

Designing a Winning Investment Strategy for CRTs

By Jeffrey L. Shields

Advisors have long focused their creative energies on planning techniques using charitable remainder trusts (CRTs), but there is often a disconnect between the planning process and plan implementation. As CRT planning becomes more complex and client specific, the importance of connecting the two becomes greater. One important factor in successful implementation is designing an investment strategy that is in concert with the CRT document. This article discusses three steps which advisors should take to design an effective investment strategy for clients with CRTs.

CREATE AN INVESTMENT POLICY STATEMENT

An advisor should have a conversation with a trustee about the planning objectives that were originally integrated into the CRT. For example, an advisor who created a unitrust with the flip feature may want to explain to the trustee about how the feature works and its purpose. An advisor may also want to explain the prudent investor act to the trustee, including discussing the balance a trustee must continue to strike between the charitable and non-charitable beneficiaries. This will help a trustee create an investment policy statement that both outlines the CRT's goals and objectives and addresses the following:

- What type of trust (annuity or unitrust)?
- What is the unitrust or annuity percentage or amount?
- Is it a standard or net income unitrust?
- Are there any other unique characteristics of the trust?

- Are there income tax issues for the non-charitable beneficiary (beneficiaries)?
- What is the investment horizon for the trust (life expectancy, term of years, etc.)?
- What rate of inflation should be assumed on a forward basis?

A trustee will want to include investment performance benchmarks in the policy statement and require at least an annual performance review. Trustees should be encouraged to use the benchmarks to evaluate trust performance. The investment policy statement may describe the types of investments that prove problematic to a CRT such as debt-financed income and unrelated business taxable income. If a trustee retains an investment management firm it will be important that the portfolio manager understands all of these issues and feels comfortable managing to these issues.

CONSTRUCT THE PORTFOLIO

A CRT investment policy statement will provide a starting point for portfolio construction. The first step in portfolio construction is asset allocation. There are several issues that a trustee should consider:

Target Return Assumption: A CRT that requires a 12% annual payment may require a different asset allocation than a CRT with a 5% annual payment. It is important that the trustee consider a target return that includes an inflation assumption.

Diversification: All investment strategies assume some level of risk. Diversification is used to reduce



overall risk in the portfolio to achieve a less volatile investment return.

Fixed Income and Equities: The appropriate mix will depend upon a CRT's payment amount and time horizon. Fixed income helps reduce overall portfolio volatility while providing cash flow. Historically, stocks have provided growth.

Many CRTs will utilize mutual funds, common trust funds, or separate accounts within a variable annuity contract for investment purposes. Smaller CRTs often rely on vehicles like these to provide a trust with adequate diversification. A larger CRT will generally hold individual stocks and bonds, but may use a mutual fund to gain exposure to a specific investment discipline, such as international equities. Expenses should be considered in any assumptions used for future returns.

EVALUATE TAX CONSIDERATIONS

Advisors are often well-versed in the four-tier taxation system, but many trustees and financial advisors do not understand the effect this system has on the distributions to non-charitable income beneficiaries.

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- Tier One: Ordinary Income from Investment Activities (dividends, interest, and short-term capital gain)
- Tier Two: Long-Term Capital Gain
- Tier Three: Other Income (tax free income)
- Tier Four: Return of Principal

A CRT will assume a client's cost basis and holding period of the contributed property, but it will pay no tax on the income realized at the CRT entity level (unless there is UBTI). The income taxation is passed through to the non-charitable income beneficiaries who receive payments. The characteristics of these payments depend on the type of income realized by the CRT. Non-charitable beneficiaries would prefer to receive capital gains income if they are in the higher tax brackets.

In many states, it is possible for a CRT document to define income to include realized capital gain. An advisor should discuss how the trust is constructed in order to help the trustee manage to those expectations from a tax perspective.

Most trustees of CRTs would benefit from advisors spending more time helping them to connect the planning elements of the CRT to the implementation process. If advisors and trustees pay careful attention to the investment strategy issues above, their clients are much more likely to realize the many benefits CRTs provide.

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CRTs AT COMMUNITY FOUNDATIONS

The East Bay Community Foundation has worked with a number of donors who have established Charitable Remainder Trusts (CRTs). A popular strategy is to establish a charitable fund at the Foundation as the remainder beneficiary of a CRT. By doing so, donors receive the following benefits:

expertise

Donors gain access to the broad array of philanthropic services at the Foundation. They can take advantage of this access to inform their current as well as their future giving.

flexibility

Donors can modify their fund agreement at any time without cost. If their charitable interests change, they can revise their fund agreement.

security

Donors do not have to worry about what would happen if a charity in their fund agreement ceases to exist at some time in the future. The Foundation would find funding opportunities which met the donor's charitable interests.

For more information about CRTs and Community Foundations, please contact Virginia Hooper or Chris Nicholson at 510.836.3223.

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