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# Planned Giving

An Investment in Cape Cod's Future

## The Charitable Lead Trust: A Creative Way to Give to Charity Now and to Loved Ones Later

If you are a parent or grandparent, you may have wondered whether you could make a substantial charitable gift without diminishing the legacies you intend to leave to your heirs. There is, in fact, an option called a **charitable lead trust** that enables you to benefit both charity and your heirs and to reduce taxes in the process.

Under this plan, you irrevocably transfer assets to a trustee and provide that payments be made to a charity such as our organization for a specified period of time. At the end of that time, the principal is distributed to your heirs. A lead trust that provides for the principal to be paid to individuals other than you is called a **nongrantor charitable lead trust**.

Such a trust is particularly appropriate if:

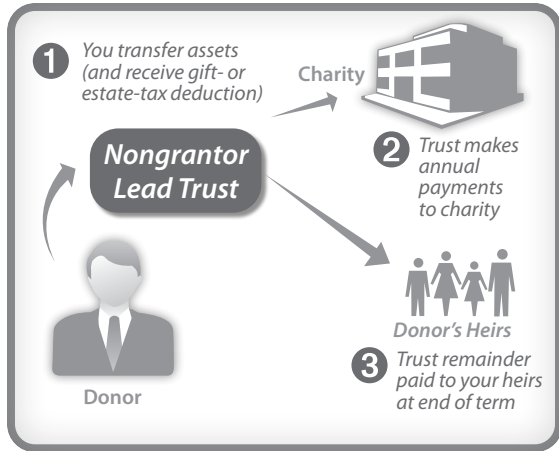
- You want to transfer a business to heirs in the future.
- You have relatively young children or grandchildren, and you want them to mature and get established in their careers before transferring significant wealth to them.
- Your estate is large enough to be subject to gift and estate taxes, and you would like to reduce them. In 2026, an estate larger than \$15 million for an individual, or \$30 million in the case of a couple combining exemptions, would be subject to federal gift and estate tax. Even if your estate would not be subject to federal estate tax, it might be subject to state estate tax if you reside in one of the states with such a tax. That is because the state estate-tax exemption is likely to be smaller than the federal exemption.
- You have assets expected to appreciate in value and you want to transfer them to heirs eventually.



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In this guide you will find answers to questions that are commonly asked about charitable lead trusts.



### How are the payments to the charity determined?

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

A trust that simply pays the actual net income will not qualify for tax benefits.

### Which method of determining the charitable payout rate is better?

The charitable lead annuity trust is far more common because it generates a much larger charitable deduction. You might also prefer it because all trust earnings in excess of the annual payments to charity will accumulate for your heirs. On the other hand, the charitable lead unitrust would preserve more for heirs if the return on investments is below the payout rate.

Suppose that \$1,000,000 is transferred to a charitable lead trust that has a 6% payout rate and will last 15 years. Here is what your heirs would receive under different scenarios:

Amount Received by Heirs After 15 Years \$1,000,000 Trust with 6% Payout		
Constant net return	Charitable lead annuity trust	Charitable lead unitrust
4%	\$599,528	\$738,569
5%	784,214	860,058
6%	1,000,000	1,000,000
7%	1,251,290	1,160,969
8%	1,543,042	1,345,868

### 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 gift and estate tax.

**Example:** Mary funds a lead annuity trust with \$1,000,000 and stipulates that we are to receive \$60,000 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 \$351,174. The difference (\$1,000,000 - \$351,174 = \$648,826) qualifies for a gift-tax charitable deduction. If she had simply given the \$1,000,000 to her children, the entire amount would have been taxable.

### When can I establish a lead trust?

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

### What determines the size of my 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 near the end of this guide show deductions for various trust terms and charitable payout rates.)

**Charitable-planning pointer:** A lower federal discount rate increases the charitable deduction from a charitable lead annuity trust. Although the discount rate has risen somewhat in the last few years, it remains relatively low and thus continues to generate attractive tax savings. The “federal discount rate” refers to the interest rate announced by the IRS each month that is used to calculate various deductions, including the charitable deduction from lead trusts.

### 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 have payments made for the duration of a person’s life—subject to certain restrictions regarding the relationship to that person.

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

### Is capital gain subject to tax?

If the trust holds assets that appreciate and the trust then distributes those assets to your heirs, the gain will not be subject to gift or estate taxes. Suppose, for example, that the assets were worth \$1,000,000 when you created the trust, \$700,000 of that amount was deductible, and the assets’ value will have

increased to \$2,000,000 by the time the trust ends. Your heirs will receive \$2,000,000, 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 that you expect to keep increasing in value.

When your heirs sell the assets, they will be taxed on the capital gain. If you created the trust during your lifetime, they will take over your cost basis. Even so, the trust can be beneficial because the current estate-tax rate is considerably higher than the capital-gain tax rate.

The trust may possibly need to sell part of the assets transferred to it and use some of the proceeds to make the charitable payments. Although the trust is taxable on the gain, it can deduct the charitable payments—so it will not actually pay any tax unless the realized gain exceeds the payments to charity.

### What kinds of assets can I transfer?

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

You will maximize the tax benefits if you transfer assets with good growth potential. Perhaps you want to pass your business to the next generation, but you are worried about the 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.

If you fund the trust with closely held stock, 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, as beneficiaries of a lead trust?

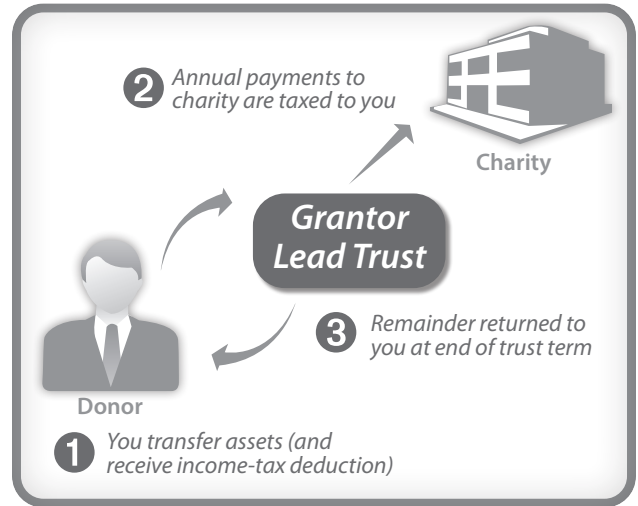
Yes. While you may name whomever you wish, when you skip a generation, the *generation-skipping tax* (GST) may apply. Each individual is allowed an exemption for transfers to persons below his or her children's generation.

**Note:** The GST exemption follows the same schedule as the federal estate-tax exemption.

If you select a charitable lead unitrust, you can determine exactly how much of your lifetime GST exemption to allocate in order to eliminate any generation-skipping tax at the termination of the trust. However, if you select a charitable lead annuity trust, you cannot determine in advance just how much of your GST exemption to use—so the trust could conceivably owe some GST when the trust terminates. On the other hand, the charitable lead annuity trust might generate a larger estate-tax charitable deduction at this time. Thus those two factors must be weighed in choosing the type of trust.

### 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. This is called a **grantor charitable lead trust**. Although you receive an income-tax charitable deduction, you will be taxed on the trust's income even though you are not receiving it. Nevertheless, a grantor lead trust can make sense if the deduction can be applied against a high marginal tax rate and the trust income will be taxed at a lower rate. That may well be the case if most of the trust income will be realized capital gain and dividends.



The up-front income-tax charitable deduction generated by a lead trust remains attractive even though the federal discount rate has increased in recent months.

### When would a grantor charitable lead trust be advantageous?

If the following three conditions apply to you, a grantor lead annuity trust could make sense:

- You will have an unusually large income this year, and much of it will be taxed at the highest federal marginal rate of 37%.
- You would like to make a substantial charitable gift, perhaps for a capital campaign.
- You would like to recover all or part of whatever capital you contribute.

**Example:** George has a spike in income this year resulting in his being subject to a 37% tax rate. He has also been asked for a major capital campaign gift by a favorite charity. He would like to make the gift and reduce his taxes, but he would like to preserve most of his capital—especially a stock that he thinks has tremendous growth potential.

He contributes \$1,000,000 of the stock to a charitable remainder annuity trust that will pay the charity \$75,000 per year for a period of eight years, a gift totaling \$600,000. Each year enough of the stock is liquidated to make the payments to the charity, but the remaining stock does well as expected, in fact, achieving a total return of about 8%.

George receives an up-front income-tax charitable deduction of \$496,719, reducing his current income tax by approximately \$183,786 during the period he uses the deduction. The exact amount George can claim as a charitable deduction depends on two factors: the total amount of his charitable gifts (including the deduction described here) and his adjusted gross income. At the end of the eight-year period, the remaining stock is returned to him; and at that time it has a value of about \$1,053,183, which means the amount returned to George would be slightly more than he originally contributed to the trust. He pays tax on realized capital gain in the shares of the stock that are liquidated, but he realizes significant income-tax savings that can be invested. He also makes his intended capital campaign gift to the charity.

### **Grantor or nongrantor lead trust— which to choose?**

In the past, nongrantor lead trusts were more common than grantor lead trusts. Most people who established such trusts wanted to transfer substantial assets to heirs while reducing gift and estate taxes, so they provided that at the termination of the trust the remaining assets went to children or grandchildren. However, an increasing number of people, who are not necessarily high-net-worth, are now considering the grantor lead trust. They are looking for a way to reduce current income tax while preserving capital.

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

This is highly technical, but it is possible to do this by including in the trust agreement a power that causes you to be treated as owner of the trust for income-tax purposes. The trust assets wouldn't be included in your estate because you retain no personal financial benefit, but you would also receive an income-tax deduction as well as a gift-tax charitable deduction. The trust income would be taxable to you. Consult expert tax counsel to discuss this planning option.

### **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; reserving for yourself the power to change charitable beneficiaries is unwise because it could cause the trust assets to be included in your estate. However, you could have the payments made to a donor-advised fund and then recommend the grants to the charities of your choice.

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.

## **Percentages of Contributions That Are Deductible**

The following charts compare the deductible percentages of contributions to charitable lead annuity trusts and charitable lead unitrusts for different payout rates and trust terms and assuming annual payments to the charity at the end of the year.

**Charitable Lead Annuity Trust  
Percentage of Contribution Deductible**

Payout Rate*	Trust Term in Years				
	5	10	15	20	25
5%	22.0	39.8	54.1	65.6	74.9
6%	26.4	47.7	64.9	78.7	89.9
7%	30.8	55.7	75.7	91.8	100
8%	35.2	63.3	86.5	100	100
9%	39.6	71.7	97.3	100	100
10%	44.0	80.0	100	100	100

\*Payout rate refers to the percentage of the initial value of the assets 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, 75.7% (about 757,000) would be deductible for gift and estate taxes (or for income-tax purposes if the principal reverts to the donor).

**Charitable Lead Unitrust  
Percentage of Contribution Deductible**

Payout Rate*	Trust Term in Years				
	5	10	15	20	25
5%	21.8	38.8	52.1	62.5	70.7
6%	25.6	44.7	58.8	60.4	77.2
7%	29.3	50.0	64.7	75.0	82.4
8%	32.9	55.0	69.8	79.7	86.4
9%	36.3	59.4	74.1	83.5	89.5
10%	39.6	63.5	77.9	86.7	91.9

\*Payout rate refers to the percentage of the value of the trust assets 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 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 remainder beneficiaries (heirs or donors).

**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 assets 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 assets 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.

**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.

**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.



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