

Copyright 2008 All Rights Reserved. Pentera, Inc. (317) 875-0910 ext.231

The Charitable Lead Trust:
A Cost-Effective Method
of Benefiting Charity
Then Your Heirs

Changes in the Tax Law: Time for a Checkup!

Fewer estates are affected by the federal estate tax because of the dramatic changes brought about by Tax Relief 2001 (see chart below). The tax is repealed for the year 2010—but it will be back at 55% in 2011 with an exemption of \$1 million unless repeal or higher exemption amounts are re-enacted prior to that time.

The uncertainty surrounding the eventual fate of the estate tax requires constant vigilance.

Note: If you have a moderate-to-sizeable estate, your estate plans will require periodic reviews with your attorney and other advisors to avoid getting trapped in an unforeseen situation. You may have to adjust your plans to achieve your financial and philanthropic objectives.

**Progression of Estate-Tax Rate
and Exemption-Amount Changes**

Calendar Year	Exemption Amount	Maximum Estate-Tax Rate
2001	\$ 1 Million	55%
2002	\$ 1 Million	50%
2003	\$ 1 Million	49%
2004	\$ 1.5 Million	48%
2005	\$ 1.5 Million	47%
2006	\$ 2 Million	46%
2007	\$ 2 Million	45%
2008	\$ 2 Million	45%
2009	\$ 3.5 Million	45%
2010	Tax Repealed	-0-
2011	\$ 1 Million	55%

Note: Estate-tax laws are set to revert to pre-2001 tax-reform status unless changes are extended or made permanent by Congress.

Copyright 2008 All Rights Reserved. Pentera, Inc. (317) 875-0910 ext.231

THE CHARITABLE LEAD TRUST: A Cost-Effective Method of Benefiting Charity Then Your Heirs

Transferring property to those institutions and individuals you wish to benefit is not always an either/or proposition. With careful planning, however, you may be able to arrange your transfers to accomplish more than one objective.

For example, if you have assets that are appreciating, children who may want to start a business in the future, and a desire to assist this institution, you may wish to consider creating a charitable lead trust, an arrangement that would allow you to support our work and minimize potential transfer taxes until your children are ready and able to step out on their own.

Under this plan you irrevocably transfer assets to a trustee and provide that payments be made to us for a certain number of years (or until the end of your or another's life). Then the principal will be distributed to your children, grandchildren, or other heirs. The principal passes to your heirs at greatly reduced gift- and estate-tax rates and sometimes escapes them altogether.

This booklet answers some commonly asked questions about lead trusts.

Why does a lead trust save gift and estate taxes?

When you create a lead trust, only the present value of the remainder interest (the amount remaining for your heirs when the trust terminates) will be subject to tax.

***Example:** Mary funds a lead trust with \$1,000,000 and stipulates that we are to receive \$80,000 per year for 15 years, after which the remaining principal will be distributed to her two children. She will report a taxable gift of only \$85,130. The difference (\$1,000,000 - \$85,130 = \$914,870) is a charitable gift-tax deduction. If she had simply given the \$1,000,000 to her children, the entire amount would have been taxable.*

When can a lead trust be established?

You may establish a lead trust either during your lifetime or under your will. Creating it during life and designating the remainder for heirs results in a *gift-tax deduction*. Creating it by will produces an *estate-tax deduction*.

What determines the size of the charitable deduction?

Three factors will affect your deduction: the duration of the trust, the amount it pays to us each year, and the federal discount rate in effect when you establish the trust. Lengthening the trust term

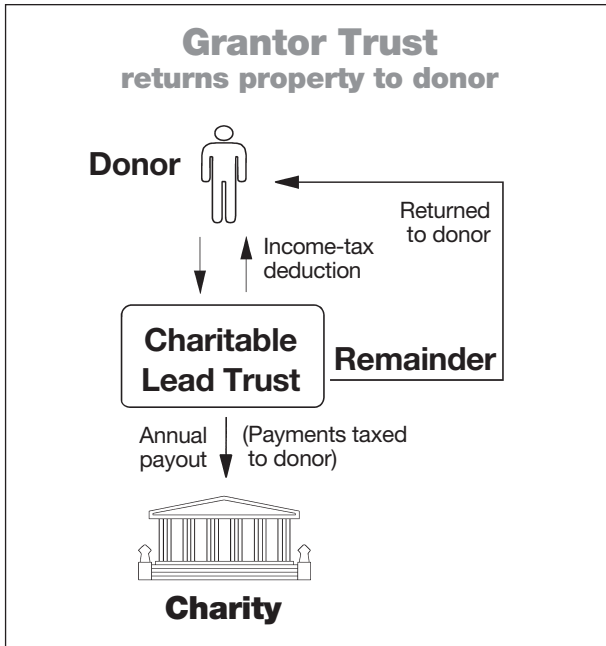
and enlarging the payments to us will increase the deduction. (The tables on pages 8 and 9 show deductions for various trust terms and charitable payout rates.)

Charitable planning pointer: A lower federal discount rate increases the charitable deduction. With today's low rates, those who establish a lead trust now can obtain a significant deduction without having to postpone distributions to heirs as long as before.

Will a lead trust also save income tax?

You receive an income-tax deduction if the principal is to be returned to you at the termination of the trust *or* if you have retained some other power over the trust causing you to be treated as the owner. The "price" for obtaining this deduction is that you are taxed on the trusts's payments to us—even though you are not receiving them. If you expect your income-tax bracket to drop, it may be advantageous to have an up-front deduction when your bracket is high and then be taxed on the income when your bracket is lower.

However, this is a rather uncommon use of the lead trust. Most people do not have the principal returned to themselves but rather distributed to heirs. Since they retain no personal financial interest in their trusts, they are not treated as owners. While they receive no tax deductions, they are not taxed on the payments to us. Their motivation is to get the property into the hands of heirs at the lowest possible gift- and estate-tax rates. (See Nongrantor Trust diagram, p. 7.)



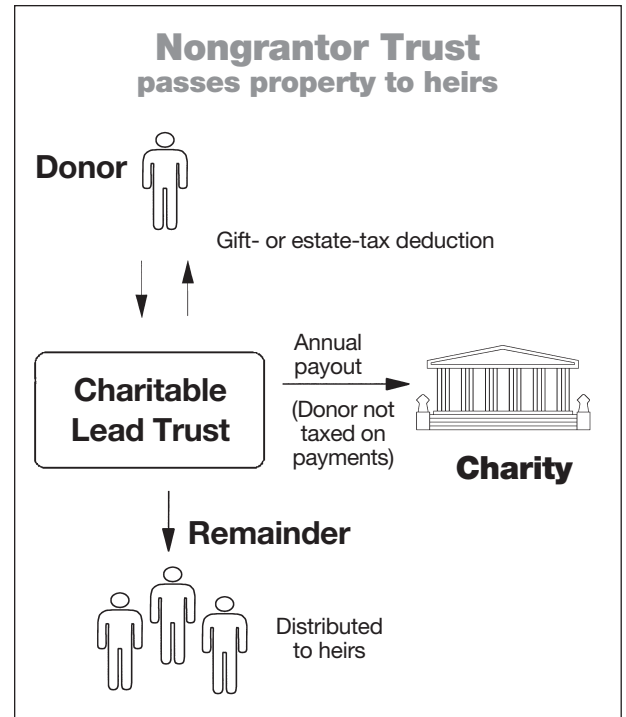
If the property is returned to me, is there any way I can avoid being taxed on the charitable payments?

You could fund the trust with tax-exempt bonds. You would get an up-front charitable deduction, and the bond interest wouldn't be taxed to you. The bonds would be returned to you at the end of the term. **Note:** Don't choose a payout rate higher than the bond interest, or you will have to liquidate some of the bonds.

How long will the trust make the charitable payments?

That is your choice, subject only to the *rule against perpetuities* applicable in some states. While most lead trusts last for a term of years, you may choose to extend it for the duration of your or another's life.

The current ages of your children or grandchildren, when they would be mature enough to manage the property, and how long you want to support our work will all be factors in your decision. Also, you might choose a trust term that would result in no transfer tax or will at least produce the deduction required for your estate plan.



How are the trust's charitable payments determined?

If the trust is to qualify for a charitable deduction, the payments must be a fixed dollar amount—*charitable lead annuity trust*—or a fixed percentage of the trust assets as determined annually—*charitable lead unitrust*.

Copyright 2008 All Rights Reserved. Pentera, Inc. (317) 875-0910 ext.231

Note: The percentages in these tables are based on a representative discount rate and assume that the charitable payout is made annually. We would be pleased to provide you with the current deductible amount.

Charitable Lead Annuity Trust Percent of Contribution Deductible

Payout Rate*	Trust Term in Years				
	5	10	15	20	25
5%	22.5%	41.4%	57.2%	70.4%	81.5%
6	27.0	49.6	68.6	84.5	97.8
7	31.5	57.9	80.1	98.6	100.0
8	36.0	66.2	91.5	100.0	100.0
9	40.5	74.5	100.0	100.0	100.0
10	45.0	82.7	100.0	100.0	100.0
11	49.5	91.0	100.0	100.0	100.0
12	54.0	99.3	100.0	100.0	100.0

*Payout rate refers to the percentage of the initial value of the property transferred to the trust. If \$1,000,000 were transferred and a 7% payout selected, we would receive \$70,000 (7% x \$1,000,000) each year. Assuming the trust was for 15 years, 80.1% (\$800,520) would be deductible for gift and estate taxes (or for income-tax purposes if the principal reverts to the donor).

Example of charitable lead annuity trust: John transfers \$1,000,000 and stipulates that we are to receive \$70,000 per year for the duration of the trust. If the trust earns more than \$70,000, the excess will be added to the principal and accumulated for heirs (the remaindermen). If it earns less than \$70,000, the principal will be invaded to make the required payment, thereby diminishing the amount left for the remaindermen.

Charitable Lead Unitrust Percent of Contribution Deductible

Payout Rate*	Trust Term in Years				
	5	10	15	20	25
5%	21.9%	39.0%	52.4%	62.8%	71.0%
6	25.8	44.9	59.1	69.7	77.5
7	29.5	50.3	65.0	75.3	82.6
8	33.1	55.2	70.0	80.0	86.6
9	36.5	59.7	74.4	83.8	89.7
10	39.8	63.8	78.2	86.9	92.1
11	43.0	67.5	81.4	89.4	94.0
12	46.0	70.8	84.2	91.5	95.4

*Payout rate refers to the percentage of the value of trust property as determined annually. If \$1,000,000 were transferred and a 7% payout selected, we would receive each year 7% of that year's trust value. The amount would vary from year to year. As with the charitable lead annuity trust, the deduction is determined by matching payout rate and length of trust term.

Example of charitable lead unitrust: James transfers \$1,000,000 and stipulates that we are to receive 7% of the net fair-market value of the trust assets as determined annually. If the value of the trust property increases to \$1,100,000 by the beginning of the third year, we would be paid \$77,000 that year. Conversely, if the value of the trust property fell to \$900,000, we would receive \$63,000. As with the annuity trust, the principal is invaded if necessary to make the required payments.

The charitable payout must be determined by one of the two methods described above. A trust that simply pays net income to charity, whatever it may be, will not qualify for tax benefits.

Which method of determining the charitable payout is better?

If you believe your property will appreciate in value and would like your heirs to benefit from the growth, then a charitable lead annuity trust is preferable.

***Example:** Mary's \$1,000,000 contribution to support our work consists of growth stock with a total net return (including appreciation) of 10% per year. The stock funds a 15-year charitable lead annuity trust that pays \$80,000 per year. When the trust terminates, the principal will have grown to slightly more than \$1,635,400.*

If Mary had transferred the stock to a charitable lead unitrust instead, the principal distributed to her heirs would have been approximately \$1,345,800—a reduction of about \$289,600. Of course, we would have received more. Since we receive a percentage of trust assets as valued each year, we share in the growth. With the charitable lead annuity trust, on the other hand, the charitable payout is held at a fixed level. All appreciation is accumulated for heirs. If the trust's total return had been less than 8%, the heirs would have fared better with a charitable lead unitrust.

Is capital gain subject to tax?

If the trust holds property that appreciates and then distributes that property to your heirs, the gain will not be subject to gift or estate taxes. Suppose, for example, that the property was worth \$1,000,000 when you created the trust, \$700,000 of that amount was deductible, and the property's value will have increased to \$3,000,000 by the time the trust ends. Your heirs will receive \$3,000,000, but you will have paid gift and estate taxes on a mere \$300,000—which is why the lead trust is so appealing if you want to transfer an asset you expect to keep increasing in value.

Note: When your heirs sell the property, they will be taxed on the capital gain. Their basis will be the value of the property at the time of your death if the trust was funded under your will. If you created the trust during your lifetime, they will take over your basis.

Possibly the trust will sell part of the property, use some of the proceeds to make the charitable payments and reinvest the balance. In this case the trust will be taxed on the gain, though it may deduct the charitable payout.

What kinds of property may be transferred?

Cash, publicly traded securities, closely held stock, and real estate are all acceptable. Ideally, the property will generate enough income to make the charitable payments. If not, assets will have to be sold.

You will maximize the tax benefits if you transfer property with good growth potential. Perhaps you want to pass your business to the next generation, but you are worried about estate tax forcing a sale or liquidation. A lead trust could hold closely held stock for a certain period, and then your children would succeed to full ownership. Transfer tax would be considerably reduced, lessening the burden on the company.

It would be necessary to choose a payout rate and trust term so that the charitable deduction would not exceed 60% of the value of the stock transferred to the trust. Otherwise, the prohibition against excess business holdings would apply.

Can I name my grandchildren, rather than my children, beneficiaries of a lead trust?

Yes. While you may name whomever you wish, when you skip a generation, the *generation-skipping tax (GST)* may apply. Each individual is allowed an exemption for transfers to persons below his or her children's generation. **Note:** The GST exemption follows the same schedule as the federal estate-tax exemption as shown on the chart printed inside the front cover.

Through the use of a charitable lead unitrust, you can pass more than the allowed exemption to grandchildren free of this tax.

Example: *Margaret transfers \$2,500,000 to create a charitable lead unitrust with an 8% payout. After 15 years the remaining property is distributed to her grandchildren. She allocates her exemption to the trust. No generation-skipping tax will apply, and the \$5,000,000 will pass to the grandchildren free of tax.*

However, the charitable lead *annuity* trust doesn't work as well when grandchildren are beneficiaries because the exemption is allocated at the **termination** of the trust. In the example above only a portion of the \$5,000,000 will be exempt, and the trust is worth \$5,000,000 at the end of 15 years. Thus, it is generally more prudent to use the *unitrust* variety when grandchildren are beneficiaries.

Can I create a lead trust for heirs and get both gift- and income-tax deductions?

One of our donors found a way to do this that was approved by the IRS. She gave a person other than the trustee the power to swap trust property for other property of equal value, which was sufficient to cause her to be treated as owner of the trust and obtain an income-tax deduction. The trust assets aren't included in her estate because she retained no personal financial benefit. She was able to simultaneously reduce her current income tax and limit the taxable gift to her heirs. The payments to us, however, did become taxable.

What control do I have over the charitable payments?

You may give your trustee or another person the right to select the charitable beneficiaries year by year, but reserving for yourself the power to change beneficiaries is unwise because it could cause the trust assets to be included in your estate.

When you name us as beneficiary, you may direct the payments to any approved purpose. Indeed, you may advise us each year how you would like the payments to be used.

For more information

We are available to discuss with you how a charitable lead trust might meet your philanthropic and financial objectives. For more information or to schedule an appointment, please call or write.

You should consult your attorney about the applicability to your own situation of the legal principles contained herein.
