Development of Charitable Trusts in the United States

Chien-Chung Huang, Silai Yi, Shuang Lu, Jacqulean Salib, and Di Sun
Charitable Trusts? Foundation?

- A charitable trust holds and manages the finances for a donor and distributes the funds as they see fit to the organization the donor chooses.

- A foundation is a nongovernmental entity with a principal purpose of making grants to unrelated organizations or individuals for scientific, educational, cultural, religious, or other charitable purposes.

- Charitable trusts are one type of private foundations, and private foundations can be structured as a charitable trust.

- Charitable Split-Interest Trust: financial interest from the trust is split between a charity and a non-charity, usually donor’s heirs.

- Two types: Lead and Remainder
Charitable Lead Trust (CLT)

- A CLT is a trust that pays a fixed annuity or unitrust amount to a charitable organization for a certain amount of years (tax deductible).
  Upon terminations of the payments, the remainder interest is transferred to a noncharitable beneficiary (not tax deductible).

<table>
<thead>
<tr>
<th>Fixed</th>
<th>Unitrusts</th>
</tr>
</thead>
<tbody>
<tr>
<td>At least 5% of the fair market value (FMV) of the initial trust assets</td>
<td>At least 5% of the FMV of trust assets</td>
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</table>

Process of CLT

- The donor makes arrangements for the disposition of the estate, but defers the time when the beneficiary can actually take control of property.

- In the interim, the charity receives ongoing benefit from the trust.

- When terminations of the payments, the assets pass to the beneficiary, they are not subjected to federal estate tax.
CLT: How it Works

Source: http://deserettrust.com/charitableleadtrust.html
## Advantages and Disadvantages of a CLT

### Advantages

- When the assets have a high potential for appreciation in the future.
- Well suited for donors whose heirs are still young and not capable of assuming control of a substantial amount of assets.
- Allows the heirs to bypass federal estate tax
- Provides charity with immediate support

### Disadvantages

- Donor cannot claim an income tax deduction on the contributions made to the trust.
- May have to pay a gift tax on those contributions that are earmarked for the beneficiary.
Charitable Remainder Trust (CRT)

- A CRT is the exact *opposite* of the CLT.
- A CRT provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for a term of years, with an irrevocable remainder interest to be held for the benefit of charity.
- First pay the beneficiary before permanently being awarded to the charity.
CRT: How it Works

Source: http://www.ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/charitable-remainder-annuity-1.html
Charitable Remainder Trust (CRT)

- **CR Annuity Trust**: The amount distributed each year must be set at least 5% of the initial FMV of the trust assets.

- **CR Unitrust**: the amount received equal to at least 5% of the FMV of the trust assets determined each year at a specified rate.

- **Tax-exempt trust**: the assets in CRT will be ultimately given to the charity free of tax, including estate and gift tax, however, any income received by your non-charitable beneficiaries is taxable.
Five Percent Payout Rule

- Required by federal tax law
- Required to distribute 5% of investment assets each year for charitable purposes
- If not distribute the required amount, it is subject to an initial penalty equal to 30% of the shortfall. It must also distribute the shortfall or be subject to a penalty equal to 200% of the shortfall
- Ensures fulfilling of the mission of the organization
Development of Charitable Trusts in the US

- **1954: Uniform Supervision of Trustees for Charitable Purpose Act:** Established a division for the recording of charitable trusts in the attorney general’s office.
- **1972: Uniform Management of Institutional Funds Act:** Set investment standards of conduct for governing boards of nonprofit organizations.
- **1992: Restatement of the Law of Trust: Prudent Investor Rule:** Trustee should consider the purposes, terms, distribution requirements of the trust. Trustee must use reasonable care, skill and caution. Risk management is required.
- **1995: Uniform Prudent Investor Act:** Uses up to date “investment principles” using the Modern Portfolio Theory, maximizes expected return based on the market risk.
- **1997: Uniform Principle and Income Act:** Provides procedures for trustees and allows more flexibility in allocating investment returns between the income for beneficiaries and remainder beneficiaries to ensure that the intention of the trust creator is the guiding principle for trustees.
- **2006: The Uniform Prudent Management of Institutional Funds Act:** Replaces the Uniform Management of Institutional Funds Act in 1972 by updating the prudence standard that applies to the management and investment of charitable funds.

*Development of legislations and regulations overtime improves accountability of charitable trusts*
Modern Portfolio Theory (MPT)

- Investment is a tradeoff between risk and expected return. Overall, assets with higher expected returns are riskier.

- Assumes that investors are rational and markets are efficient.

- MPT is a theory of finance, attempts to maximize portfolio expected return for a given amount of portfolio risk, or minimize risk for a given level of expected return, by carefully choosing the proportions of various assets.

- **Fundamental concept**: the assets in an investment portfolio should not be selected individually. Rather, consider how each asset changes in price relative to how every other asset in the portfolio changes in price.

- **Diversification**: Investors can reduce exposure to individual asset risk by holding a diversified portfolio. It may allow for the same portfolio expected return with reduced risk.
Modern Portfolio Theory (MPT)

### Benefit vs. Risk of Charitable Trusts

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Risks</th>
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<td>♦ Increased returns.</td>
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Case Study

Bill & Melinda Gates Foundation and Bill & Melinda Gates Trust

History

- **1994:** William H. Gates Foundation, with initial stock gift of US$94 million
- **1999:** renamed the Bill & Melinda Gates Foundation
- **October, 2006:** *Two-entity structure.* The Bill & Melinda Gates Foundation (the foundation) and the Bill & Melinda Gates Foundation Trust (the trust).
  - The *foundation* distributes money to grantees while the *trust* manages the endowment assets.
  - **Foundation:** works to reduce inequities around the world.
  - **Trust:** manages investments and transfer proceeds to the foundation as necessary to achieve the foundation’s charitable goals.
- Both entities are *tax-exempt private foundations* that are structured as a *charitable trust.*
- In 2012, the Foundation had assets of $36 billion, operated programs in more than 100 countries and regions.
The Trust Financial Statement

2006-2011

% of grants by year
The Trust Financial Statement Cont.

2006-2011: Total Return (%)

2006-2011: % of return by year
**Impacts & Implications**

- The integration of the Foundation and the Trust enabled Gates Foundation to expand its scale of assets and scope of services.

- The dual-entity system lead to a more effective management approach of the endowment, and contributed to collaborations between the foundation and its donors.

- Efficient financial management helps to secure financial stability and sustainability.

- By entrusting money to an independent entity, charitable trust helps to ensure organizational accountability.

- Ultimately, charitable trust helps to enhance individual or organizational donors’ financial capacity in fulfilling their mission and vision.
Resources


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