

CHOOSING A GIFT TYPE

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When creating a life income gift, donors should carefully consider the long-term implications of selecting a standard unitrust with fluctuating payments versus an annuity trust or gift annuity with fixed payments. However, donors are often so focused on the tax consequences of the gift and what the initial income will be that they do not consider the long-term consequences of this choice. This article describes a hypothetical situation of a planned giving officer talking to two donors about the trade-offs between a gift annuity and a standard unitrust. In the process, the gift planner endeavors to disclose key investment risks and educate the donors about the implications of their choice.

Annuity Payments and Inflation

Jim and Diane are both 67 years old and retired. They meet with Carrie, a gift planner at Charity, ready to fund a 5.5% charitable gift annuity with approximately \$182,000 in appreciated stock. Their older friends, Harry and Olive, recently set up a gift annuity and were extolling the many benefits of their gift at a Charity event. Jim and Diane find the prospect of a set amount of money arriving in their bank account each quarter particularly appealing during these rocky economic times.

Chart A

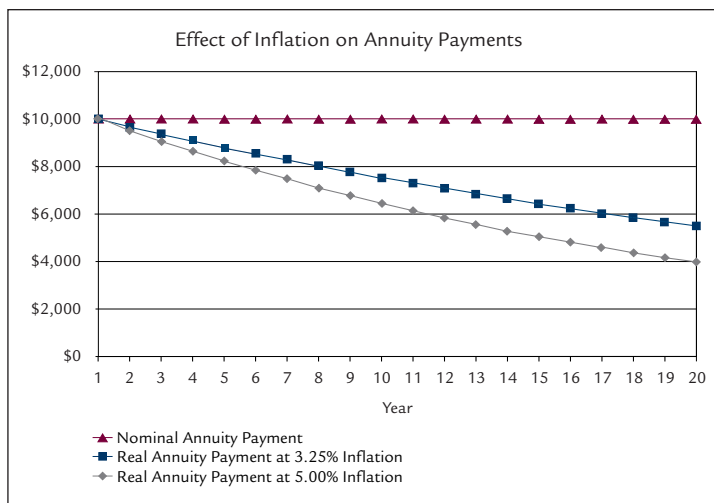
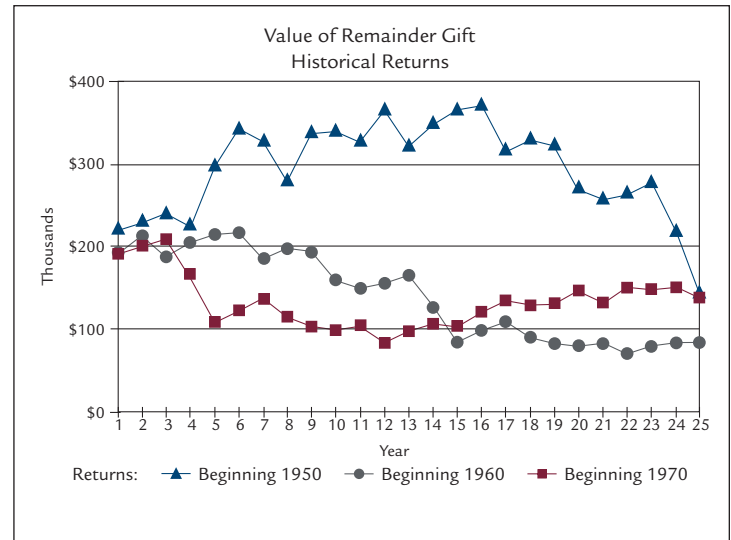


Chart B



Carrie realizes that Jim and Diane are relatively young donors. She consults the Annuity 2000 Life Expectancy Tables and discovers that their joint life expectancy is indeed quite long at 25.3 years. In her next meeting with Jim and Diane, Carrie shares with them Chart A. She points out that the horizontal burgundy line in the chart represents the approximate \$10,000 in gift annuity payments they would receive each year. She reminds them that the line does not, however, represent the amount of the goods and services the payments will purchase each year. Due to inflation, the purchasing power of the annuity payments will diminish over time.

Carrie explains how the blue line represents the purchasing power of their annuity payments if we experience an annual inflation rate of 3.25%, the long-term historical average inflation rate as measured by the Consumer Price Index. She points out that the gray line represents the purchasing power of the payments if we experience a somewhat higher 5.0% annual inflation rate over the period. She concludes by saying, "At the end of 20 years, if inflation averages 3.25%, your payments will buy only a little over 50% of the goods and services they bought in Year 1. If inflation averages 5.0% per year, you will be able to buy only about 40% as much as in Year 1."

Jim and Diane are quite pleased that Carrie has characterized them as young. But Diane, perhaps realizing that she is likely to outlive Jim and be the annuitant who experiences the greatest loss in purchasing power asks Carrie, "Is there anything we can do to offset the effects of inflation?"

Payments with the Potential to Grow

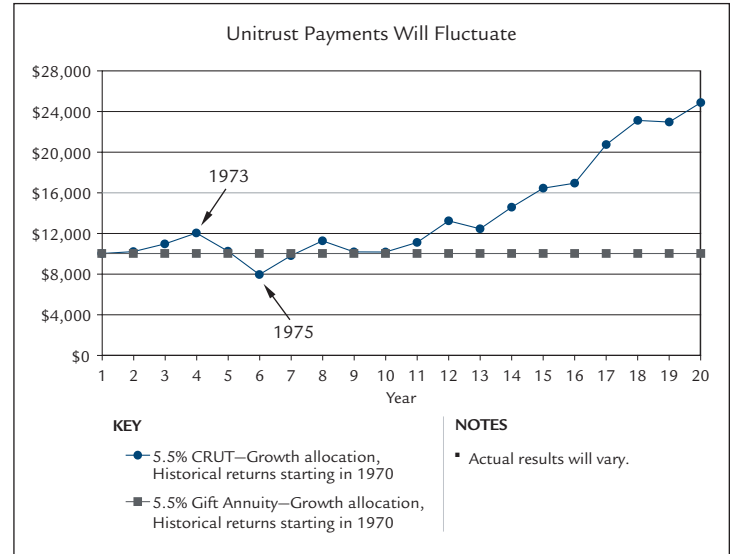
Carrie was prepared for this question. She shares with Jim and Diane Chart B, an illustration from her planned giving calculation software showing the payments from a 5.5% standard charitable remainder unitrust compared to a 5.5% gift annuity. The illustration assumes an annual investment return of 8.2%, a return estimate provided to her by her Treasurer and based on a balanced portfolio of 70% stocks and 30% bonds. She explains to Jim and Diane that, over the long term, the market value of the unitrust is likely to grow. She describes how unitrust payments are calculated each year by multiplying the payout rate (in this case 5.5%) by the market value of the trust at the start of the year. If the market value grows, then the trust payments will also grow, thus helping to offset the effects of inflation.

Noticing that the line in Carrie's unitrust illustration slopes gently upward to the right and never goes down, Jim asks, "Why would anyone not want an income that grows year after year?" Carrie realizes she must be clear about the risks of a unitrust—markets do not always go up and, from year to year, results can be quite volatile. She shares with Jim and Diane Chart C which shows the hypothetical annual payments of a 5.5% unitrust from 1970 to 1989. The ups and downs of the investment markets, she explains, will be reflected in a fluctuating market value of the unitrust, which in turn will result in payments that go up and down from year to year, as shown by the blue line. Jim and Diane both frown when they see the significant decline in payments that would have occurred had their unitrust been in existence during the 1973-74 bear market. Carrie reminds Jim and Diane that if they decide to establish a unitrust, their decision is irrevocable and that once the trust is signed, they cannot change how the payments are calculated.

What Returns Can Be Expected?

Not wanting to end on a sour note, Carrie quickly reminds Jim and Diane that they have the benefit of a long time horizon on their side. She states that while no one can know for sure what future returns will be, over the long term, stocks have increased in value despite their ups and downs. Diane does not know quite what to think. Looking at Carrie, she asks "If we choose a unitrust, what kind of returns can we expect?"

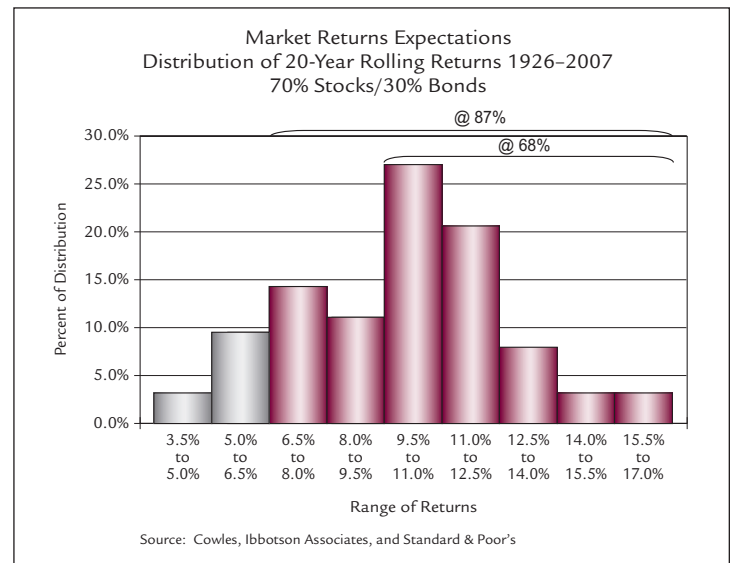
Chart C



Reaching into her folio once again, Carrie pulls out Chart D and says, "This chart summarizes investment returns on a hypothetical portfolio of 70% stocks and 30% bonds in all of the 20-year periods that have occurred since 1926. So, 1926-1945 is one 20-year period; 1927-1946 is another; 1928-1947 still another. There are a total of 63 20-year periods."

Carrie goes on to explain that the height of each bar represents the percentage of all the 20-year periods in which the annualized return was in the range noted at the bottom of the bar. So, for example, in about 10% of the 20-year periods, the annualized returns from the portfolio were between 5.0% and 6.5% (the second bar from the left). Diane is very observant and notices that

Chart D



in about 87% of all the 20-year periods, the annualized return was 6.5% or greater (the bars shaded in burgundy). "That's right," says Carrie, "and in about 13% of the outcomes, the annualized returns were 6.5% or less, as indicated by the gray shaded bars."

Carrie summarizes that if Jim and Diane decide they like the unitrust and choose a 5.5% payout rate, and if historical returns are a reliable guide, then they have a reasonable opportunity for nominal growth in their unitrust payments over their anticipated 20-plus year joint life expectancy. Annualized returns in excess of the payout rate and fees charged to the trust can be reinvested, enabling the trust to grow. However, for their payments to have a better chance of keeping pace with inflation, the trust will have to earn closer to 9.5% or more per year (the sum of the payout rate plus inflation and any fees charged to the trust), which has occurred in about two-thirds of the 20-year periods shown.

She reminds them again that they must be prepared for market volatility and payment volatility along the way. And she tells them that past market performance is not necessarily an indicator of future returns. Jim and Diane thank Carrie for her help and indicate that they would like to think over these points and consult with their financial advisor. Carrie leaves them with copies of the illustrations they discussed as well as written disclosure materials.

Educating Donors

There is, of course, no way for us to know how markets will perform and which gift type will prove to be the best for Jim and Diane. The important point to emphasize is that the choice of gift type involves trading off fundamental investment risks that are common to all investment portfolios, in this case, market volatility versus inflation. These very same risks apply to retirement accounts and personal assets.

The donors' friends, Harry and Olive, are each age 81 so the gift annuity was an appropriate vehicle for them. The erosion in the purchasing power of their payments will likely be relatively small due to the shorter gift horizon. Accepting this slight erosion was a reasonable trade-off in exchange for fixed payments.

In contrast, if Jim and Diane were to select a gift annuity, the significant loss in the purchasing power of their payments due to their longer horizon might be too steep a

price to pay for eliminating payment volatility. Jim and Diane should seriously consider accepting the fluctuations in their annual unitrust payments since it provides them with the opportunity for growth in their payments over time.

Obviously, gift planners will not have these types of in-depth conversations with every donor. It is most impor-

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tant to have these discussions when donors are contemplating seemingly illogical gifts (very young donors who want to establish gift annuities or people in their 80s and 90s who want to establish standard unitrusts), when gift sizes are very large, and when donors are uncertain about which gift type to choose. The irrevocability of the gift type decision justifies the time and effort gift planners put into this donor education. Gift planners best serve their charities and their donors when they provide accurate information and fully disclose risks to their donors.

Please note that exhibits similar to Charts A and D are included in standard Kaspick & Company disclosure statements available on our Web site. You can also use our Web-based Gift Advisor software to illustrate these trade-offs and to create Charts B and C. Please contact your Relationship Manager if you would like assistance in thinking through how best to educate donors and disclose key investment risks. ■