eventual gift, but also to retain the privileges of its charitable charter and its tax-exempt status.

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94. See LASSER, *op. cit. supra* note 8, at 36-37, 62-63.

95. See Blackwell, *Annuity Funds and Living Trusts*, Coll. & Univ. Bus., Aug. 1951, p. 47.