PSU Foundation
PORTLAND STATE UNIVERSITY

AN OFTEN OVERLOOKED — YET FINANCIALLY POWERFUL — TAX AND CHARITABLE PLANNING STRATEGY

The charitable lead trust has been used by some of America's most prominent families to pass assets to the next generation at a minimal tax cost. For donors whose assets exceed the federal estate, gift, and generation skipping tax exemptions that increased significantly on January 1, 2018, the charitable lead trust presents a unique opportunity to achieve their estate and philanthropic planning objectives. The charitable lead trust may be a great way for you to transfer assets to children and grandchildren, and support Portland State University Foundation and your other favorite charities, all at a significantly reduced tax cost.

How the Charitable Lead Trust Works

The charitable lead trust makes annual distributions to one or more charities for as long as the trust lasts. When the most common form of lead trust terminates, it distributes its remaining assets to children, grandchildren, or other heirs named by you when you created the trust. You receive a charitable deduction in the year you create the trust for the value of the payments promised to charity. The difference between the value of the assets you give to fund the trust and the value of the payments is considered a taxable gift from you to the heirs of the trust. However, the assets in the trust are no longer in your estate and any growth in their value while in the trust will be free from transfer taxes. You can establish this type of charitable lead trust either during your lifetime or as part of your estate plan. An alternative form of lead trust distributes its remaining assets back to you rather than to heirs. The tax benefits of the two types of lead trust differ, as explained below.

Non-Grantor vs. Grantor Charitable Lead Trusts

Non-Grantor Charitable Lead Trust – This is the most commonly used form of charitable lead trust. The purpose of the non-grantor charitable lead trust is to pass property to heirs at significantly reduced gift and estate tax cost. You receive a gift tax charitable deduction in the year you create the lead trust. The amount of your deduction depends on the payout to charity and term length you choose. In many cases, the deduction can eliminate most or all of the taxable gift to heirs.

A non-grantor charitable lead trust is not tax-exempt. While the trust receives an income tax charitable deduction for all distributions it makes to Portland State and other charities, it will owe income tax in any year during which its taxable income exceeds its distributions to charity. The trust inherits the donor's cost basis in the funding assets and the heirs of the trust inherit the cost basis of the trust when the trust's assets are distributed to them at the end of the trust. As a result, the tax consequences of funding a non-grantor lead trust with appreciated assets should be carefully considered before using them to fund this type of trust.

Grantor Charitable Lead Trust – In contrast to a non-grantor charitable lead trust, the less frequently used grantor charitable lead trust distributes its remaining assets to the donor of the trust. The donor (or grantor) is therefore treated as the owner of the trust assets. The donor receives an income tax deduction rather than a gift tax deduction in the year she creates the trust for the value of the payments promised to charity. This makes the grantor lead trust especially suitable for a donor who is seeking a substantial income tax charitable deduction in the year the trust is funded. A grantor lead trust also can be a tax-efficient means to pay off a multi-year pledge without giving up all of the asset used to finance the pledge.

Since the donor is treated as the owner of the trust's assets, the donor is taxed on all trust income during the term of the trust, including any income that is distributed to charity. The donor's ongoing tax obligations require tax analysis to determine if this type of lead trust is a prudent financial decision.

Charitable Lead Annuity Trust vs. Charitable Lead Unitrust

A charitable lead trust can determine the amount of its distributions in either of two ways.

Charitable Lead Annuity Trust – The charitable lead annuity trust distributes the same amount to charity each year for the duration of the trust, whether the trust principal increases or decreases in value. The amount of these payments is calculated when the trust is funded. If the donor chooses a payment amount that is high enough and a trust term that is long enough, the donor's deduction can be 100% of the funding amount, eliminating any possibility of transfer taxes on the funding assets. A typical payout rate is 5% - 7% of the initial value of the trust and a typical term length is 10 – 20 years.

With the non-grantor form of lead annuity trust, all growth in the trust assets during the trust term is passed on to the heirs of the trust. Largely for this reason, the non-grantor lead annuity trust is the most popular form of lead trust.

Charitable Lead Unitrust – The charitable lead unitrust distributes to charity each year a fixed percentage of its principal value as recalculated on a specified date each year. When the trust's principal value increases, its payment to charity increases. When the trust's principal value decreases, its payment to charity decreases. As a result, the beneficiaries of the trust's charitable payments and the trust's heirs share the benefit of any growth in the trust's assets during its term, as well as the cost of any decline in the trust's value. Unlike with a charitable lead annuity trust, the donor's charitable deduction for funding a charitable lead unitrust cannot be 100% no matter how high the payout rate or how long the trust term chosen. Nevertheless, a typical payout rate is 5% - 7% of the trust's value as revalued annually and a typical term length is 10 – 20 years.

A lead trust created for the benefit of grandchildren presents a special tax planning challenge related to a tax called the generation skipping tax. You may want to consider creating a charitable lead unitrust in this situation, as it is easier to plan for generation skipping tax issues when creating a lead unitrust than when creating a lead annuity trust.

Illustration of a Non-Grantor Charitable Lead Annuity Trust

The following illustration is for a non-grantor charitable lead annuity trust funded with $1 million cash that will distribute $60,000 (6%) each year to charity. The trust will last for 20 years. The illustration assumes an investment rate of 3% income and 5% capital appreciation.

Principal Placed in Plan	$1,000,000
Annual Annuity to Portland State	$60,000
Gift Tax Deduction	$909,380*
Taxable Gif	$90,620
Gift Tax Paid by Donor	$0**
Total Income Tax Paid Over Term by Trust	$0
Principal after 20 Years	$1,915,239
Benefit to Family	$1,915,239
Total Distributed to Portland State	$1,200,000
Total Benefit	$3,115,239

**Assumes an applicable federal interest rate of 2.8%.*
***Assumes the donor has more than $90,620 of her lifetime gift tax exemption available.*

In this example, the lead annuity trust nearly doubles in value during its 20-year term and transfers all of that value to the donor's heirs free of gift and estate tax. Over its 20 years of operation, the trust also distributes $1.2 million to charity.

Charitable Lead Trust Considerations

Irrevocability – To be a qualified charitable lead trust, the trust must be irrevocable.

Tax implications – A charitable lead trust can be either a non-grantor charitable lead trust (the trust assets will pass to future generations) or a grantor charitable lead trust (the trust assets will revert to the donor).

Timing of the Gift – A charitable lead trust can be funded during life – an intervivos lead trust – or at death – a testamentary lead trust.

Payments – Distributions to charity from a charitable lead trust can be a fixed amount for the life of the trust (a charitable lead annuity trust) or a variable amount that will change each year (a charitable lead unitrust).

Beneficiaries – The lead trust must identify the charities to receive trust distributions during the term of the trust or, alternatively, how the charities will be identified. The trust must also identify the individual beneficiaries who will receive any remaining trust assets when the trust terminates.

Term – The charitable lead trust must contain a term, customarily a term of years. The term can also be for an individual or individuals' lifetimes. If for a term of years, it can be for longer than 20 years.

Suitable funding assets - All of the following assets can work well for funding a lead trust: cash, securities, a closely-held business, commercial property, or a combination of these assets. Assets that are likely to increase substantially in value can be especially attractive candidates for transfer into a lead trust. On the other hand, assets that have appreciated substantially prior to creating the lead trust can present tax challenges for the trust.

Careful Planning

You should always consult your legal, tax, and financial advisors when considering a lead trust gift. The charitable lead trust is a powerful charitable planning tool that can be effectively adapted to fulfill a variety of donor objectives, but it must be carefully and prudently drafted, administered, and invested to ensure the desired outcome.

We are here to assist

If you have questions please contact our office of Planned Giving at **503-725-8307**, or by sending an email to **conwaym@psuf.org**.