Advisor's Quarterly

Resources for Donors

Choosing a Payout Rate for Your Charitable Remainder Unitrust

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When thinking about establishing a standard charitable remainder unitrust, donors and their advisors naturally focus on the income tax charitable deduction, the opportunity to avoid capital gains tax on the sale of appreciated property, and the initial payment the donors will receive from the trust. Often, less attention is given to the longer-term effects of the choice of unitrust payout rate. This is unfortunate, since the payout rate decision:

- is irrevocable,
- is the most important determinant of the trust's value to its income and remainder beneficiaries, and
- determines the pattern of the payment stream from the trust over time.

One of the most common misconceptions regarding the payout rate decision is that a higher payout rate will significantly increase the benefit to the income beneficiaries. While this tends to be true for beneficiaries over age 75, increasing the payout rate will provide comparatively little benefit to beneficiaries who are in their 60s or younger. The best way to illustrate these concepts is by example.

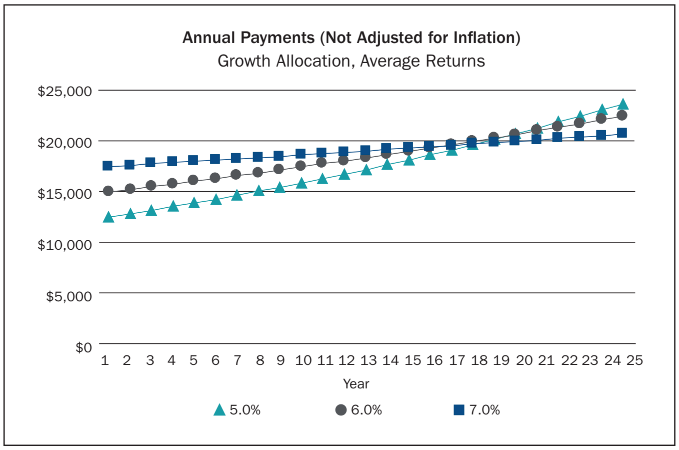
Assume that Mr. and Mrs. Smith, both age 70, would like to establish a $250,000 standard charitable remainder unitrust, receiving lifetime income in return and naming their favorite charity as trustee and remainderman. According to the 2012 IAR table, the Smiths have a joint life expectancy of about 25 years. They are considering a payout rate in the 5% to 7% range. The charity trustee expects to invest the trust in a growth-oriented portfolio with an expected annual total return, net of fees, of 7.7%. The general inflation rate is assumed to be 3.25% per year, while the charity expects to experience an additional inflation premium of 1.5%, bringing its inflation rate to 4.75%. (This is consistent with the higher inflation rates historically experienced by educational institutions and other charities.) Finally, the Smiths are in the 24% federal income tax bracket, and live in a state with a 5% income tax.

Lower Payout Rates Help Preserve Purchasing Power

It is important first to understand that unitrust payments are dependent upon the market value of the trust as revalued each year, typically on January 1. When the market value of the trust grows, the payments grow. Conversely, when the market value of the unitrust declines, the payments decline. For example, if a 5% payout trust has a valuation of $100,000 on January 1, the payments that year will total $5,000. If the valuation the following January 1 is $102,000, the distribution for the next succeeding year will be $5,100.

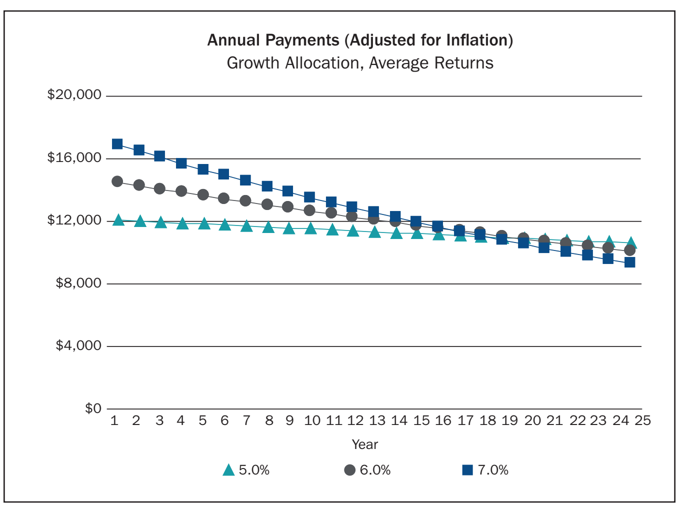
Chart A illustrates the projected payments from a 5%, 6%, and 7% unitrust over the anticipated 25-year horizon of the Smiths' trust. The payment stream from the 7% trust starts at a higher level than the other trusts, but does not grow as fast over time. This is because a higher payout leaves less of the investment return inside the trust where it can compound tax-free. Notice that the payment streams cross over at about year 18. In the later years of the trust, for example, the 5% trust would make larger dollar payments to the Smiths than would the 7% trust. This could be important to the Smiths in later retirement years when their expenses may be higher and/or their retirement plan assets have been drawn down.

Chart A



Of course, the value of any type of payment stream is most accurately measured in terms of purchasing power. Chart B takes these same payment streams from the 5%, 6%, and 7% trusts and adjusts them for inflation. The result is a considerably different picture. Again the payments from the 7% trust begin at a higher level, but they also decline at the most rapid rate. Every year the Smiths would be able to buy fewer goods and services with the payments from their trust. The 6% payment stream declines less rapidly. Even the 5% trust, which uses the lowest possible payment rate, is not able to grow in purchasing power. It does decline the least, however, and at the end provides the highest inflation-adjusted payment.

Chart B

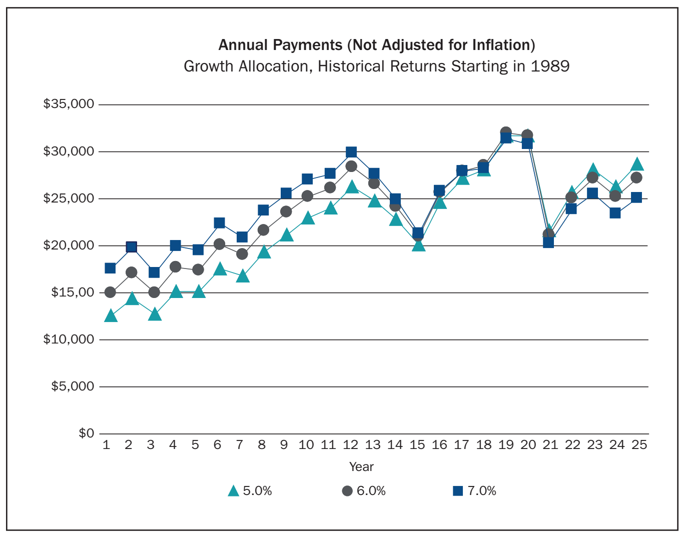


In the Real World Payments Go Up and Down

When illustrating the differing payment streams from unitrusts, we often use long-term average investment returns. When a trust has a long horizon, say of 25 to 30 years, there is a high probability that the trust will experience an average return over the entire period that is close to the expected return, in this case, 7.7%. But over shorter periods of time, returns can fluctuate widely around that expected number.

Chart C illustrates this phenomenon by substituting for the long-term average investment return the actual investment returns experienced by this same growth-oriented portfolio in the marketplace beginning in 1989. Here again, the 7% payment stream starts out higher, and the 5% and 6% payment streams begin to outpace it starting about year 18. No trust is likely to produce the smooth, gently upward-sloping lines that are depicted in Chart A. Instead, trust payment streams go up and down with the investment markets as depicted in Chart C.

Chart C



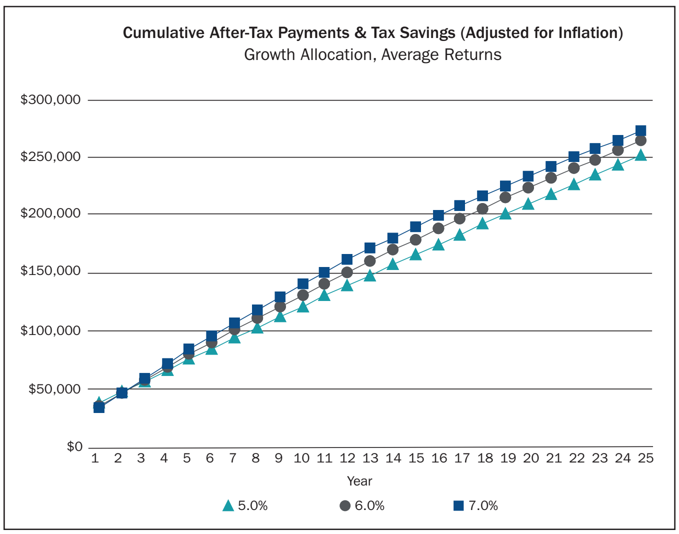
Lower Payout Rates and Total Benefits to the Donor

In addition to examining how the payout rate decision affects the pattern of payments over time, donors should evaluate its impact on the total benefits they will receive. These benefits include the value of the stream of anticipated payments and the value of tax savings derived from the income tax charitable deduction. To arrive at an accurate comparison, we need to adjust for income taxes to be paid on the payments, and for inflation.

The evaluation for the Smiths is depicted in Chart D. Each data point in the chart represents the cumulative value in today's dollars of all after-tax payments received up to and including that particular year, plus the income tax savings generated at the time of the gift. For example, over the course of the entire 25-year expected horizon of the 5% trust, the Smiths expect to receive total benefits of $252,700 in today's dollars. If the Smiths were to select a 7% trust, the total value of the tax savings and after-tax payments they are estimated to receive would be about $273,800 in today's dollars, or about 8% more.

Why is there so little difference between the three lines in Chart D? One reason is that lower payout rates generate higher charitable deductions, and therefore save more tax dollars than the deductions generated by higher payout rate trusts. This "boosts" the starting point of the 5% line as compared, for example, to the 7% line. A second reason was discussed earlier; namely that the payments from lower payout rate trusts better maintain their value over time.

Chart D



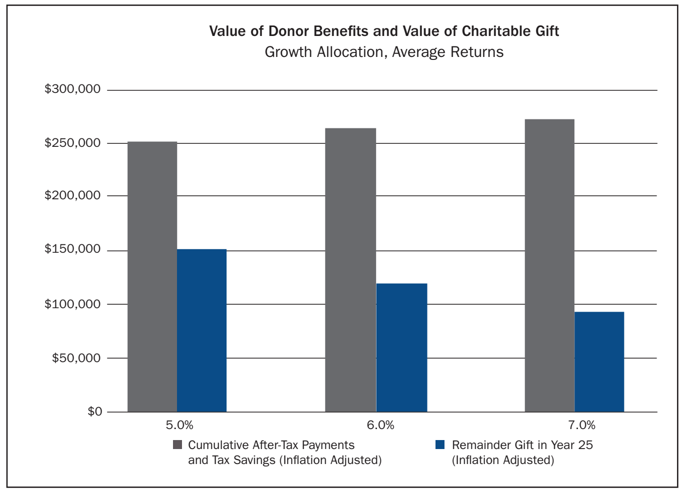
Lower Payout Rates Leverage the Gift

This brings us to one final and important factor to consider when selecting a unitrust payout rate: the impact upon the value of the gift to charity. Chart E juxtaposes the value of the trust benefits to the Smiths with the value of the benefits to their favorite charity, and illustrates how lower payout rates leverage the charitable gift.

The gray bars in Chart E represent, in today's dollars, the value of the tax savings and after-tax payments the Smiths are estimated to receive over the life of the trust. The blue bars represent, in today's dollars, the value of the remainder gift to charity.

Looking closely, you will notice that changing the unitrust payout rate from 5% to 6% to 7% makes less of a difference in the height of the gray bars than in the height of the blue bars. More specifically, if the Smiths choose a 5% trust instead of a 7% unitrust, the total value of their benefits will fall from about $273,800 to $252,700, a drop of about 8%. But if they select the 5% rate, they will improve the trust remainder value from $93,000 to $152,000, a dramatic 63% increase in the value of their gift to their favorite charity. This is powerful leverage indeed!

Chart E



Summary

Charitable remainder unitrusts are typically considered to be the preferred life income gift for younger donors because the payments have the opportunity to grow over time. To achieve the full benefits of this arrangement, these donors should seriously consider selecting a lower payout rate. This decision can dramatically enhance their gift to charity without diminishing significantly the value of the benefits they will receive from the trust. ■