Payout from Life Income Trusts

Q: How is the payout to beneficiaries determined for charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds?

A: An annuity trust provides for payment of a fixed annual amount that never changes. A unitrust provides an annual distribution that varies each year, based on the value of the assets in the trust. Distributions from a pooled income fund also vary, depending on how much income is earned by the fund.

CHARITABLE REMAINDER ANNUITY TRUST		
Year	Value of Trust Assets at Beginning of Year	Annual Distribution
1	$200,000	$10,000
2	206,000	10,000
3	212,000	10,000
4	208,000	10,000

and so on…

Charitable Remainder Annuity Trusts. At the time the trust is created, you and the trustee will agree on the annual distribution. This is based on a specified percentage, which must be at least 5 percent of the value of the assets transferred to the trust. For example, if you establish a 5 percent annuity trust for yourself for life with securities worth $200,000, you will receive $10,000 each year for the rest of your life, as long as the trust has assets sufficient to make the payments.

(SEE REVERSE FOR ADDITIONAL TYPES OF TRUSTS.)

5% CHARITABLE REMAINDER UNITRUST (STANDARD)		
Year	Value of Trust Assets at Beginning of Year	Annual Distribution
1	$200,000 X 5%	$10,000
2	206,000 X 5%	10,300
3	212,000 X 5%	10,600
4	208,000 X 5%	10,400

and so on…

5% CHARITABLE REMAINDER UNITRUST (NET INCOME)			
Year	Value at Beginning of Year	Net Income at End of Year	Annual Distribution
1	$200,000	$16,000	$10,000
2	206,000	16,300	10,300
3	212,000	9,500	9,500
4	212,000	12,000	10,600

and so on…

Charitable Remainder Unitrusts (Standard). Your annual distribution will be a specified percentage—chosen by you at the time you make the gift—of the value of the trust assets measured on the same date each year. Most unitrusts administered by Stanford are valued annually on January 1. The percentage agreed upon must be at least 5 percent (and usually does not exceed 7 percent if Stanford is the trustee).

This produces a variable income that is paid out of trust income and, to the extent necessary, from gain on the sale of trust assets or the trust principal itself. The annual distribution will rise or fall, depending on the value of the trust assets. For example, if you transfer securities worth $200,000 into a 5 percent unitrust, your income will vary with the value of the trust investments, as illustrated in the table on the left.

Charitable Remainder Unitrusts (Net Income). This second type of unitrust is used in limited circumstances. The annual distribution to the income beneficiary is equal to the **lesser** of two amounts: (i) the standard unitrust amount described above (a percentage of the value of the trust assets revalued annually) or (ii) the actual net income earned by the trust assets. “Income” is essentially dividends, interest, and rent earned by the trust investments. If the investments do not earn enough income to cover the standard unitrust amount in any year, there is a shortfall for that year, and only the net income will be distributed. (See table at left.) Unlike a standard unitrust, profits from the sale of assets or the assets themselves cannot be used to make the unitrust distribution. The trust, however, can be drafted to direct the trustee to make up any shortfall in later years if the trust generates more income than the standard unitrust amount.

Charitable Remainder Unitrusts (Flip). Because standard unitrusts can be invested for total return, they are often able to grow more significantly and, over time, produce more income to the beneficiaries, than net income unitrusts. It is generally not advisable to fund a standard unitrust exclusively with illiquid assets (such as real estate). This is because if the trust has no liquidity, the trustee will be forced to distribute partial interests in the illiquid trust assets to the beneficiaries. Fortunately, federal tax regulations allow a unitrust to initially use the “net income” payout mechanism until most of the trust's illiquid assets are sold; then the trust will "flip" to a standard unitrust payout mechanism. Thus, a trustee may accept illiquid assets to fund a unitrust without concern for liquidity when making payments to the beneficiaries prior to sale of such assets. After sale of the assets, the trustee can “flip” to the standard unitrust payout mechanism and invest for total return.

The “flip” unitrust can also be effectively used to establish a trust for retirement purposes. The “flip” can be set to occur at a certain future date specified in the trust agreement when the beneficiary plans to retire. Prior to that date, the unitrust is invested for maximum growth and minimum income, then following the “flip”, the payout will be made according to the standard percentage method and may produce potentially much larger payouts based on a substantially larger principal value.

Pooled Income Funds. Your gift to either of Stanford's two pooled income funds purchases shares in the fund. All of the income earned by the fund is divided proportionately among the “shareholders.” Although the exact amount of the annual distribution cannot be known until the end of each year, Stanford makes estimated payments for the first three quarters. If the performance of the investment portfolio changes substantially either way as the year progresses, participants in the fund may receive more or less income than they expected.

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