► **Greycourt White Paper**

White Paper No. 3 – *Philanthropy in Estate Planning: Balancing Charity against Personal Spending Needs*

Background

Many wealthy clients have philanthropic goals, but few receive sufficient guidance regarding how best to balance these goals against personal spending needs. Deciding how to distribute wealth can be a complicated and often emotional process. As a result, investment advisors need to understand their clients' wealth-distribution preferences and must help quantify potential investment risks associated with different levels and forms of gifting. By helping identify who bears residual investment risk under varying gifting regimes, investment advisors can ensure that their clients' wealth is distributed in a way that fits their client's individual, family, and philanthropic ambitions.

Among the wealthy, philanthropy is rarely the primary conduit for the distribution of their wealth, but it is typically an important goal in their total wealth distribution plan. In order to advise their clients properly, investment advisors need to understand their clients' desired hierarchy of wealth distribution. The process for determining client preferences is fairly straightforward once the advisor recognizes that these preferences are influenced by both analytical and emotional factors. Once a hierarchy of desired wealth disposition has been identified, one critical step in establishing an effective investment strategy is determining who actually bears the risk of poor investment performance. This presentation describes a framework for assessing who bears the residual investment risk under different forms of philanthropic giving.

Discussion

Disposal of wealth

Truly wealthy individuals can dispose of their money in three ways—consumption, inheritance, and philanthropy. From the standpoint of the wealth holder, personal consumption is the most important of the three. As defined here, consumption is the purchase of non-durable goods & services that do not retain residual value. Over the years, I have worked with clients whose net worth have ranged from $1 million to many billions of dollars, and regardless of their wealth, they were concerned, first and foremost, about ensuring their ability to maintain their chosen lifestyle. In most cases, these individuals built their fortune through hard work and, as they grow older, want to ensure that they do not have to depend on their children for financial support. Of course, among the wealthy, just as among the general population, some individuals are extremely frugal despite the great wealth they have accumulated while others are somewhat more lavish, with consumption habits that can really take a bite out of their portfolios.

Inheritance is the second most common venue for the wealthy to dispose of their wealth, or at least it used to be.1 In the "good old" old days, parents would often ask, "How can I arrange leave more money to my kids so they will think better of me?" Today, that kind of thinking is not as prevalent. The wealthy now seem to be more engaged in philosophical soul searching, trying to sort out the implications of leaving wealth to children (even though such soul searching is, in many cases, often more lip service than reality).

Individuals can gift either during their lifetime or at death. Current tax law provides an exclusion from gift tax for annual gifts of up to $10,000 per individual recipient. (A married couple may gift $10,000 each for a total annual exclusion of $20,000 per individual recipient.) Even for substantially larger gifts that would be subject to the 55% gift tax, the most tax-efficient way to pass wealth to the next generation is to simply make outright gifts so that the wealth can be transferred to the next generation as soon as possible. However, despite the demonstrable advantages of such a strategy, few individuals are comfortable irrevocably transferring substantial sums of their wealth to the next generation well in advance of their own demise. A second, and less objectionable, means of transferring wealth is via bequest, the "I hold all my money until I die and then you get it" approach.

Even under this simple strategy, certain assets when gifted pose a challenge. Items such as homes, art and antiques that provide real or psychological benefits to the owner retain residual value that can be passed to the next generation. The problem with such assets is that they are relatively illiquid. When the wealth is transferred to the next generation, problems can arise in terms of generating sufficient liquidity for the recipient to pay the required estate taxes.

Philanthropy is typically third in the prioritization of the uses for an individual's wealth while the payment of taxes uniformly represents the least desired use of wealth. However, despite wealthy individuals' aversion to the payment of taxes, most agree that tax revenues do fund some useful services such as maintaining a nation's military and physical infrastructure and aiding the welfare of its citizens. Philanthropy serves an altogether different purpose from the payment of taxes. Philanthropy has been described as the support of institutions that enhance the richness (as opposed to the basic needs) of life.
In the final analysis, for exceedingly wealthy individuals where consumption represents only a small fraction of their overall assets, ultimate wealth disposition boils down to a choice between philanthropy and heirs.

Inheritance versus Philanthropy

Given the limited choices available in terms of wealth disposal, the next consideration is to examine what drives individuals to make the choices they do in allocating their wealth between family members and philanthropy.

Financial Security Needs. A sense of financial security is a key consideration in the decision-making process of wealth allocation. For example, investors who were raised during the great depression often have a heightened sensitivity to risk. If clients believe they might lose their wealth, they will be less likely to give money to others during their lifetime. The reasons for heightened risk aversion are not, however, always readily apparent. I once worked with a client

who should not have had much sensitivity to risk at all. This client was an unmarried 40-year-old bachelor. Although he was third-generation wealthy, worth hundreds of millions and had no living relatives, he was obsessively concerned about the prospect of losing his money and about the cost of fees and taxes. I could not figure out why. He could not possibly consume his wealth, but as I got to know him, the nature of his fear became clear. He had become addicted to the jet setting lifestyle that his wealth afforded him and realized that if his wealth was lost he had no marketable skills to fall back upon and was essentially unemployable.

Family Circumstances. Family circumstances are another important factor in wealth allocation. Whether or not a client is married or has children (as well as the financial independence of the children) can obviously influence a client's attitudes toward consumption, inheritance, and philanthropy.

Personal Philosophy. A very important consideration in wealth allocation is an individual's attitude toward the impact that transferring substantial wealth to succeeding generations can have on the lives of their heirs. Personal philosophies in this regard can be widely divergent. For example, some individuals believe that any inheritance beyond the provision of the basic, not luxury, security of heirs should be used for philanthropy. This sentiment was well expressed by an individual who stated that he sees no justification for self-respecting people to expect to survive on what their forebears have done and is not interested in endowing his children and grandchildren with the ability to live on Fifth Avenue or own a Rolls Royce. Clearly, for such an individual, philanthropy will play a major role in the ultimate disposal of his or her wealth.
A more typical philosophy of wealth disposition is often expressed by individuals who are motivated by the desire to leave large estates to their heirs so that succeeding generations will be able to do all the things they were never able to do.

Motives for Giving

Those who work with the wealthy know from experience that ensuring sufficient personal cash flow is the most important consideration for clients. A second priority is typically wealth transfer to heirs while wealth transfer through philanthropy is often the last priority. In the mid-1990s, an associate professor of sociology at Harvard, Francie Ostrower, interviewed 100 wealthy individuals in New York, people she refers to as "elites." She tried to segment their attitudes toward the transfer of wealth to philanthropy based on personal circumstances.
Table 1 summarizes Ostrower's results. The column on the left shows the average percentage of the portfolio these "elites" plan to transfer to charity during both their lifetimes and upon their deaths. The column on the right shows the percentage of wealth going to charity only upon death. Two types of family circumstances are represented, one in which children were present and one in which they were not. The distinction between the two family types is clear. Individuals having children were planning to transfer only one half to one third as much of their wealth to charities or philanthropic entities as were those who had no children.

Ostrower also segmented the population based on philosophical beliefs about inheritance. Those who associated negative consequences with inheritance planned on transferring an average 53 percent of their wealth to charity during both their lifetimes and at death, and those who associated positive consequences with inheritance planned on transferring a much smaller

amount to charity—10 percent during life and 18 percent upon death. Again, both family circumstances and philosophy have a great role in how the allocation decision plays out.

Residual Investment Risk

It is important for individuals who are charitably inclined to understand the impact that different methods and magnitudes of gifting may have on their remaining, non-charitable wealth. To illustrate this point, let's consider the case of a fictitious client named I.M. Generous, who has a portfolio of $100 million in cash.

I.M. Generous is not your Sam Walton type of millionaire. He needs a $2 million after-tax annual personal cash flow for the rest of his life, adjusted for inflation, which represents a lot of consumption. Despite his planned pattern of conspicuous consumption, he also would like to be generous to his children. At the end of his life, he wants to transfer $75 million (net of estate taxes) to his heirs. Beyond that amount he wants to transfer any excess wealth to charity.

Our first step is to develop a baseline case in which Mr. Generous makes no gifts during his lifetime, but upon his death he simply bequeaths $75 million (net of estate taxes) to his children and passes the remaining balance to charity. Now, clearly, this approach is the simplest form of giving, and it preserves the greatest degree of flexibility in wealth transfer from the standpoint of I.M. Generous.

Baseline scenario. In order to estimate the value of I.M. Generous' portfolio under the baseline scenario and thus the amount available for inheritance, look at Table 3. Starting with a portfolio of $100 million. Mr. Generous first withdraws his $2 million annual spending requirement. In 2001, the portfolio generates investment income of approximately $2.99 million, some taxable and some nontaxable. The portfolio also realizes price appreciation of approximately $4.5 million. Management fees of about $394,000 and income taxes of about $306,000 reduce the value of the portfolio. Additionally, the portfolio's active portfolio managers generate realized capital gains that result in the payment of $51,000 in short-term capital gains taxes and $149,000 in long-term capital gains taxes. At the end of Year 1 (2001), Mr. Generous' portfolio is worth approximately $104.6 million dollars, which flows over to Year 2 (2002) as the beginning balance. In Year 2, his spending increases by approximately the rate of inflation (i.e., 3 percent) to $2,060,000. The portfolio earns ordinary income of about $3.13 million and appreciates by about $4.7 million. Again, the portfolio must pay taxes due to realized short- and long-term capital gains caused by active management decisions. In addition, the portfolio must pay additional capital gains taxes as it is forced to rebalance to its targeted asset allocation mix. Clearly, the stocks in the portfolio are expected to appreciate faster than the bonds, and therefore, the portfolio needs to be rebalanced—selling off the equity securities, incurring a capital gains tax, and putting the proceeds back into bonds. Further, the $3.13 million of interest and dividend income generated falls short of the actual cash outflow that is required in order to pay for management fees, taxes and personal consumption. Therefore, I.M. Generous must invade principal to meet these expenditures. This principal invasion generates even more capital gains that increase the portfolio's tax liability.

Under the scenario just described, I.M. Generous spends merrily for the next 20 years. At the beginning of Year 2021, the portfolio has appreciated to approximately $221.2 million. Spending

that year, given the rate of inflation, is approximately $3.5 million. Unfortunately, by December 30, I.M. Generous passes away. According to the provisions of his will, his estate transfers $75 to his heirs. This generates an estate tax bill of $91.7 million. After his heirs and tax authorities collect their respective shares of the estate, approximately $66.45 million remains to be transferred to charity.

Having developed the most likely outcome of this baseline scenario, it is now important to consider who bears the residual risk of poord investment performance—I.M. Generous, his heirs, or charity. Table 4 illustrates that the cumulative distribution of wealth to Mr. Generous for his spending needs over the 20-year period is $53.74 million. The center column shows the anticipated payouts to the three parties based on the expected returns, which have a 50 percent probability of occurring. In order to examine what happens to the payouts under both the best- and the worst-case return scenarios, I ran a Monte Carlo simulation that generated 100 sets of normally-distributed investment returns. As can be seen from Table 4, even under the worst-case scenario, the amount that I.M. Generous has targeted for consumption is never at risk. Under the expected and best-case scenarios, Mr. Generous satisfies his stated goal of transferring $75 million to his heirs net of estate tax. If economic conditions are bad, however, the amount available to be transferred to his heirs declines. A one in four chance exists that he will transfer less than $75MM to his heirs. In this baseline scenario, despite the potential shortfall to heirs, charity is the real bearer of risk. Once the investment environment falls short of expectations, the amount transferred to charity declines quickly to zero.

Charitable Remainder Unit Trust. One wealth-transfer technique that is both commonly used and relatively straightforward is the charitable remainder unit trust ("CRUT"). Using this planning technique, I.M. Generous would shift a portion of his assets into an irrevocable trust designed to distribute back to him a percentage of the value of the portfolio on an annual basis, say, 7 percent. For engaging in this transaction, I.M. Generous receives a charitable deduction, typically 10 percent of the value of the assets transferred, and at the end of his life, the assets in the CRUT flow to charity. A CRUT is an effective technique to defer the payment of capital gains taxes on the assets transferred and to create a current tax deduction to shelter capital gains realized outside the CRUT. In addition, it establishes personal liquidity in the form of the annuity transferred back to Mr. Generous and helps to satisfy his future charitable goals at his death, when the CRUT transfers to charity.

Table 5 illustrates the initial outflow of $10 million in charitable gifts from Mr. Generous' personal portfolio and an equal inflow of $10 million to the CRUT in 2001. In Year 2 (2002), the CRUT annuity begins to flow back to Mr. Generous beginning in an amount of $758,975, reaching an annuity amount of $817,505 in the Year 2021. At the end of his life, Mr. Generous can still transfer $75 million to his heirs, pay the required estate tax and transfer $66,940,715 to charity—an additional $500,000 compared with the amount estimated in the baseline case. Table 6 shows who bears the residual risk of wealth transfer when a CRUT is part of the wealth-transfer-planning process. With the CRUT, I.M. Generous can transfer a slightly greater amount ($500,000) to charity than under the base case because the CRUT adds to his overall wealth. The projected increase in wealth beyond the baseline case is in part due to the beneficial effect of compounding non-taxed assets held within the CRUT structure. This compounding results in increasing the dollar size of the annuity payments back to I.M. Generous over time. At his death,

he has amassed greater wealth to transfer. Table 6 also considers scenarios for transferring $10 million, $20 million, $30 million, or $50 million to a CRUT during Mr. Generous' lifetime. Not surprisingly, the larger the amount transferred to the CRUT, the greater the amount that charity is certain to receive, even under poor economic circumstances.

Risk is a zero-sum game. If charity's risk decreases as more assets are contributed to a CRUT, then risk to the heirs must increase proportionately. Under expected return scenarios, regardless of the amount transferred to the CRUT, the $75 million desired transfer to heirs is achieved. However, relative to the baseline case (i.e., do no planning and transfer wealth only at death), the amount transferred to the heirs under poor economic circumstances decreases markedly as the amount transferred to the CRUT increases. Furthermore risk to heirs is not symmetric. Under better-than-expected economic conditions all excess wealth accrues to charity since I.M. Generous has capped the amount to be transferred to heirs at $75 million. This asymmetric shifting of risk from charity to heirs may or may not be acceptable to I.M. Generous.

Private Foundation. For many philanthropically-minded individuals, one downside to a CRUT is that no wealth is transferred to charity until the end of their lives. For those concerned about current support of charitable causes, a private foundation may be an effective planning vehicle. To establish a private foundation, an individual irrevocably transfers assets from his or her personal portfolio to the account of the private foundation. By law, a foundation must annually transfer at least 5 percent of its assets to charity in order to retain its tax-exempt status. Should I.M. Generous choose to establish a private foundation, he will receive a charitable deduction equal to the full amount transferred to the foundation. While there are limitations as to the amount of income that can be sheltered by such deductions in any single tax year, I.M. Generous can use these deductions to shelter income and/or capital gains incurred in his personal portfolio. This approach, while beneficial in creating sizeable charitable deductions, potentially reduces the base of assets available to I.M. Generous needed to generate personal cash flow. So, if Mr. Generous gives a too large an amount to the private foundation and subsequent economic conditions deteriorate, he could actually cause himself to run short of personal cash flow and may reduce the size of the estate inherited by his heirs to zero.

Again, upon funding a private foundation let's consider what happens and who bears the residual risk under different economic assumptions. In this case, it is fairly straightforward, as shown in Table 8. One can see that charity does well relative to the baseline scenario under poor economic environments. To estimate how much is transferred in total to charity, I added the 5 percent distributions that are made to charity each year to the projected value of the assets remaining in the foundation at I.M. Generous' death. Over a twenty –year time horizon, even under the worst circumstances, a $10 million foundation transfers $10.37 million to charity. Interestingly, under favorable economic conditions, regardless of the size of the foundation formed, a lower final, accumulated amount was transferred to charity than was the case in the baseline scenario. Although seemingly anomalous, this result arose because the time value of the 5 percent annual distributions paid from the foundation was not taken into account, whereas under the baseline scenario, all of the money was transferred 20 years hence.

Let's now take a look at who bears the residual risk from the standpoint of heirs. Perhaps not surprisingly, as illustrated in Table 9, I.M. Generous' heirs bear the brunt of the residual

investment risk when a foundation is established. Under the expected return scenario, that has a 50 percent probability of occurrence, heirs receive their maximum bequest of $75 million unless I.M. Generous establishes a foundation larger than $30 million. If I.M. Generous chooses to transfer $30 million or more of his $100 million in wealth to a foundation today, he will, even under expected economic conditions, only be able to transfer $61.8 million to his heirs upon his death. Clearly, this would violate one of I.M. Generous' own stated wealth transfer objectives.

Gift Form and Timing

When advising clients about charitable giving, it is important to understand both the flexibility of the structure chosen and the impact the structure has on the timing of the charitable gifts made. Bequests are the most flexible form of gifting, although they defer the transfer of wealth to charity until the death of the donor. CRUTs are the next most flexible structure because they enable the transfer of a large proportion of the appreciation of the trust's assets back to the donor. Foundations offer the most immediate transfer of wealth to philanthropy or to charity but also reduce the donor's flexibility to the greatest degree.

Summary

Investment advisors must commit to understanding the role that philanthropy plays in the wealth-distribution preferences of their clients. Investment advisors should help their clients quantify the implications of different types of gifting structures in order to clarify who among the client, his heirs and charity actually bears the brunt of residual investment risk.

GREYCOURT & CO., INC.
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(This paper was written by Gregory R. Friedman, a Principal at Greycourt.)

Table 1. Wealth Attitude Survey: Amount Targeted for Philanthropy

Item	During Life/ at Death	Only at Death
Family circumstances		
No children	50%	59%
With children	21	29
Believes inheritance causes		
Negative consequences	53	53
Positive consequences	10	18

Source: Based on data from Francie Ostrower's *Why the Wealthy Give: The Culture of Elite Philanthropy* (Princeton, N.J.: Princeton University Press, 1995).

Table 2. Case Study Assumptions

Asset Class	Pretax Total Return	Capital Appreciation	Yield	Risk	Desired Allocation
Tax exempt bonds	5.0%	0.0%	5.0%	5.5%	40.0%
Taxable bonds	7.0	0.0	7.0	5.5	0.0
U.S. equities	8.5	6.5	2.0	14.0	45.0
Non-U.S. equities	12.0	11.0	1.0	27.0	15.0
Portfolio pretax return	7.6				

Table 3. Gifting Strategy: Simple Bequest to Charity (Expected Scenario)

Item	2001	2002	2021
Starting balance	$100,000,000	$104,571,857	$221,237,094
Less:			
Annual spending	(2,000,000)	(2,060,000)	(3,507,012)
Charitable gifts			
Plus:			
Investment income	2,989,000	3,126,612	6,790,919
Capital gains	4,483,499	4,667,154	10,186,377
Less:			
Management fee	(394,450)	(412,610)	(896,179)
Income taxes	(305,613)	(319,683)	(694,344)
Short-term gains taxes (manager)	(51,227)	(82,550)	
Long-term gains taxes (manager)	(149,352)	(256,187)	
Short-term gains taxes (rebalance)		(4,428)	
Long-term gains taxes (rebalance)		(18,335)	
Estate tax			(91,666,667)
Amount to heirs			(75,000,000)
Ending balance	$104,571,857	$109,234,593	$66,450,188

Table 4. Gifting Strategy: Simple Bequest to Charity (Worst- and Best-Case Scenarios)

Item	Worst-Case Scenarios				Expected Scenario[a]	Best-Case Scenarios			
Probability of occurrence	2.5%	5.0%	10.0%	25.0%	50.0%	25.0%	10.0%	5.0%	2.5%
Allocation of wealth (millions)									
Amount to charity	$0.00	$0.00	$0.00	$0.00	$66.45	$130.13	$232.73	$282.87	$342.38
Amount to heirs	37.97	46.01	55.36	74.01	75.00	75.00	75.00	75.00	75.00
Amount to self	53.74	53.74	53.74	53.74	53.74	53.74	53.74	53.74	53.74

[a]Expected scenario based on expected return for the period.

Table 5. Gifting Strategy: CRUT (Expected Case Scenario)

Item	2001	2002	2021
Starting balance	$100,000,000	$94,082,560	$209,225,109
Less:			
Annual spending	(2,000,000)	(2,060,000)	(3,507,014)
Charitable gifts	(10,000,000)		
Charitable remainder trust (CRUT)	10,000,000	10,802,250	11,678,644
Plus:			
Investment income	2,684,000	2,829,837	6,647,905
CRUT annual inflow		758,975	817,505
Capital gains	4,207,299	4,572,477	9,971,857
Less:			
Management fee	(354,200)	(373,446)	(877,306)
Income taxes	(274,428)	(425,860)	(827,318)
Short-term gains taxes (manager)	(45,999)	(74,714)	
Long-term gains taxes (manager)	(134,112)	(231,870)	
Short-term gains taxes (rebalance)		(4,207)	
Long-term gains taxes (rebalance)		(15,743)	
Estate tax			(91,666,667)
Amount to heirs			(75,000,000)
Ending balance	$94,082,560	$99,058,009	$66,940,715

Table 6. CRUT Gifting Strategy: Amount to Charity

Item	Worst-Case Scenarios				Expected Scenario[a]	Best-Case Scenarios			
Probability of occurrence	2.5%	5.0%	10.0%	25.0%	50.0%	25.0%	10.0%	5.0%	2.5%
Amount gifted to charity (millions)									
Base case	$0.00	$0.00	$0.00	$0.00	$66.45	$130.13	$232.73	$282.87	$342.38
$10 million CRUT	5.38	5.47	6.47	11.93	66.94	139.83	219.98	279.41	356.82
$20 million CRUT	10.94	11.36	12.59	16.46	69.70	142.51	228.93	290.96	367.54
$30 million CRUT	15.40	17.26	19.71	23.63	69.32	142.80	231.11	293.40	368.20
$50 million CRUT	26.99	28.30	32.21	42.97	69.39	142.59	234.07	299.86	369.39

[a]Expected scenario based on expected return for the period.

Table 7. CRUT Gifting Strategy: Amount to Heirs

Item	Worst-Case Scenarios				Expected Scenario[a]	Best-Case Scenarios			
Probability of occurrence	2.5%	5.0%	10.0%	25.0%	50.0%	25.0%	10.0%	5.0%	2.5%
Amount gifted to heirs (millions)									
Base case	$37.97	$46.01	$55.36	$74.01	$75.00	$75.00	$75.00	$75.00	$75.00
$10 Million CRUT	36.39	43.80	53.50	72.08	75.00	75.00	75.00	75.00	75.00
$20 Million CRUT	34.52	41.40	50.94	69.33	75.00	75.00	75.00	75.00	75.00
$30 Million CRUT	32.66	39.00	48.42	65.10	75.00	75.00	75.00	75.00	75.00
$50 Million CRUT	28.95	34.03	43.01	56.83	75.00	75.00	75.00	75.00	75.00

[a]Expected scenario based on expected return for the period.

Table 8. Foundation Gifting Strategy: Amount to Charity

Item	Worst-Case Scenarios				Expected Scenario[a]	Best-Case Scenarios			
Probability of occurrence	2.5%	5.0%	10.0%	25.0%	50.0%	25.0%	10.0%	5.0%	2.5%
Amount gifted to charity (millions)									
Base case	$0.00	$0.00	$0.00	$0.00	$66.45	$130.13	$232.73	$282.87	$342.38
$10 million foundation	10.37	12.30	15.26	20.67	60.29	123.15	225.65	277.42	333.33
$20 million foundation	20.10	23.45	29.95	40.99	58.79	114.51	212.08	266.58	316.02
$30 million foundation	29.04	33.95	45.00	61.25	88.19	114.68	193.22	247.89	292.57
$50 million foundation	42.23	52.98	69.13	99.38	146.98	204.35	276.40	308.88	343.92

[a]Expected scenario based on expected return for the period.

Table 9. Foundation Gifting Strategy: Amount to Heirs

Item	Worst-Case Scenarios				Expected Scenario[a]	Best-Case Scenarios			
Probability of occurrence	2.5%	5.0%	10.0%	25.0%	50.0%	25.0%	10.0%	5.0%	2.5%
Amount gifted to heirs (millions)									
Base case	$37.97	$46.01	$55.36	$74.01	$75.00	$75.00	$75.00	$75.00	$75.00
$10 million foundation	31.36	37.19	46.14	62.52	75.00	75.00	75.00	75.00	75.00
$20 million foundation	24.42	28.49	36.39	49.80	75.00	75.00	75.00	75.00	75.00
$30 million foundation	20.36	23.81	31.56	42.95	61.84	75.00	75.00	75.00	75.00
$50 million foundation	9.00	11.30	14.74	21.19	31.34	43.57	58.93	65.86	73.33

[a]Expected scenario based on expected return for the period.