

Personal Financial Planning

STRATEGIES
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Practical Applications of Charitable Remainder Trusts: Part 1

Charles J. McLucas

Here are the "nuts and bolts" issues that must be addressed when setting up this valuable tax advantaged vehicle.

This is the first of a two-part article covering some of the practical areas of decision making underlying the establishment and operation of Charitable Trusts. Part 1 will discuss the appropriate payout rate, a checklist of items that frequently get overlooked in setting up the trusts and investment portfolio design concepts. Part 2 will consider the importance of the investment manager to diversification, drafting of CRTs, life insurance trusts, and the handling of mortgaged real estate.

Because the near term chances for a substantial reduction in the capital gains tax appear slim, many advisers have discovered that the use of Charitable Remainder Trusts can be an excellent alternative to paying capital gains taxes on the sales of appreciated property. This article will explore some of the practical considerations in the establishment and month-to-month operations of these trusts. As the "Unitrust" is the most flexible and widely used of Charitable Trusts, our discussion will focus primarily on Charitable Remainder Unitrust (CRT) operations. (For a review of the many benefits of CRTs, see this author's article in the July/August 1994 issue of *Personal Financial Planning*.)

Given the substantial stock market rise in 1995, many clients are probably concerned about capturing the paper gains they have made. Although the temptation to sell off portfolios is strong, the fact that taxes could eat up over one-third of their gains in most states continues to prevent investors from making this move. At the same time, many "baby boomers" are considering selling their businesses to family or outside investors to provide for "retirement income." As discussed further in this article, a CRT may be the perfect solution for transferring the business and retaining the highest retirement income as well as for diversifying a stock portfolio.

What Is an Appropriate Unitrust Payout Rate?

One of the first, and possibly the most important, decisions to be made in establishing a CRT is the rate to be paid out during the life of the trust. While there is no maximum rate, the minimum rate that must be paid is 5%. Because the rate selected may not be changed, it is critical for an appropriate rate to be established.

The client's age, financial position, goals, objectives, and risk tolerance are all

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CHARITABLE REMAINDER TRUSTS

EXHIBIT 1

Pretax Effective Return Rates

6.00% Unitrust			7.50% Unitrust		
	Investment	\$500,000	Investment	\$500,000	
	Tax Savings	14,632	Tax Savings	8,434	
	Net Invest.	485,368	Net Invest.	491,566	
Years	Tot. Return	Pretax Eff. Rate	Tot. Return	Pretax Eff. Rate	
0	\$30,000	6.18%	\$37,500	7.63%	
1	31,350	6.46%	38,625	7.86%	
2	32,761	6.75%	39,784	8.09%	
3	34,235	7.05%	40,977	8.34%	
4	35,776	7.37%	42,207	8.59%	
5	37,385	7.70%	43,473	8.84%	
6	39,068	8.05%	44,777	9.11%	
7	40,826	8.41%	46,120	9.38%	
8	42,663	8.79%	47,504	9.66%	
9	44,583	9.19%	48,929	9.95%	
10	46,589	9.60%	50,397	10.25%	
11	48,686	10.03%	51,909	10.56%	
12	50,876	10.48%	53,466	10.88%	
13	53,166	10.95%	55,070	11.20%	
14	55,558	11.45%	56,722	11.54%	
15	58,058	11.96%	58,424	11.89%	
16	60,671	12.50%	60,176	12.24%	
17	63,401	13.06%	61,982	12.61%	
18	66,254	13.65%	63,841	12.99%	
19	69,236	14.26%	65,756	13.18%	
20	72,351	14.91%	67,729	13.78%	
21	75,607	15.58%	69,761	14.19%	
22	79,010	16.28%	71,854	14.62%	
23	82,565	17.01%	74,009	15.06%	
24	86,280	17.78%	76,230	15.51%	
25	90,163	18.58%	78,517	15.97%	
26	94,220	19.41%	80,872	16.45%	
27	98,460	20.29%	83,298	16.95%	
28	102,891	21.20%	85,797	17.45%	
29	107,251	22.15%	88,371	17.98%	
30	112,360	23.15%	91,022	18.52%	
AVERAGE CUMULATIVE RATE OF RETURN FOR SELECTED NUMBER OF YEARS					
	4	6.61%	4	7.98%	
	8	7.25%	8	8.48%	
	12	7.97%	12	9.02%	
	16	8.78%	16	9.61%	
	20	9.70%	20	10.25%	
	24	10.74%	24	10.94%	
	28	11.92%	28	11.70%	

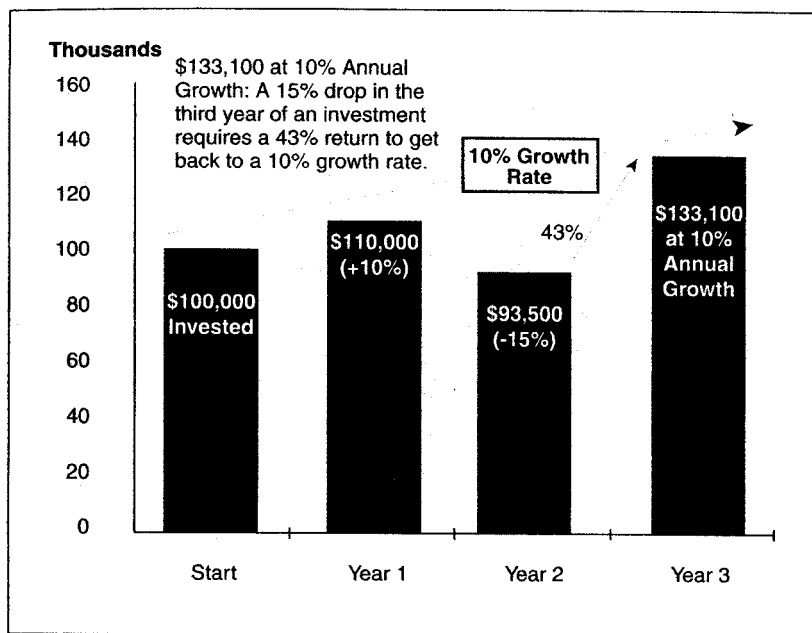
Note: Effective Return Rates reflect Unitrust payout amounts before payment of income taxes.

factors that enter into the decision about the appropriate rate. The typical CRT will continue in existence for many years, and most likely provide increasing income each year. Therefore, it is important to review the options carefully, remembering in particular that bigger is not always better. As shown in Exhibit 1, which com-

pares a 6% payout rate to a 7 1/2% rate, the income and effective rate of return for the 6% unitrust exceeds that of 7 1/2% after 15 years. The longer the trust is in place, the more dramatic these differences will be. Accordingly, the planner should advise younger clients to consider the lower payout rate.

EXHIBIT 2

The Difference in Recovering From Investment Losses



As a general rule, an increasing benefit payable to the beneficiary is preferable. Therefore, do not set a rate higher than the expected average investment rate less 3%. Such a guideline will normally allow for variations in the investment return and still provide for annual increases in income. Convincing a client to take a lower, rather than a higher, payout percentage can be a difficult task. Most software programs that include CRT illustrations will provide side-by-side comparisons of two or more rates that can be reviewed with your client. A higher rate than the general rule may be appropriate for older clients whose life expectancy is under 15 years; clients willing to assume more risk in their investment portfolios; and where only a small amount of income will be needed currently and a larger amount after retirement. The net income with makeup provisions of CRTs should be selected with a view towards building up a potential backlog of undistributed income to be paid out at a later time.

What About the Investment Portfolio?

The second, and possibly more important, decision regarding the establishment of a CRT is where to invest the proceeds that fund the trust. Most CRTs require the holder to actually "earn" the income to be distributed. Thus, the selection of the investment portfolio can make or break a client's satisfaction with the decision to establish a CRT.

Consistency is the watchword for most CRT portfolios, or as someone once said, "better a steady dime than a rare dollar." Why is consistency important and how do planners help their clients achieve it? Exhibit 2 answers that question. It reflects that a steady 10% return grows from \$100,000 to \$133,000 after only three years. But what happens if there is a 15% drop in the second year? It will take a 43% return the next year to achieve the same level as a 10% annual return!

How can clients control potential market risk? By using multiple levels of diversification.

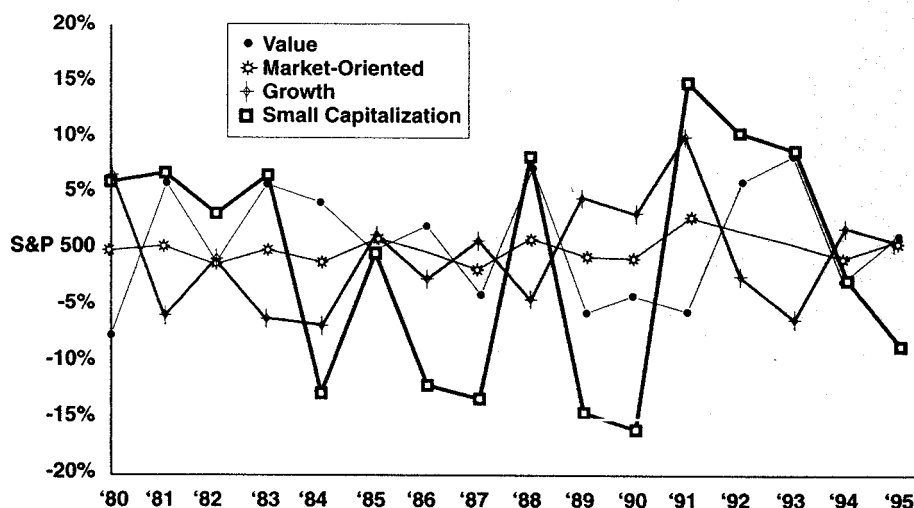
The first level involves the appropriate mixing of stocks, bonds, and other investment grade assets. Portfolios that minimize portfolio risk for a given expected return (or equivalently maximizes portfolio expected return for a given level of risk) are said to be efficient. Several software programs are available to help an adviser create an "optimal" portfolio for a desired risk level.

The second level of diversification relates to various stock and bond investment management styles. In considering equity management styles, four basic techniques are well-known:

- **Growth.** Managers' efforts are devoted to identifying companies with above-average, consistent growth in profitability. These stocks usually have high price/earnings ratios and pay lower dividends than value companies.
- **Market-Oriented.** Managers focus on developing well-diversified portfolios with average growth and valuation char-

EXHIBIT 3

How Did Equity Manager Styles Perform Against the Market?



SOURCE: 1) Russell 1000 Value, 2) Russell 1000, 3) Russell 1000 Growth, 4) Russell 2000 Indexes.

acteristics near to those of the broad market. Many add value by overweighting economic sectors they believe are undervalued. A large number of issues fall into this category.

- **Value.** Managers focus on stocks with low price/earnings ratios and high dividend payouts.
- **Small Capitalization.** The distinguishing characteristics of this style is the focus on smaller companies. Some of these companies are unseasoned and growing rapidly, while others are simply smaller businesses with long histories. They are characterized by low dividend yields and above-average volatility.

A performance comparison of these various styles with the S&P 500 is illustrated in Exhibit 3. By carefully using all four styles in a portfolio, a more consistent investment return can be achieved.

Aside from being aware of investment concerns in diversifying a CRT portfolio, the client's objectives and risk tolerances must be considered. If a client wants immediate payments from his or her CRT

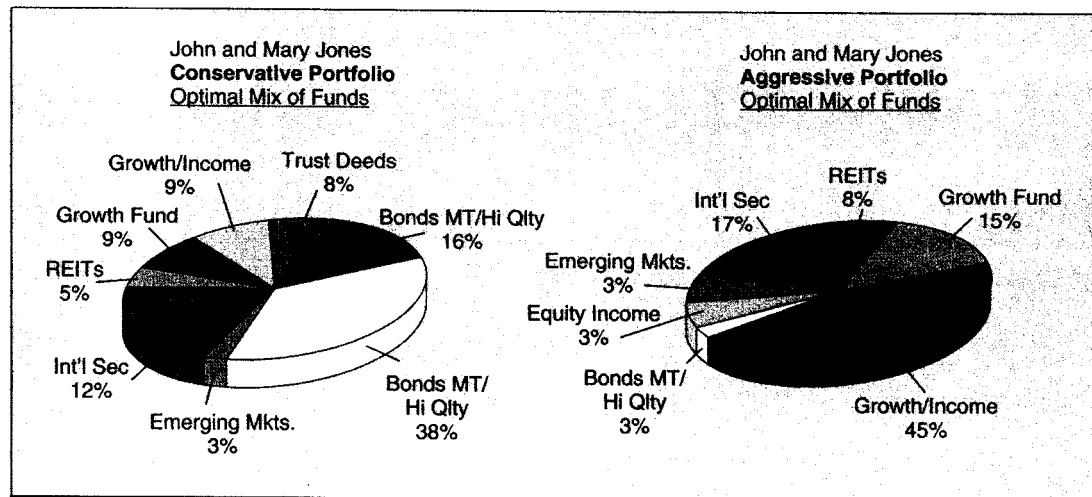
and has low risk tolerance, a conservative portfolio such as the one depicted in Exhibit 4 might be considered. If a higher risk tolerance client is looking for more future growth, examine the aggressive portfolio in the same exhibit. Exhibit 4 sets out two possible portfolio designs that might be considered.

Setting up a CRT

Once the payout ratio and investment decisions are made, the planner can turn to the documentation aspects of the CRT. Here is a checklist of commonly overlooked issues in the establishment of a CRT.

1. File quickly for Federal I.D. at the time of signing the documents. The IRS procedure for obtaining an I.D. has recently changed in some districts. If the application is submitted by fax, expect to wait five days. The number

EXHIBIT 4
Two Different Risk Portfolios



- is needed for banking purposes, property sales, investment accounts, and related reasons, and should be obtained as soon as possible.
2. Make certain Form 8283—Noncash Contributory Report is prepared and signed by the appropriate parties in a timely manner.
 3. Complete and file Form 8282 within 125 days of the sale of any donated trust property.
 4. If insurance is needed to replace family assets, see that the policy is in

place prior to the transfer of assets to the trust.

5. Prepare and file Form 709—Gift Tax Return if the donated property is valued over \$10,000.
6. Prepare a statement to attach to the donor's tax return that explains the nature of property donated and the calculation of tax deductible remainder interest.
7. Obtain a charitable receipt letter from the trustee or charitable organization, if appropriate. ■

Practical Applications of Charitable Remainder Trusts: Part 2

Charles J. McLucas, Jr.

Business transfers, life insurance trust funding, and mortgaged real estate considerations dominate this final discussion of CRTs.

Part 1 of this article (*Personal Financial Planning*, July/August 1996) discussed the importance of selecting the payout rate from charitable remainder trusts, investment selection, and documentation aspects of the CRT. Part 2 will briefly touch on the need to choose appropriate investment managers, and discuss certain drafting considerations, the role of life insurance trusts and how to handle mortgaged real estate.

Selecting an Investment Manager

As noted in Part 1, the diversification of assets between (1) stocks and bonds and (2) various investment styles should provide reasonably reliable investment returns. However, to further reduce risk, a third level of diversification is also required—the selection of suitable investment managers. It is important to note that a “good” system applied in a disciplined, consistent fashion will outperform the search for the “best” system. This is demonstrated by examining the best performers at 231 major banks, insurance companies, and investment managers. For example, consider Exhibit 1, which indi-

cates that, of the managers falling in the top 25%, *not one remained in the highest quartile* for five consecutive years. Planners clearly face a difficult problem here. They must exercise special caution in the selection process and avoid remaining with investment managers who underperform and/or display unusual performance inconsistencies over the long run.

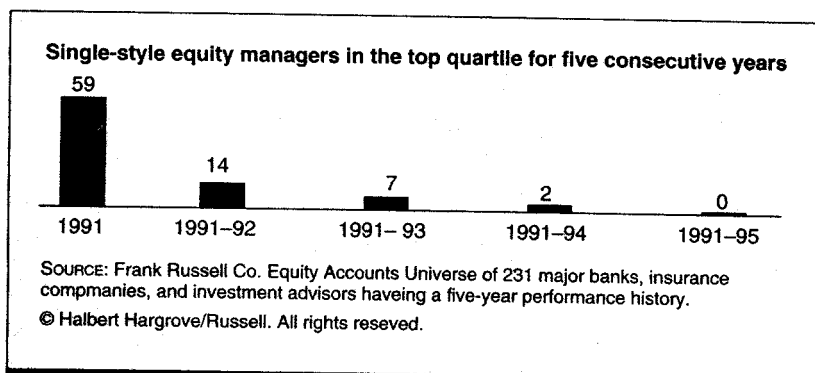
The selection of investment management firms is much like the task of a conductor of an orchestra. The conductor must attempt to select the best performers on each instrument, keeping in mind the coordination of the instrumentalists as a whole and how well they play together. Fortunately, there are a few firms in the country that have developed the requisite skills to become investment managers. These firms can be hired at reasonable fees by planners who do not want to make investment decisions themselves.

Planners who decide to select the appropriate managers should consider the following factors:

1. What are the investment objectives of the client that is establishing the CRT? Using the example of the orchestra conductor, what type of music does the client want to hear—jazz, pop, or classical? That determination will affect the search for a manager.

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EXHIBIT 1
Is Picking Today's Hot Managers the Solution?



2. A quantitative approach should be taken to the selection. How is their performance compared with that of their peer group? Given the appropriate indexes, what is their risk-adjusted return over various time periods?
3. Qualitative analysis should be done also. Who are the people in the investment firm? What is their investment philosophy? Who makes the decisions? Do they have adequate administrative capability to handle the sums of money they manage, and are they doing economic and securities research?

Flexibility of Distributions

Regardless of the investment strategy, a trust document should contain a clause to give the trustee the power to allocate capital gains (other than those from the sale of the donated asset) to income or principal.

Such a clause might read:

The trustee may in its discretion make a reasonable allocation to income of gain from the sale of capital assets, which during the time such assets were held by the trust,

produced limited or no income. Apportionment and allocation of any receipt and expenses for which no provision is made herein or in the (state of situs) principal and income law shall be made by the trustee in the trustee's discretion.

This provision will enable the trustee, if necessary, to make up current income requirements by capital gains dividends or selling appreciated securities.

Transfer of Business to Family or Employees

Many successful, self-employed baby boomers who are rapidly approaching retirement years are giving much thought to transferring the family business to children and/or key employees. How can this be accomplished with minimal, if any, tax consequences? A small amount of stock can be given or sold to the children who are going to be involved in the business. Each year parents contribute stock to a CRT and the corporation then redeems the stock with retained earnings and retires it. Not only is a retirement unitrust being funded, but the parents will receive a current annual deduction based on the fair market value of the stock contributed. Eventually, the children (or key employees) will own the company without any sale debt, the parents will have a CRT paying them income for the rest of their lives, and the yearly tax savings can be used to purchase life insurance for the children not involved in the business. Exhibit 2 indicates how this might work for a business valued at \$600,000.

An option to the use of the life insurance trust might be to have the child or children own the policy and pay the premiums themselves.

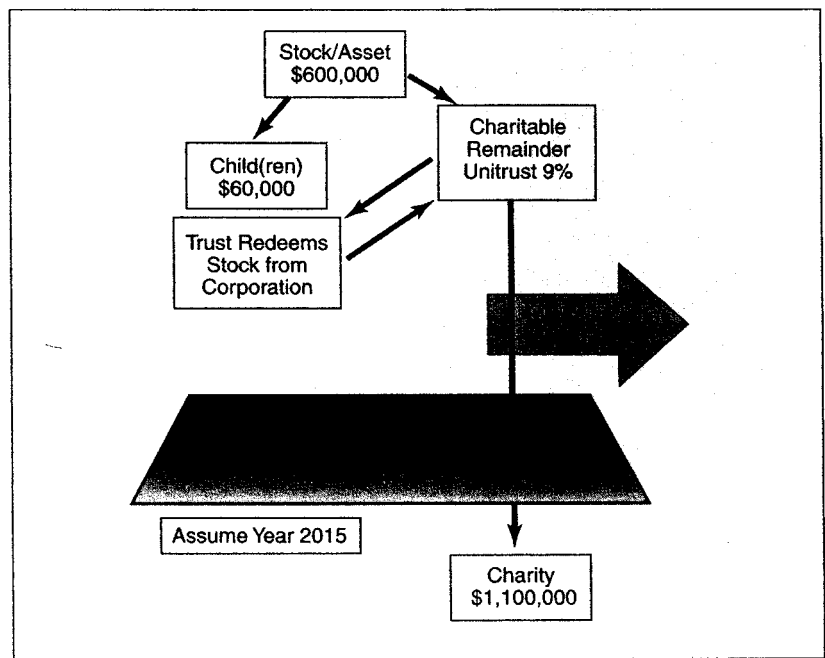
Irrevocable Life Insurance Trust Funding

Many clients who establish CRTs also set up a life insurance trust at the same time to provide cash to beneficiaries (free of estate taxes) who will not receive benefits from the CRT. A problem that frequently arises in funding insurance trusts with normal second-to-die policies is determining the appropriate type of insurance. Because the need for insurance is permanent, the appropriate product to meet that need should be some form of permanent insurance. Some of the current choices at this time are the following:

1. *Traditional whole life.* This type is for the conservative investor. The premium is level and fixed as well as the death benefit. The cash value is guaranteed.
2. *Variable life.* This type of coverage is for a more moderate investor. While the premiums are fixed as to timing and amount, the death benefit will vary depending on the investment performance in the separate account (mutual fund portfolio). Cash value is not guaranteed, as it depends on the performance of the separate account.
3. *Variable universal life.* This type of coverage is for the more aggressive investor. The premiums are discretionary as to the timing and amount. The death benefit could vary greatly based on additional premium payments and the investment performance of the separate account. The policy could lapse due to insufficient cash value as fees and charges are deducted from cash value.

An option to the use of the life insurance trust might be to have the child or children own the policy and pay the premiums themselves.

EXHIBIT 2 Transfer of Business Trust



How to Handle Mortgaged Real Estate

When real estate is being considered as the asset to fund the CRT, how is the problem of having a mortgage on the property handled? Under Section 664(c), the trust might lose its tax exempt status if it had unrelated business taxable income (UBTI). Debt financed income from rental real estate is considered in UBTI, IRC Section 514(c)(2). Therefore, the sale could generate loss of the tax exempt status and create a capital gains tax.

To avoid this problem (which is outlined in detail in PLR 9015049), a portion of the property equaling the amount of mortgage should be retained by the donor. Second, a co-tenancy agreement should be prepared as part of the documentation of the transfer. The co-tenancy agreement should have provisions to prohibit use by the donor, contain the indemnity of the trust by the donor against the liability encum-

bering the property, and provide a mechanism for making decisions concerning management and sale of the property held as co-tenants. While this process is somewhat cumbersome, it will allow a transaction to proceed to sale and to the elimination of most of the capital gain tax that would otherwise be lost.

In summary, CRTs provide a unique opportunity to provide significant cash flow, and income estate tax savings to the donor. However, as each individual

has unique financial objectives, risk tolerances, and family goals, care must be taken in handling the details of establishing and funding these types of trusts. Many clients are living longer and may need to generate substantial cash flows for long periods of time. Planners must assist clients who are considering CRTs to make wise, long term choices in the payout rate, investment choices, and all the other variables that go into establishing a CRT. ■