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Benchmarking Planned Gift Investments

As the pace of making deferred gifts to non-profit institutions has increased, the importance of this asset pool to the remainder interest institution has grown. What was once a low-profile maintenance effort, run perhaps by the finance department, has come under the scrutiny of trustee board members. Greater oversight attention is inevitable, and brings the potential of added costs.

Some added costs add value. Examples of costs that enhance the program include professional skills applied to the administrative tasks, professional attention to investment policy and security selection, and a reliable custodian for safekeeping of assets. Other costs may be unnecessary or induce counter-productive action. One such cost may be a misguided effort to benchmark investment returns.

These split-interest trusts bring serious public relations obligations, special tax considerations, and legal constraints. An attempt to benchmark returns for these instruments must be accomplished carefully, or it may disrupt an otherwise successful program.

We counsel our planned-giving clients to use caution in adopting traditional benchmarks. It is unreasonable to transfer the application of endowment practices to this specialized area. Endowment assets belong only to the charity and the distribution of endowment earnings is paid by the charity to itself—the fund serves one master. Charitable Remainder Trusts and other deferred gifts do *not* belong to one party.

There are two concerned interests that share ownership. The first interest is the income beneficiaries, which may be one or several parties. The second is the remainder interest, which is often held by the trustee but could also be held by other parties. The board that is acting as trustee of these complex trusts is charged with protecting *all* interests and cannot act in the same manner it might for its own endowment.

Clifford Associates recommends that organizations consider each of the two interests in setting investment benchmarks. The income obligations and their tax treatment are different for each trust. Each trust must therefore benchmark in a manner that is realistic *for that trust*. Similar considerations apply to the remainder value.

To further complicate the issue, each party must consider the other's interest in order to comply with the Uniform Prudent Investor Act. An example might be a decision to target income generated by the trust to meet the income objective set by the donor. This preoccupation with income might not be prudent if it robs from the principal any chance of offsetting inflation. By the same token, a target intended to maximum capital growth helps the remainder interests but may create volatile valuations which adversely impact the beneficiary distribution calculations. These unique investment targets and objectives that are peculiar to each trust require individually tailored benchmarks.

(Continued on page 4)

Planned Giving Strategies

There are various forms of planned giving arrangements, each with unique characteristics that have evolved to address specific donor needs. This is the first of a two-part article which will attempt to identify these characteristics and needs, and explain the corresponding investment approach applicable to the following types of arrangements:

- 1) Charitable Gift Annuities
- 2) Charitable Remainder Annuity Trusts
- 3) Pooled Income Funds
- 4) Charitable Remainder Unitrusts
 - Standard (no net income limitation)
 - Net Income with Makeup
 - Net Income with no Makeup
 - Flip

Charitable Gift Annuities

A charitable gift annuity is an arrangement whereby assets are given to a charity in return for the charity's promise to make payments of a fixed amount to a beneficiary designated by the donor. These annuity payments are a general obligation of the charity and often continue for the beneficiary's life.

The type and amount of taxable income reportable by the beneficiary from the receipt of the annuity payments is determined at the time of gift and does not depend on the type of income earned by any underlying investments as in the *4-tier system*. Generally, each annuity payment is split between ordinary income and a tax-free portion. This split is based on the relationship between the total annuity payments expected to be made by the charity (*expected return*) and the present value of these expected payments to the beneficiary (*investment in contract*). The ratio of the *investment in contract* over the *expected return* applied to each payment represents the tax-free portion of that annuity payment. After all of the *investment in contract* has been returned to the beneficiary as tax-free portions of the annuity payments, subsequent payments to the beneficiary are entirely ordinary income. This occurs when the beneficiary outlives the life expect-

ancy estimate used in calculating the present value of the expected annuity payments.

The donation of appreciated securities for gift annuities create a wrinkle in the tax character of the annuity payments. The difference between the market value of the donated assets and the donor's cost basis is the *total gain* in the gifted assets. The portion of the *total gain* that must be reported by the donor is based on the relationship between the market value of the donated securities at the time of gift (*gift value*) and the present value of the expected beneficiary distributions (*investment in contract*). The ratio of the *investment in contract* over the *gift value* applied to the *total gain* is the gain that must be reported by the donor (*reportable gain*). If the donor is a beneficiary, the donor recognizes the *reportable gain* over the expected life of the annuity payments. If the donor is not a beneficiary, the donor recognizes the *reportable gain* in the year of the gift.

Charitable Gift Annuity Strategies

Overall, the cost of creating and subsequently administering a charitable gift annuity is significantly less than other types of planned gifts which makes charitable gift annuities most appropriate for small gifts. Unlike annuity trusts and unitrusts, charitable gift annuities do not require a trust agreement or trustee. Reporting to the beneficiary on the taxability of the payments does not involve annual calculations incorporating the types of income received by the underlying investments. In addition, there are no annual tax returns that must be filed for each gift annuity. However, some states require that an annual report be filed with a state regulatory agency covering the activity and balances of an investment pool holding all gift annuities.

Like annuity trusts, the periodic payments to the beneficiary are fixed and do not change over the life of the payments. Unlike annuity trusts, gift annuity payments are not subject to the availability of trust assets. For these rea-

sons, gift annuities appeal to donors who are looking for certainty in the periodic payments to the beneficiary. Charities assume more risk with gift annuities, since the beneficiary distributions are a general obligation of the charity itself.

The unrealized capital gain held by donors of appreciated securities will be reported as capital gain income to the beneficiary over the life of the annuity payments or, where the donor is not a beneficiary, in the year of the gift. Capital gain recognition by beneficiaries of annuity trusts and unitrusts depends upon the timing of and proceeds received from the sale of the donated securities by the trustee. Unlike trustees of charitable remainder trusts and pooled income funds, there is no way for a charity to delay or eliminate the recognition of gifted appreciation as capital gain income to the donor or beneficiary of a charitable gift annuity.

Charitable gift annuities are often pooled for investment and logistical purposes. State law may require that the charity invest the donated assets in a specific manner until all required beneficiary payments have been made. The investment of these assets is constrained by some states to fixed income securities, often government bonds. This limits the potential equity exposure and in turn may reduce long-term total return.

Where full investment discretion exists, a pool's asset allocation is determined by taking into consideration the charity's tolerance for risk and the expected duration of the annuity obligations. Equity investments usually produce higher long-term total returns but more variability in short-term returns, thereby increasing the short-term risk. If the expected duration is long, more variability in short-term returns is acceptable, which supports an increase in equity investment exposure.

Charitable Remainder Annuity Trusts

A charitable remainder annuity trust is a separate legal entity created by the transfer of assets to a trust governed by the terms of a trust agreement. Periodic distributions of a fixed amount are made from the trust to the benefi-

ciaries designated by the donor. Upon the trust's termination, which may occur on the death of the beneficiary or after a specified number of years, the amount remaining in the trust is transferred to a charity.

Like pooled income funds and unitrusts, the type and amount of taxable income reportable by the beneficiary from the receipt of annuity trust distributions is based on the amount, type, and timing of income earned by the underlying investments under the *4-tier system*.

Charitable Remainder Annuity Trust Strategies

Like gift annuities, the fixed nature of the beneficiary distributions appeal to donors looking for predictability. Unlike gift annuities, the charity is protected since the obligation to make the beneficiary distributions only continues as long as there are sufficient assets in the trust to make the payments. Unlike unitrusts, the beneficiary distributions will not increase as the trust grows nor will they decrease if the trust assets decline in value.

If the expected duration of the trust is long it could hold a significant amount of equities, thereby minimizing the trust's ordinary income (interest and dividends). Equity investments usually increase the variability of short-term returns. Since the amount distributed to the beneficiary will not fluctuate with changes in the portfolio's periodic value, as in a unitrust, the annuity trust remainder interest assumes all of the risk associated with the short-term variability of equity returns. This increased risk may be offset by the higher long-term returns expected from equity investments as compared to bonds, leaving more for the charitable remainder when the trust terminates.

Unlike gift annuities, the taxability of the beneficiary payments depends on the income earned by the trust investments under the *4-tier system*. Equity portfolios minimize the *tier-1* ordinary income (interest and dividends) received by the trust. The liquidity required by the beneficiary distributions could be generated by periodic sales of trust assets. Depending on the timing of these sales and the proceeds received, the trust could incur mostly

(Continued on page 4)

("Benchmarking..." continued from page 1)

An additional benchmarking pitfall is the practice, common to endowments, of diversifying among asset classes as well as among investment styles with benchmarks keyed to each of those components. This practice has some merit for large pools such as endowments, although the investment style issue has been brought under question. We have found this approach to be impractical for the small trusts typical of a deferred gift program. A core, high-quality investment program with below-average volatility is usually the preferred strategy. Some style diversification may be appropriate in a limited way, but generally speak-

ing, multi-manager approaches are unworkable for deferred gifts.

After over a decade of managing and administering hundreds of these arrangements, our conclusion is that benchmarks must be driven by trust circumstances and frequently must be expressed in absolute terms rather than on a peer-group or relative basis. We work with our clients to establish a monitoring program that focuses on issues of relevance and avoids complications that are costly and not productive. Over-engineering should be avoided at all costs or costly it will be!

Jim Fox

("Planned Giving Strategies," continued from page 2)

long-term capital gains. This would have a positive effect on the tax characterization of the beneficiary distributions since a large portion of the payments would be considered *tier-2* long-term capital gains or even *tier-4* non-taxable return of corpus.

Donated appreciated securities could be held and sold during periods of down markets. If liquidity were provided by funding the trust with cash in addition to appreciated securities, the sale of the appreciated securities could be delayed or, depending upon the circumstances, the appreciated securities could be held until the trust terminates, and then be transferred in-kind to the charitable remainder organization. Delaying or even eliminating the recognition of capital gains inherent in donated appreciated securities is an advantage of the annuity trust and the *4-tier system* over the charitable gift annuity.

Tax exempt bond interest also has favorable implications for the beneficiary's tax reporting. Beneficiary distributions will be characterized as *tier-3* tax exempt interest only after all *tier-1* ordinary income and *tier-2* capital gains have been distributed to the beneficiary. Beware of the pitfall associated with selling donated appreciated securities and investing in tax exempt bonds expecting to show only *tier-3* tax exempt interest on the beneficiary's tax return. The trust assumes the donor's cost basis and any gain between the trust's selling price and the donor's cost must be distributed to the beneficiary before any nontaxable income. Depending upon the magnitude of the gifted appreciation, it could be possible that *tier-3* tax exempt income would never be deemed distributed to the beneficiary.

In most cases, the trust's asset allocation will be a mix of equity and fixed income investments taking all factors into consideration including a determination of a what level of risk is prudent under the circumstances.

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Part 2 of this article will address Pooled Income Funds and Charitable Remainder Unitrusts.

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