
CLIFFORD ASSOCIATES

INVESTMENT COUNSELORS SINCE 1915

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TRUSTEE DUTIES

The trustee of a charitable remainder trust assumes certain duties and responsibilities under local and federal law, IRS rules and regulations, and the trust agreement itself. These duties encompass two basic areas, investment and administration. The trustee is responsible to various government agencies such as the State Attorney General, state taxing authority, and Internal Revenue Service. In addition, the trustee is responsible to the income beneficiaries (*income interest*) and those who will receive the trust assets remaining when the trust terminates (*remainder interest*).

Investment Responsibilities

The trust assets must be invested in a manner that balances both the *income interest* and the *remainder interest*. The first step in this process is to determine an appropriate asset mix by taking into consideration several factors including (1) the type of trust, (2) the expected duration of the trust, (3) the risk tolerance of those holding the *income* and *remainder interests*, and (4) the required or expected beneficiary distributions. Once the target asset mix is determined, investments are selected for each asset class. When making the investment selections, the trustee is often subjected under state law to the *prudent investor rule*. (Please see our Summer 1997 issue for a discussion of the Prudent Investor Rule.)

Administrative Duties

This article will focus on the trustee's administrative duties and responsibilities. The trustee may be required under local law to register the charitable remainder trust which often involves the mailing of a *registration statement*, copy of the trust document, and registration fee to a local government agency such as a county district court within a short time after the trust is created. On an ongoing basis, the trustee's administrative responsibilities include (1) beneficiary distributions, (2) financial reporting, and (3) tax reporting.

Beneficiary Distributions

The trustee must insure that the beneficiary is paid the correct amount at the appropriate time. The amount of the distribution, or the manner by which the amount is calculated, is specified by the trust agreement. The amount may be fixed for the life of the trust, as in an *annuity trust*, or change each year based on periodic valuations of the trust assets, as in a *unitrust*. Additionally, in the case of a *net income unitrust*, the amount distributed depends not only on periodic valuations of the trust assets but also on the type and amount of income earned by the trust. In most cases the timing of the distributions is also specified by the trust agreement.

(Continued on page 2)

(“Trustee Duties” continued from page 1)

Unitrust assets must be valued at least annually. The date of this valuation is usually specified in the trust agreement as either a particular day such as January 1 or a descriptive term such as the first business day of each year. The unitrust percentage is applied to this valuation to determine the amount paid to the beneficiaries. An adjustment to the initial calculation is required when additional funds are contributed to the unitrust since the amount paid to the beneficiaries is increased based on the amount and timing of the contribution. The trust agreement should specify the method used to adjust the amount paid to the beneficiary due to additional post-valuation contributions and for the year in which the trust terminates.

Net income unitrusts present a special challenge since the amount paid to the beneficiaries depends not only on the periodic value of the trust assets and the unitrust percentage, but also on the *distributable income* earned by the trust each year. The first step is to define *distributable income*. The trustee must look not only to local law, which usually takes the form of a *principal and income act*, but also the trust document itself. Provisions in the trust document that do not materially depart from local law govern the determination of *distributable income*. The amount paid to the beneficiaries is the lesser of (1) the *distributable income* earned by the unitrust and (2) the amount determined by applying the periodic unitrust valuation to the unitrust percentage.

Once the required liquidity is obtained in light of the target asset mix, the payment can be wire-transferred directly into the beneficiary's bank account or a physical check can be prepared and mailed to the beneficiary. Electronic fund transfers (EFTs) are the most efficient method of distribution. EFTs eliminate the intermediate steps involved in transporting a physical check from the trustee or custodian to

the beneficiary and then from the beneficiary to the beneficiary's bank. On the other hand, the mailing of a physical check allows the trustee an opportunity to correspond with the beneficiary.

Financial Reporting

Reports of the trust's activity and asset values must be prepared for the charities holding a *remainder interest* and those individuals holding an *income interest* in the trust. The trust agreement will often specify the frequency and nature of the required reporting. At a minimum, annual reporting will probably be required but it is not unusual to see quarterly reporting requirements. Charitable institutions that serve as trustee have special reporting needs. These organizations have reporting responsibilities to their governing board, donors, and accounting, treasury, and development offices.

An *executive summary* is often most appropriate for reporting to a governing board and chief executive officer. At a minimum, the *executive summary* should inform the reader as to (1) the value of the planned giving assets and how they are invested, (2) the types and number of trusts held, and (3) a summary of the activity incurred by all trusts combined. In addition, an analysis of the trust's investment performance should be rendered. This report should be limited to only a few pages.

More detailed information is needed by the charity's accounting, treasury, and development offices. This information includes, for each trust, (1) the beginning and ending accounting cost and market value, (2) the activity incurred during the reporting period, (3) the historical gift value, (4) the amount paid to the beneficiary, and (5) the trust's expected duration.

FASB 116 & 117 require that charities reflect the present value of irrevocable *remainder interests* in a charitable remainder trust as a fund balance on their *Statement of Financial Position* (balance sheet). In addition, charities serving as trustee of a charitable remainder trust must record the present value of the future beneficiary distributions as a liability on their *Statement of Financial Position*. These calculations require estimates of future returns on investment and actuarial computations when the trust's duration depends on a life.

At least annually, beneficiaries and donors should be informed of the trust's market value, how the trust is invested, and the activity incurred by the trust since the last report. Additionally, since the amount distributed from a unitrust changes each year, reporting is required to explain the amount paid to the beneficiary. These reports should show each trust valuation and the amount paid to the beneficiary as calculated by the application of the unitrust percentage. In the case of a net income unitrust, an additional calculation is required that compares the actual income earned by the trust (as defined by the trust agreement or local law) to the maximum payable which may include a makeup carry-over from the prior year.

Tax Reporting

Trustees must file information returns using federal forms 5227 (*Split-Interest Information Return*) and 1041-A (*U.S. Information Return Trust Accumulation of Charitable Amounts*) for each charitable remainder trust by April 15 unless an extension is granted. In addition, some states have their own information returns that must be completed by the trustee. These information returns generally (1) report on the change in the cost basis and the yearend value of the trust assets, (2) ask a

series of questions investigating possible violations of restrictions against *self-dealing*, *lobbying expenditures*, and *unrelated business income*, and (3) identify the beneficiaries, the amount distributed to them, and how the distributions were characterized.

Each year the beneficiaries must be informed of how to report, on their personal income tax return, the payments they received from the trust. The character of the amounts paid to the income beneficiaries by a charitable remainder trust, as reported on the beneficiary's income tax return, is based on a *4-tier system* that includes ordinary income, short-term and long-term realized gains on sales, nontaxable income, and trust principal. (Please see our Summer 1998 issue for a discussion of the 4-tier system.) The trustee must report this information to the beneficiary using federal schedule K-1, form 1041 (*Beneficiary's Share of Income, Deductions, Credits, etc.*) and, in some cases, the state equivalent of this federal schedule.

The Clifford Solution

Clifford Associates has developed a comprehensive approach to satisfying these trustee duties and responsibilities. We offer a program integrating the investment and administrative aspects into a cohesive plan addressing the unique circumstances of each particular charitable remainder trust and trustee. Our experience in this area has taught us that the investment and administrative functions are interrelated and dependent upon each other.

As third-party administrator, we perform the required duties for the trustee. If a trustee is needed, we can arrange for a trustee of record for whom we will act as agent. In either situation, the investment and administrative functions are coordinated through one effort.

Ken Dike

Trading 'Round the Clock

Valuing securities is a requirement assumed by the trustee, as described in this issue's companion article. In addition to the instances noted, valuations are necessary at the time of charitable gifting, as well as for estate valuations. Historically, a copy of the *Wall Street Journal* for the day in question was all that was required. One simply looked up the security on its exchange and averaged the high and low prices of the day or used alternative conventions such as the average of the opening and closing prices, or simply the closing price.

Now we are encountering a significant shift in methodology caused by increasing competition among markets and the globalization of trading activities. Linkage of national markets around the world means that trading will never end—soon some market will be active in the world continuously.

Both the NASDAQ and the New York Stock Exchange (NYSE) have already agreed to extend trading beyond the traditional closing. We assume that foreign exchanges will follow their example. Although a final decision has not yet been made as to the exact hours of operation, the NYSE recently told us that their chairman, Richard Grasso, is proposing an early morning session for the exchange, from 5:00 a.m. to 9:00 a.m., New York time. The exchange would then close for 1/2 hour, reopening from 9:30 a.m. until 4:00 p.m., its current trading hours. Trading would resume at 5:00 p.m. and continue until midnight!

The NYSE may take the first steps toward these extended hours as early as July 2000. In a few months—not years—we will *not* have a traditional closing price to which we peg our valuations. Mutual funds will face a serious dilemma in pricing each security held in its portfolio in order to give investors net asset values. This past summer, the NYSE and the NASD formed an Extended Hours Working Group to study and report on various effects of the proposed hours. Reports were issued in early October and have received praise from SEC Chairman Arthur Levitt.

As an organization offering investment advice and planned gift administration, Clifford has a critical interest in encouraging regulators to provide guidance. No one knows how this is going to play out. One thing seems certain, very soon the 4:00 p.m. EST price will no longer be the closing price. We will keep our clients advised of developments in this crucial area.

Jim Fox

Major Exchanges Trading Hours (Eastern Time)	
London Exchange	3:00 am to 11:30 am
NYSE	5:00 am to 9:00 am (proposed) 9:30 am to 4:00 pm 5:00 pm to 12:00 am (proposed)
Tokyo Exchange	7:00 pm to 1:00 a.m
The stocks of many U.S. companies trade on all of these exchanges (General Electric, for example).	

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