

C H A R I T A B L E
L E A D T R U S T

a donor's guide

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TRANSFER FAMILY WEALTH WITH Charitable Lead Trusts

If you want to benefit a charitable organization like ours and transfer assets to your children or other descendants, you might consider a charitable lead trust. With this trust, you transfer assets to an irrevocable trust that pays a qualified charitable organization a fixed payment for a term of years you select or for a person's life. When the trust term ends, individuals ("remainder beneficiaries") receive whatever remains in the trust ("remainder interest"). You select the charitable organization, determine how much it receives and select the remainder beneficiaries. This brochure assumes you want to transfer assets to your descendants, who are the remainder beneficiaries.

Since your descendants won't receive the property immediately, a charitable lead trust might be a way to give them future financial benefits. You can structure a lead trust to supplement the future pension for nonworking parents or beneficiaries engaged in lower-paying professions, to encourage self-sufficiency during your beneficiaries' working years or to teach charitable values by soliciting their input on purposes for the charitable distributions.

Federal tax law defines charitable lead trusts—they're nothing new, nothing cutting edge. The Internal Revenue Code tells you how to create one.

Remainder Beneficiaries

The lead trust remainder interest can revert to you when the term ends, or it can be distributed to or in trust for the benefit of other individuals.

Generally, if you structure the trust as a "grantor trust" for income tax purposes because you or your spouse receive the remainder interest or

retain certain controls over the trust, you receive an income tax charitable deduction for the present value of the charitable payments upon funding the trust. In future years, however, you must report the trust income on your personal income tax return. Unless you are having unusually high income in one year and can benefit from this deduction, you probably won't use this type of lead trust. With a grantor lead trust, the property and appreciation on it may also be included in your taxable estate.

More often the trust is drafted as a "nongrantor" trust for income-tax purposes, meaning, among other things, that the remainder interest passes to individuals other than you or your spouse and you don't receive an income tax deduction when funding the trust. This brochure discusses a qualifying "nongrantor" lead trust naming your descendants as the remainder beneficiaries.

You can create a nongrantor lead trust during life or at death. The effects of each depend on many factors, including whether the charitable organization is paid an annuity or unitrust amount, the type of asset gifted, and the asset's appreciation.

In addition to benefiting us and your descendants, in the right circumstances a nongrantor lead trust might provide some transfer-tax benefits. If circumstances allow, a nongrantor lead trust created in life might reduce transfer taxes on a highly appreciating asset, reduce the initial cash outlay for gift taxes or provide income tax savings if your annual charitable gifts exceed your charitable income deduction limitation. Unlike a lead trust funded in life, a lead trust funded at death allows for the property funding the trust to receive a basis step-up, and your estate will receive an estate tax deduction for the present value of your payments.

A potential disadvantage therein is the fact that, if funded in life, the asset

doesn't get a basis step-up, and you lose the income from the asset gifted. Regardless of when funded, your heirs must wait to receive the property.

Because the trust provides for a charitable organization at a potential cost to your family, you should use the lead trust only if you are charitably inclined. Your attorney must advise you about the tax and nontax results of using the lead trust in your situation, including the financial effect on you and your family.

How a Nongrantor Charitable Lead Trust Works

For transfer tax purposes, your transfer to the trust is treated as two separate gifts. The first gift is to us in the form of an annual payment. The second gift is the remainder interest that your descendants, as the remainder beneficiaries, ultimately receive.

With a lead trust, your descendants won't receive their remainder interest immediately; it is a future gift. We receive the "gift" of annual payments first. Even though your descendants receive their gift in the future, you generally owe transfer taxes on this future gift at the time you fund the lead trust. To determine how much tax you owe on this gift, you subtract from the assets funding the trust the present value of our organization's income interest. The present value of our interest is based on several factors, including how much it receives and an applicable IRS valuation rate that is prescribed by law. As a result, you pay transfer tax only on the present value of the remainder interest your descendants eventually receive, essentially reducing the outlay of cash that may be necessary to pay any transfer taxes (or use less of your remaining applicable credit amount).

Example: You transfer \$250,000 to a nongrantor charitable lead annuity trust that will pay us 7 percent annually for 20 years and then give your children the

remainder interest. Assume the trust's net return is 7 percent annually, and the applicable IRS valuation rate is 5.6 percent.

Benefits to your family and a charitable organization:

- The charitable organization receives \$17,500 annually; \$350,000 over 20 years.
- Children receive \$250,000 in 20 years.

In this example, if the assets in the lead trust had appreciated beyond 7 percent, such excess appreciation would pass to the children transfer-tax free.

In this example, you determine the value of the remainder interest gift to your children and the amount of transfer taxes you owe by reducing the \$250,000 gift by the present value of the charitable organization's annual payments. In this case, the present value of the organization's interest is \$207,408, and the present value of the remainder interest gift is \$42,592. Assuming the maximum 49 percent federal transfer tax rate, your federal transfer taxes would be about \$20,870, which could be eliminated by any of your remaining applicable credit amount.

Structuring the trust to increase the value of the charitable gift benefits a charitable organization and minimizes the cash outlay for transfer taxes, but it also decreases what your children receive through this trust. You should balance these interests when creating the trust.

Assets for Funding a Charitable Lead Trust

You can fund a lead trust with many types of assets, including cash or publicly traded securities. Exercise careful consideration when selecting assets for funding, particularly if you use other assets like family limited partnership interests. When selecting assets, remember the trust must pay the charitable organization annually and is subject to income tax.

The Types of Charitable Payments

To receive a transfer-tax deduction for the charitable payment as described *above*, the charitable payment must be:

1. An annuity payment—the charitable organization receives the same amount annually whether the trust assets appreciate or depreciate; or
2. A unitrust payment—the charitable organization receives a specified percentage of the fair market value of the trust assets valued annually. You set the percentage upon creating the trust. The payments fluctuate with trust appreciation or depreciation.

If the trust income is insufficient to pay the charitable organization, the trustee uses principal.

Benefiting Grandchildren or Further Removed Descendants

While you might use the lead trust to transfer assets to children, you might prefer benefiting grandchildren or other descendants, particularly if your children have large taxable estates. You might want the remainder interest distributed to a long-term trust that benefits such descendants, structured so the assets escape transfer taxes in their estates. These long-term trusts, sometimes called “dynasty trusts,” can be drafted to do things like provide incentives to encourage independence, help descendants get educated or start a business and, if you want, protect assets from a descendant’s creditors. Properly established, the assets in a dynasty trust may be exempt from subsequent transfer taxes for up to 90 years in most states, and forever in others, resulting in significant overall transfer tax savings.

If descendants other than your children are the remainder beneficiaries of a lead trust or beneficiaries of a dynasty trust that receives the remainder

interest, you must consider another tax called the generation-skipping transfer (GST) tax, an additional 49 percent transfer tax (reducing to 45 percent by 2007). Generally, under today's tax laws, you have a \$1.1 million GST tax exemption (indexed for inflation by the IRC), that you can allocate to transfers you make outright or in trust for the benefit of such descendants to exempt those assets from the GST tax. Transfers exceeding this amount are subject to the GST tax.

If you want to benefit your descendants and your favorite charitable organization, you might find using a charitable lead trust and naming a dynasty trust as the remainder beneficiary attractive.

Example: You establish a \$3 million charitable lead unitrust that pays a charitable organization 5 percent of the trust assets as valued annually for 20 years. The trust's net return is 6 percent annually. In 20 years, the remainder interest passes to a dynasty trust for your descendants, all presently under age 50. Assume the IRS interest rate for valuing this interest is 5.6 percent and that you have not used any of your applicable credit amount (\$1 million in 2003, increasing to \$3.5 million by 2009), or \$1.1 million GST tax exemption.

Approximate benefits to the charitable organization and your descendants:

1. The charitable organization receives about \$3.3 million over the 20-year term.
2. In 20 years, the trust will be worth about \$3.5 million, which will fund a dynasty trust for your descendants, free of transfer tax.
3. Transfer taxes on the remainder interest are about \$56,305 after applying your applicable credit amount. For transfer tax purposes, you reduce the \$3 million transfer to the lead trust by \$1,862,715, the present value of the charitable organization's payments valued under the IRS rate, leaving a taxable gift of \$1,137,285.

4. If you allocate \$1,137,285 of your GST tax exemption to the remainder interest, then under present tax laws, the dynasty trust assets will be exempt from federal gift, estate and GST taxes during the dynasty trust term. (The GST allocation works differently with an annuity trust. You should discuss this with your attorney.)
5. Viewed differently, assume you gave \$1,137,285 of this \$3 million directly to a dynasty trust that wouldn't make any distributions for 20 years, during which time it has a net after-tax return of 6 percent annually. The dynasty trust assets in 20 years will be worth about \$3.7 million, the same as with the previously discussed lead trust, but the charitable organization receives nothing. Additionally, the difference between the \$1,137,285 funding the dynasty trust and \$3 million is included in your taxable estate.

In these alternatives your descendants receive the same amount, but with the lead trust the charitable organization receives a significant benefit. Depending on the circumstances, the result might be different, or your descendants might receive more (or less) with a differently structured lead trust. Given the right situation, funding a lead trust in life with highly appreciating assets may provide significant transfer-tax benefits, particularly if a properly drafted dynasty trust is the remainder beneficiary.

While the charitable organization receives a significant benefit with a lead trust, you should compare other reasonable alternatives and select the one that best carries out your intent.

The information in this publication is not intended as legal advice. For legal advice, please consult an attorney. Figures cited in examples are based on current rates at the time of printing and are subject to change. References to estate and income tax include federal taxes only; individual state taxes may further impact results.