



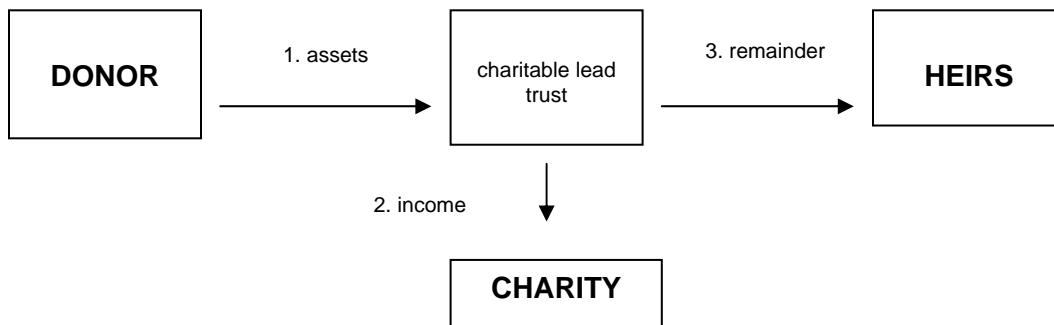
## CHARITABLE LEAD TRUSTS

The most common use of a charitable lead trust is to enable wealthy individuals who have large taxable estates to pass assets to their heirs at a discount. They are also an excellent way to give immediate and sustained support to a favorite charity.

Charitable lead trusts typically pay a specified amount of income to one or more charities for either a fixed term of years or for the lives of one or more individuals. Although there are several types of lead trusts, donors are generally seeking to lower their estate taxes while leaving their children and grandchildren a larger inheritance. Because of their complexity, charitable lead trusts are generally only used when a donor's total estate exceeds \$3 million.

### WHAT IS A CHARITABLE LEAD TRUST?

A charitable lead trust is an irrevocable trust, into which the donor places cash or other assets (stock, bonds, land, or other marketable assets). The trust makes periodic payments to the named charities. At the end of the trust, the assets are distributed to the named beneficiaries, typically the donor's children or grandchildren. The charitable lead trust will last for either a specified term of years or for the lives of one or more individuals. While the trust is in existence, the trustee manages and invests the trust assets and distributes specified annual payments to one or more charities. The following diagram explains the relationship among the donor, trustee, charitable income beneficiary and the individual remainder beneficiaries:



There are two basic types of charitable lead trusts: those that revert to the donor when the trust ends (grantor lead trust) and those that pass to persons other than the donor when the trust ends (non-grantor lead trust). Because most charitable lead trusts are used to transfer assets to heirs, this bulletin will focus just on *non-grantor* lead trusts.

### WHAT BENEFITS DO I GAIN FROM A CHARITABLE LEAD TRUST?

Because non-grantor lead trusts are intended to transfer assets to heirs, they are used to reduce gift taxes or estate taxes. Non-grantor lead trusts have no income tax advantages. If the trust is established during the donor's lifetime, the donor will receive a gift tax deduction. If the trust is

established at the donor's death, the donor will receive an estate tax deduction. In both cases, the deduction will be equal to the net present value of the income interest payable to the charity. The effect is to significantly reduce the gift or estate tax liability on the value of the trust assets when the trust ends and the assets pass to the donor's heirs.

**Example #1:** A donor creates a 20- year lead trust funded with assets worth \$2 million that pays a 7 % payout (\$140,000 annually) to charity for 20 years. The present value of that income stream to charity is worth approximately \$1.7 million. Therefore, the gift tax deduction is \$1.7 million, and the donor is deemed to have made a taxable gift of only \$230,000 ( $\$2,000,000 - \$1,700,000 = \$130,000$ ). Since every person is allowed to give \$1 million free of gift tax to other people – there is no tax on gifts to a spouse -- the trust assets essentially pass tax-free to the donor's children when the trust ends after 20 years. If the trust earns an 8 % return over the 20 years, the trust principal will have grown to over \$2.9 million. This money will then pass to the children tax-free. At the same time, it will have distributed \$2.8 million to charity. Accordingly, lead trusts can be an excellent way to pass valuable assets to younger generation members at a greatly reduced (or eliminated) gift and estate tax cost, while providing substantial support to one or more favorite charities.

**Example #2:** Let's change the facts only slightly, and assume the charitable lead trust makes a 3.5 % payout (\$70,000 annually) to charity for 20 years. The present value of that income stream is approximately \$844,000. Therefore, the donor is deemed to have made a taxable gift of \$1,156,000. This means that the donor has used her or his entire \$1 million exemption from federal gift taxes and must pay a tax on \$64,000. Over the 20 years, the trust will distribute \$1.4 million to charity. On the other hand, if the trust earns 8 % annually, the heirs will eventually receive \$5.2 million.

Many other variations are possible. However, as you compare the two examples, you can see that donors have an opportunity to balance their charitable goals with their desires to benefit their heirs. They also have an opportunity to decide when their children and grandchildren should receive part of their inheritance.

### **WHAT ARE THE DISADVANTAGES?**

The primary disadvantage of charitable lead trusts is that neither the donor nor family members will have access to either the trust income or principal while the trust is in existence. Therefore, before establishing a charitable lead trust, donors should consider carefully whether their other financial resources are sufficient to meet their future needs.

### **CAN I USE REAL ESTATE TO FUND A CHARITABLE LEAD TRUST?**

Land can be used to fund a charitable lead trust. If the real estate is income producing, then this income can be used to pay the annual distribution amount to charity. If, however, the real estate is not income producing, it may be necessary to sell the real estate so the trust will be able to make the distributions to charity. This problem may be avoided if, in addition to the real estate, the donor places enough other assets in the estate to make the annual payments and cover the carrying costs of the land. If the land has conservation value, we recommend that the donor place a conservation easement on the property before it is placed into the trust.

**HOW DO YOU DETERMINE THAT ANNUAL PAYMENT TO THE CHARITY?**

Lead trusts take two forms: in a “unitrust,” the trust’s assets are valued annually, and the charity receives a fixed percentage of that amount annually. Therefore, in the unitrust, the actual payment to the charity will fluctuate annually depending on the value of the assets in the trust. In an “annuity trust,” the charity receives a fixed annual payout that remains constant regardless of the value of the trust assets. The choice of either a “unitrust” or “annuity trust” structure will impact the tax benefits for the donor, the annual payment to the charity and the amount of assets passing back to the donor or other individuals when the trust ends.

**HOW ARE TAX BENEFITS DETERMINED?**

The tax benefits of a charitable lead trust are a function of many factors, including

- the value of the donated asset
- the duration of the trust
- the type of trust (grantor or non-grantor; annuity trust or unitrust)
- the charitable payout rate
- the federal discount rate (which changes monthly)

The Vermont Land Trust can make the calculations, using a computer program to factor in all the variables. Typically, the longer the trust term and the higher the annual payout rate to charity, the greater the gift or estate tax deduction will be for the donor.

**HOW DO I GET STARTED?**

As in the case of your will, your attorney will be the principal advisor in the preparation of a charitable lead trust. You may wish to discuss your estate and financial plan with your accountant.

Your attorney will prepare the charitable lead trust document after discussing with you how you would like to structure the trust. To assist you and your attorney in the process, the Vermont Land Trust can prepare the charitable lead trust calculations and provide forms for the lead trust document. The calculations will factor in the annuity rate and the duration of the trust, calculate the gift or estate taxes payable, if any, and estimate the eventual benefit for your heirs, based upon your investment assumptions.

Before we can make the calculations, we will need to know the following: (1) the term (duration) of the trust; (2) the annuity rate to be paid to charity, and (3) the estimated fair market value of the asset you intend to use to fund the charitable lead trust. It would also be helpful to know your “cost” or tax basis in that asset.

If you intend to fund the charitable lead trust with land, you must obtain a qualified appraisal of the land’s fair market value before the transaction is finalized. Once the appraisal has been completed, you then have a sixty-day window after the date of the appraisal to complete the transfer of the land to the Charitable Lead Trust, or you will need an appraisal update (usually in the form of a letter). If your gift is in the form of securities listed on the stock exchange, we will run the final calculations after the transfer, so that we can determine the exact value of the securities on the day of transfer.

For more information, please contact Darby Bradley at [Darby@vlt.org](mailto:Darby@vlt.org) or at the phone number below.

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