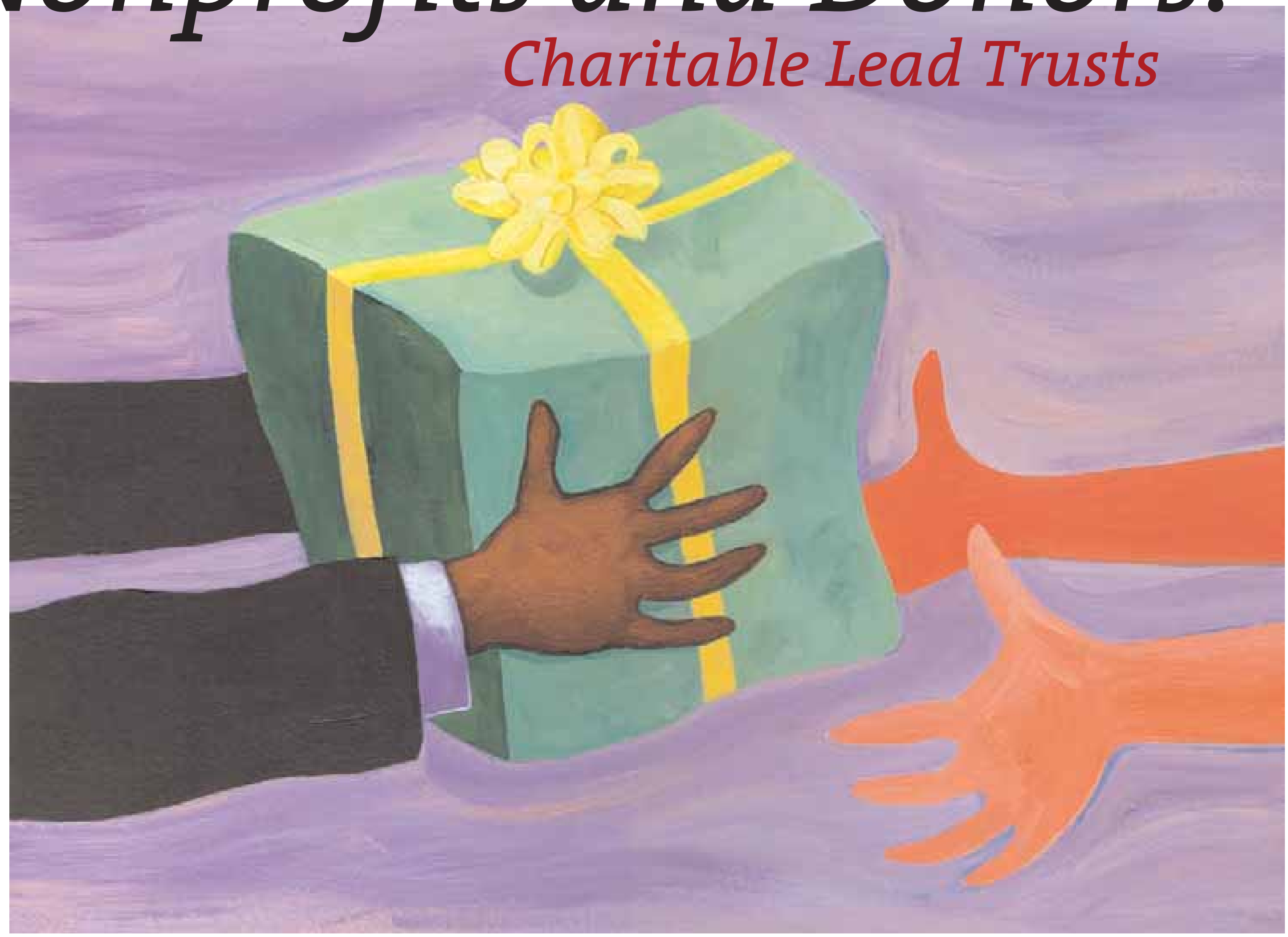
Benefiting Both Nonprofits and Donors: *Charitable Lead Trusts*



by John H. Clymer and Sarah T. Connolly, Nixon Peabody LLP

Today's most knowledgeable nonprofits are alerting supporters to new estate-planning and charitable-giving tools, some of which make resources available to the charity immediately. Even small nonprofits are telling potential donors about instruments that simultaneously enable larger gifts and generate significant tax benefits for donors and their heirs. The charitable lead trust is one such instrument.

Two Types of Charitable Lead Trust

A charitable lead trust is a trust that gives an "income" interest (the "lead interest") to one or more charities for a set number of years (three-, five-, 10-, and 20-year terms are all common). It provides that the principal (the "remainder interest") will ultimately go back to the donor—or to designated beneficiaries.

There are two types of charitable lead trust: annuity trusts and unitrusts. Both are irrevocable.

Annuity Trust

At least once a year, a charitable lead annuity trust gives a nonprofit organization either a fixed percentage of the initial net asset value of the trust or else a fixed dollar amount. The amount that must be distributed each year remains the same no matter what happens to the value of the trust's assets.

Unitrust

A charitable lead unitrust differs in that the donor specifies from the outset the *percentage* of the trust's net asset value that is to be distributed annually to a charity. The net asset value is determined anew in each taxable year on the same day. Because the percentage is fixed—but the value upon which it is based varies—unitrust payments increase or decrease with the value of the assets. Thus for the recipient organization, the income is less predictable.

How Is a Charitable Lead Trust Created?

A charitable lead trust is created by a written trust agreement between the donor and one or more trustees. The trust document will indicate whether the trust is to be an annuity trust or unitrust, will state the amount to be distributed, and will name the charity or charities to be benefited.

The trust instrument also will contain terms providing for the disposition of the trust assets when the period of payments to the charitable organizations ends. The property may pass to named beneficiaries, return to the donor, or continue in trust for family members or others. The trust instrument also will contain provisions common to all trusts, such as those related to the trustees' investment powers and duties. Usually the trustees receive investment assets at the time the trust instrument is signed. Also, a trustee is entitled to receive a trustee's fee, and a separate management fee may also be charged if the trustee is not actively managing the investments.

Federal Tax Consequences

Charitable lead trusts give the donor particular tax benefits.

Income Tax

Taxable income and capital gains realized by a charitable lead trust are taxed to the trust. The trust is allowed an unlimited charitable income-tax deduction each year for the distributions made to charity. The donor does not receive a federal income-tax deduction, either for the initial contribution to the trust or for the distributions made annually to charity, but there are advantages to reducing taxable income this way, as described below.

Gift, Estate, and Generation-Skipping Taxes

A donor may receive a federal gift-tax charitable deduction for the present value of the income interest given to charity. If the property is to pass to the donor at the end of the term, the property returning to the donor will be included in the donor's estate at death, but there will be no liability for gift tax at the time the trust is created. If the property is to pass to others at the end of the term, it will not be included in the donor's estate, but it will be subject to gift tax at the time the trust is funded, based upon the discounted value of the beneficiaries' right to receive the property in the future. The gift will not qualify for the annual exclusion from gift tax (currently $11,000 per donee), because it is a *future* interest. If those receiving the remainder of the lead trust are grandchildren, there may be a generation-skipping transfer tax imposed when they receive distributions.

Example

Let's say a donor transfers $100,000 in appreciated securities to a charitable lead annuity trust in November 2005. The trust has a 15-year term, and at the end of that period, the property remaining in trust will pass to the donor's children. To value any gift of this sort for tax purposes, the Internal Revenue Service promulgates regulations that contain actuarial and financial-return assumptions.

For November 2005, for example, the assumption was that returns would be 5 percent per year. The donor sets the annual annuity rate at slightly in excess of 9.6 percent. This produces an annual annuity payment to charity of $9,640 a year on a $100,000 initial value. Under the applicable Internal Revenue tables, an annuity of that amount, given a return assumption of 5 percent, will reduce the annuity trust value to zero at the end of the 15-year term. Therefore, there will be no taxable gift to the donor's children. However, if the average annual return on the trust's assets is actually 8 percent a year for the 15-year term (rather than the 5 percent assumption), then when the trust ends, the children will receive $55,606 free of estate or gift tax. During the 15-year term, payments to charity will have been $144,600. The donor has achieved the objective of passing more than $140,000 to charity, reducing the children's anticipated inheritance by only $55,000 while removing $200,000 from the estate, free of income, estate, and gift taxes.

Why Establish a Charitable Lead Trust?

Charitable lead trusts are created by donors who have a commitment to charity and who also wish to benefit their families or others.

Donors with a history of generous charitable giving may find that they have hit the ceiling of the income-tax charitable deduction of 50 percent of adjusted gross income for cash gifts (or 30 percent for gifts of "appreciated property," such as securities).

Placing property in a lead trust

Illustrations: Kirk Lyttle

enables them to increase an income-tax charitable deduction by removing from their own tax returns the income from the property placed in the lead trust. Donors thus lower taxable income while still having income go to charity.

Another reason a donor with significant assets and strong charitable interests may wish to take this path is the ability to benefit a favorite charity today without giving away assets forever. A lead trust can meet the donor's own future needs if it is tailored to end on an expected occasion, such as a retirement or the termination of another trust from which the donor or a family member has been receiving income. If the lead interest is designed to end when the specified event occurs, the donor or family member will then receive the trust's assets.

In short, a charitable lead trust can offer significant tax benefits to donors and their families while providing a stream of funds to serve favored charities.

John H. Clymer *and* **Sarah T. Connolly** *are partners in the Private Clients' Group in the Boston Office of Nixon Peabody LLP.*

Coming Up

in Future Issues of *Communities & Banking* Magazine

- The latest Home Mortgage Disclosure Act data: implications for New England
- What works for communities after a military base closes
- A New Haven bank reaches out to the community
- Massachusetts laws for affordable housing
- New mortgage risks for banks and consumers
- A money-management program helps the impaired elderly
- How artists build the New England economy
- Patterns of home buying among immigrants
- One state pioneers supportive housing, a better solution for homelessness
- Removing the barriers to building up assets and leaving poverty