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Planned Giving News

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BROKEN (UNI)TRUST

by Peter Boyle

After five years of a flat market and multiple years of declining interest rates, the current market value of charitable trusts may be underwater compared to their initial gift values. Many planned giving officers are fielding calls from donors who have either witnessed their payouts decline (in the case of unitrusts) or are themselves concerned about the eroded value of their annuity trusts.

FOR A VEHICLE THOUGHT TO BE A WIN-WIN, HOW DID WE GET HERE?

While the recent market performance (measured by the S&P500) has been positive, over the last five years the market is nearly flat. During the same period, most investment grade bond indexes have only managed a 6% annualized return. So, in hindsight, the best scenario asset allocation over this time frame would have been a trust 100% invested in bonds, with no expenses and only a 5% payout. The market value of this hypothetical trust would have been slightly above its initial gift value. In reality, a more likely set of circumstances involves a trust with closer to a 50% stock/50% bond allocation, reasonable expenses of about 1% and a payout rate of about 6% (annuity assumed). Under that more probable scenario, a prudently managed trust would have likely declined 20% over the last five years.

We stress "prudently" because an asset mix of 50% stocks and 50% bonds is reasonable as is a 6% payout rate. Instead, as the accompanying chart depicts, this trust fell victim to multiple years of sub 5% returns. While not without historical precedence, five-year compound returns on a balanced[1] account had not fallen below 5% in 20 years.

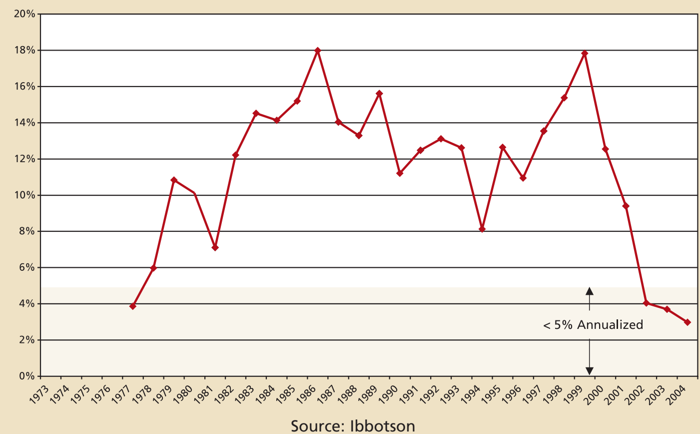
WHAT LESSONS CAN WE LEARN?

Investment returns are cyclical. Other than the early years after charitable trusts were codified in 1969, we had a really good run of favorable investment returns; arguably too good a run. In fact, only once before 2002 did the five-year annualized return on a balanced portfolio drop below 8%. As a result, we became complacent and failed to question projections of smoothly upward-sloping market values and resultant payouts.

We would be remiss if we did not take this opportunity to discuss the other side of this lesson—payout rates. Unlike gift annuities where most charities follow the American Council on Gift Annuity recommendations, no such guidelines exist for CRATs and CRUTs. Instead, planned giving officers sometimes find themselves "competing for" or "selling" these trusts. More than ever, it is critical to stress to donors that these trusts have a charitable remainder component in addition to the private income interest of the beneficiaries. In addition, these vehicles are not solely a tax avoidance tool. The tax benefits offered by CRATs and CRUTS serve to increase the "bang" for the charitable "buck" from a philanthropically inclined donor. Lastly, these trusts do not behave like certificates of deposit. True, the rate is irrevocably set, but its payment continuity relies on the prosperity of the underlying trust. Beneficiary payments will decline as the value of the CRUT declines and the payments will stop entirely if the assets in a CRAT are depleted. If, when representing the charity in the planning stage of a CRUT or CRAT, you find yourself in front of a potential donor whose first question is "what rate can you offer?", beware. If the donor does not understand the charitable component of a CRUT or

Balanced Account Performance

(5 Year Compound Return - 50% Stock / 50% Bonds)



[1] Defined as 50% allocation to the Standard and Poor's 500 and 50% allocation to the Lehman Intermediate Term Govt/Corp Index. Historical returns are provided by Ibbotson and Associates.

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CRAT, the potential for disappointment increases greatly.

While certainly not intuitive, in the long run a lower payout rate is not only more conservative, but it also produces a larger tax deduction, perhaps even a larger payout in the long-run and a larger remainder for the institution. We are encouraged that many of our institutions have understood the message as the general trend in payout rates from our clients has been declining to an average rate of 5.5% for trusts created during 2004.

HINDSIGHT IS GREAT, BUT NOW WHAT?

In many cases, it may be too late. Like a stock purchased at the top of the market, trust payout rates are irrevocably set. Further, as you recall from high school math, once your trust has declined 20% (as in the example above) it needs to increase 25% from the lower value (after payouts and expenses) to recoup its prior losses. Aside from achieving extraordinary investment returns, which entails the assumption of greater security selection risk, what else might a trustee consider?

Regardless of the approach considered, donor education and involvement is crucial. While a trust may be underwater, a careful discussion concerning the causes, outlook and potential courses of action are in the best interest of the charity.

Review the current investments. It could be that your current asset allocation could be improved, but there is no free lunch. More stocks could increase the likelihood of recovery, but they will also increase the risk. More bonds providing additional stability are enticing, but they may not yield enough to stop the long-term erosion after payouts and expenses.

Consult with the income beneficiaries to determine which of their competing priorities carries more weight. Are they most interested in stabilizing and maintaining their beneficiary payments or they do want to ensure that the charity gets some residual balance? If further downside protection to unitrust payments is critical, collapsing the unitrust into a gift annuity might be a logical approach. Be aware, as is shown in the example below, it is the income beneficiary who receives most of the benefit from this approach, not necessarily the charity.

Example 1: At 67, a donor establishes a $100,000, 5% standard unitrust. His initial annual payout is $5,000. After five years, the trust has declined to $75,000 resulting in an upcoming distribution of $3,750 per year. The strategy of collapsing the unitrust entails donating the remaining income interest to institution in exchange for a 5% gift annuity. The donor locks in the $3,750 annual payment for the balance of their lifetime and the trust assets are transferred to the charity to support the annuity payments.

At what cost? Since the income interests are equated, there is no direct tax consequence, although the future taxability of the payment stream might be altered[2]. The income beneficiary eliminates further payment downside by locking in the reduced payout, but has also relinquished any possible future increases brought about by market value increases. The institution does have immediate access to the remaining trust assets, but has also increased its potential monetary liability. Importantly, gift annuities are a liability of the institution and therefore not capped by the assets held in the trust. Offsetting that concern, now that the payment stream is fixed, and assuming the new gift annuity fund performance can exceed the payout rate, any benefit of any excess growth in the corpus accrues only to the institution and will not be shared with the income beneficiary.

Example 2: Same as Example 1 (above) except the trust is an annuity trust as opposed to a unitrust. In this example, the market value is likely less than $75,000 because the payments have remained fixed (in dollar terms) despite the declining market value. For purposes of this example, let's also assume the reduced market value is $75,000. As above, the income beneficiary has received a $5,000 annual distribution from inception. At conversion, there are two alternatives. The first is to maintain the $5,000 distribution. In this case, since the new income interest is greater than the pre-collapse value, a taxable event is created[2]. If, on the other hand, the income beneficiary is willing to accept a lower payout at the reduced level of $3,750, the result would match the outcome from Example 1 above. In this case, some additional tax benefit could apply to the income beneficiary[2].

CONCLUSION

The good news is that we believe future stock returns, while modest by recent standards, will be positive. Combined with recovering bond yields, the result is a future that looks rosier. Like a stock purchased at the top of the market or a trust funded that same day, there are no easy answers. It is likely these market cycles will repeat themselves again sometime in the future. In the meantime, let's work towards educating ourselves, our boards and our donors. Emphasize the charitable benefits of supporting your organization and the philanthropic role these trusts are meant to serve. Well structured trusts can and do create a solid foundation for an ongoing win-win relationship between donor and charity.

Clifford Associates will continue to aid you in your work with donors. Please let us know if there is anything we can do to assist in the donor education process. §

[2] The taxability of such a transaction is beyond the scope of this article. If you would like further details, please let us know.

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