Step Lead Trusts and Shark Fin Lead Trusts Can Perform Well for Family

A year ago we wrote a feature article about the step lead trust. A year before that, we wrote an article about the “shark fin” or “balloon” lead trust. In both cases, we suggested that economic conditions were ideal for setting up these types of trusts in part because of the very low IRS discount rate. Well, it was about 3% then. It is 1.2% now. With the IRS discount rate at a new record low, it seems worthwhile to revisit these gift plans.

Lead trust basics

First, let's review some lead trust basics.

Many gift planners describe the lead trust as the opposite of a charitable remainder trust. By this they mean that during its term, a lead trust makes payments each year to charity (the "lead interest") and then distributes its remaining assets to individuals when it terminates, rather than the other way around.

The most common form of lead trust is a non-grantor lead trust, where the assets remaining in the trust at termination go to family members or other heirs. Because the lead trust assets ultimately go to heirs, this gift plan is typically viewed as an excellent estate planning technique for wealthy individuals who want to pass assets to heirs and make substantial charitable gifts.

A non-grantor lead trust earns a gift tax deduction for the present value of the payments it will make to charity. The difference between this amount and the funding amount of the trust is considered a taxable gift from the donor to the remainder beneficiaries of the trust, typically family members. Income earned by the trust is taxable to the trust. However, the trust’s distributions to charity are deductible from this taxable income without limitation, which can result in the lead trust owing no income tax. Assets in the trust are outside the donor's estate; they are not subject to estate tax when the trust terminates and its remaining assets pass to heirs.

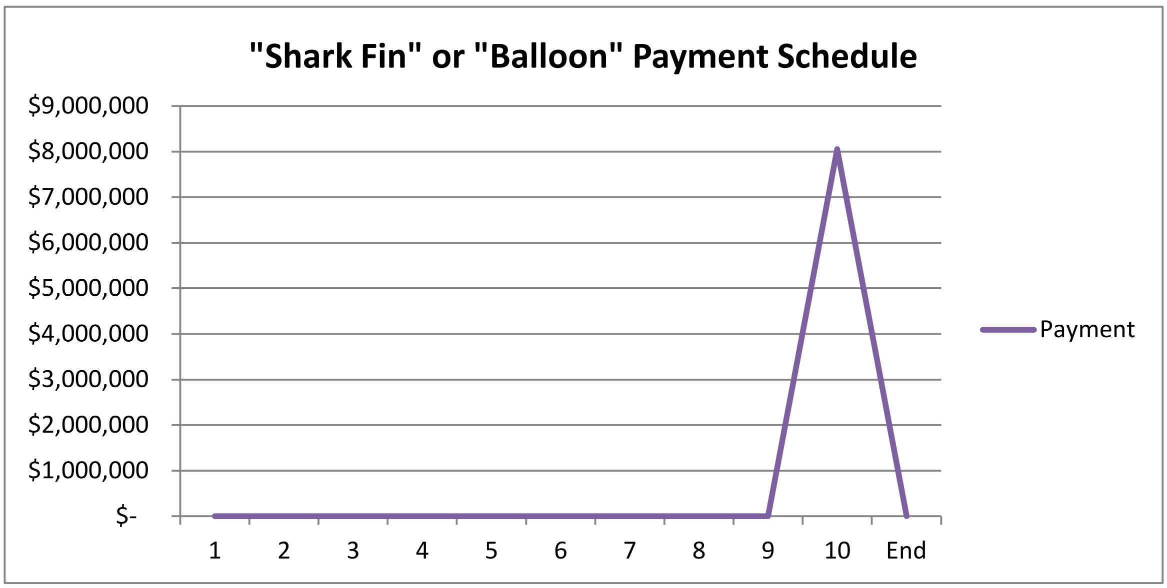
Like charitable remainder trusts, charitable lead trust payments can be in the form of an annuity amount, where the payment amount is established at the time of the gift, or a unitrust amount, where the payment amount is a specified percentage of the trust value as revalued each year. For a variety of reasons, some of which are discussed in detail below, most charitable lead trusts take the form of a charitable lead annuity trust.

The Step Lead Trust

The step lead trust differs from a standard charitable lead annuity trust only in the pattern of its payments to charity. While a standard lead annuity trust makes payments to charity that are the same amount every year, a step lead trust makes payments to charity that increase in steps during the trust term, for example 10%/year. The IRS made clear in Revenue Procedure 2007-45, which provides annotated sample trust instruments for charitable lead annuity trusts created during the donor's life, that this sort of payment schedule meets the requirements of a charitable lead annuity trust. The IRS reaffirmed its position just recently with a favorable private letter ruling regarding a 10-year testamentary lead annuity trust with payments that will increase 20% each year (PLR 201216045).

The Shark Fin Lead Trust

A shark fin (or "balloon") lead trust is really just an extreme form of step lead trust: rather than increase its payments at a steady clip over the course of its term, a shark fin lead trust makes small payments every year of its term except the last, and then makes a very large payment in its final year. If you graph this payment pattern – and use your imagination – the final payment looks something like a shark's dorsal fin slicing through the water.



It is also possible to structure a shark fin lead trust so that it makes large payments over several final years, not just one. In that case, the fin would have a flat top rather than come to a point, and most likely would be shorter, too.

Note: The notion of having payments increase by no more than 20% each year is considered a "safe harbor" by some practitioners. It derives not from the revenue ruling mentioned earlier, but rather from a ruling relating to the grantor retained annuity trust (GRAT), a popular non-charitable estate planning vehicle that is similar to a charitable lead annuity trust in certain respects (see Treas. Reg. §25.2702-3(b)(1)(ii)). These planners are concerned that if charitable lead annuity trust payments escalate by more than 20% from any year to the next, such as in the shark fin lead trust, the IRS could take exception. The IRS has not ruled specifically on the shark fin lead trust.

Why a Step Lead Trust or Shark Fin Lead Trust?

One way that the lead trust reduces transfer taxes is that any growth in asset value that occurs within the trust is passed on to the trust's heirs completely free of gift and estate taxes. The more the trust grows, the more the trust transfers to heirs and the more gift and estate taxes may be avoided.

Current economic circumstances make it unusually easy to set up a lead annuity trust that is likely to grow in value over its term:

1. At 1.2% for June, the IRS discount rate has never been lower. In effect, the IRS is saying that a charitable lead trust will earn only a 1.2% annual return on its investments over its term. As a result, the payout rate necessary for a lead annuity trust to earn a 100% deduction is the lowest ever (see table below). A lower payout rate translates into more opportunity for the trust to retain earnings and increase in value over its term. In the case of a lead annuity trust, this growth will be entirely to the benefit of the trust's ultimate beneficiaries (e.g., family members).

IRS Discount Rate	**Deduction % for 20-year CLAT with 5% payout rate**	**100% Deduction Payout Rate for 20-year CLAT**
1.2%	88.4%	5.65%
2.0%	81.8%	6.12%
3.0%	74.4%	6.72%
4.0%	68.0%	7.36%
5.0%	62.3%	8.00%
6.0%	57.3%	8.72%

2. While it is difficult to predict stock prices in the short term, many investors feel that in the longer term we will have solid growth in stock prices to look forward to as the U.S. and world economies recover from the financial shocks of 2008 and 2009, as well as from the persistent unemployment and debt challenges of today.

The potential for asset growth in the long term coupled with the extremely low IRS discount rate has created ideal circumstances under which a charitable lead trust can grow in value over time. The step lead trust and shark fin lead trust aim to leverage these benefits even more than a standard charitable lead trust does.

Making the payments of the trust lower in its early years (step lead trust) or very low until its final year (shark lead fin trust) reduces the effects of poor investment results in the early years, should they occur. Assuming that decent investment results are more certain over the longer term, to differing degrees each approach will tend to allow the accumulation of more assets for the donor's heirs than a straight lead annuity trust would.

We should note that while a lead trust can minimize or eliminate gift and estate taxes, it does not avoid capital gains tax. The trust assumes the donor's cost basis in the funding assets. The trust's ultimate beneficiaries, the donor's heirs, assume the cost basis of the assets distributed to them from the trust. If the heirs then sell any of these assets, they must pay capital gains tax on the appreciation that has accumulated since the trust - or the donor - acquired them. Estate tax rates currently are much higher than capital gains tax rates (35% versus 15%), so for a donor with an estate large enough to owe estate tax, passing on a potential capital gains tax to heirs rather than paying an estate tax should be appealing.

Results with Different Investment Returns
To demonstrate the advantages of a step lead trust and a shark fin lead trust, we compared the benefits of these two trusts and a standard lead annuity trust under different investment assumptions. Each trust has a 20-year term, earns a 100% gift tax deduction, and is funded with $1 million. The step lead trust payments increase 20% each year.

Note: All of the calculations in this article were performed using PG Calc's *Planned Giving Manager 6.6* software, which was released on May 31. If you are a *PGM* client, run the How to illustrate step and balloon ("shark fin") lead trusts DemoClip for guidance on how to model these variations of a charitable lead annuity trust.

Using June's IRS discount rate of 1.2%, the standard lead annuity trust requires a payout of $56,538 each year to achieve a 100% deduction. In contrast, the step lead trust can earn a 100% tax deduction by distributing just $6,438 to charity in its first year, an initial payout rate of only 0.64%. The step lead trust won't need to distribute as much to charity as the standard trust until its thirteenth year. The shark fin lead trust won't need to distribute as much as the standard trust until its final year, of course, when it will distribute $1,247,980. See the table chart for the schedule of payments for each trust <link to June 2012 feature CLT payout schedules.docx >.

The table below shows the projected outcome for the family and charity under our first set of investment assumptions, a consistent 8% total return each year. You can see that the step lead trust and shark fin lead trust are both projected to provide substantially more to the family than the standard trust. Back-loading their payments to charity benefits the family members significantly even when investment returns are steady, about $550,000 more.

Projected results for 8% constant rate of return

	5.6538% Lead Annuity Trust	Step Lead Annuity Trust	Shark Fin Lead Annuity Trust
Principal Placed in Plan	$1,000,000	$1,000,000	$1,000,000
Benefit to Family	$2,073,249	$2,611,455	$2,640,045
Benefit to Charity	$1,130,760	$1,201,941	$1,266,980
Total Taxes	$419	$79,682	$364,711

Curiously, the step lead trust and shark fin lead trust will also provide more to the charity in total payments than the standard lead trust. How can that be? Keep in mind that the timing of when the charity gets it dollars varies greatly among the three trusts. In current dollars, the standard trust will provide more benefit to charity than the other two trusts if you discount at a rate higher than 1.2%. In fact, from the charity's point of view, the shark fin lead trust is similar to a charitable remainder trust with a 20-year term: the charity has to wait until the end of the trust's term to receive almost all of its $1,266,980.

What happens if the trusts have a terrible -20% investment return in their first year (think 2009), and then earn a steady 8% thereafter?

Projected results for -20% return in year 1, followed by 8% constant rate of return

	5.6538% Lead Annuity Trust	Step Lead Annuity Trust	Shark Fin Lead Annuity Trust
Principal Placed in Plan	$1,000,000	$1,000,000	$1,000,000
Benefit to Family	$865,271	$1,518,290	$1,626,516
Benefit to Charity	$1,130,760	$1,201,941	$1,266,980
Total Taxes	$0	$37,430	$265,233

You can see that while each trust is projected to distribute far less to the family than in the previous example, the step lead trust, and even more so the shark fin lead trust, preserve more assets for the family. Since the payments to charity are established at the outset in all three cases, those payments are unaffected by the change in investment performance.

What if the trusts have an excellent +20% investment return in their first year (think 2010) followed by a steady 8% return thereafter?

Projected results for +20% return in year 1, followed by 8% constant rate of return

	5.6538% Lead Annuity Trust	**Step Lead Annuity Trust**	**Shark Fin Lead Annuity Trust**
Principal Placed in Plan	$1,000,000	$1,000,000	$1,000,000
Benefit to Family	2,493,822	2,980,605	2,988,063
Benefit to CHARITY	1,130,760	1,201,941	1,266,980
Total Taxes	31,325	123,365	424,633

In this case, the standard lead annuity trust narrows the gap between its projected benefit to family and the projected benefit to family of the other two trusts. Nevertheless, the step lead trust and the shark fin lead trust still are projected to provide about $500,000 more to the family than is the standard lead trust.

Lastly, what if the trusts experience steady 8% performance until their final year, then suffer a 20% loss?

	5.6538% Lead Annuity Trust	**Step Lead Annuity Trust**	**Shark Fin Lead Annuity Trust**
Principal Placed in Plan	$1,000,000	$1,000,000	$1,000,000
Benefit to Family	1,312,518	1,783,321	1,922,187
Benefit to CHARITY	1,130,760	1,201,941	1,266,980
Total Taxes	208,873	277,530	249,236

Even when the loss is at the end of the trust term, the point at which the step lead trust and shark fin lead trust payments are greatest, they are projected to provide more to the family than is the standard lead trust.

Now, you may rightly ask what the results are if returns fall short of 8% in most years? We tried the same scenarios using 6% in place of 8% and 4% in place of 8%. The step lead trust and shark fin lead trust still outperformed the standard lead trust in terms of the benefit to the family, although the step lead trust tends to preserve more assets for family than the shark fin lead trust at these lower rates of return. In the case of anemic long term investment performance, such as 4% total return/year, followed by a terrible final year, such as a 20% loss, the shark fin lead trust actually leaves less for the family than both the standard lead trust and step lead trust. If the 20% loss is at the beginning of the trust term rather than the end, however, we see the more familiar pattern of the step lead trust and shark fin lead trust outperforming the standard lead trust.

In sum, in the wide range of investment performance we tested, the step lead trust always outperformed and the shark fin lead trust almost always outperformed the standard lead trust from the family's perspective.

Gift and Estate Taxes

Lead trusts are particularly attractive to donors whose estates are large enough to pay gift and estate taxes. A lead trust can reduce or eliminate gift tax on the assets used to fund the trust, as well as eliminate gift and estate taxes on any asset growth that occurs inside the trust. It is worth noting that the gift tax and estate tax exclusion for 2012 is $5.12 million per person and $10.24 million per married couple. This means that, except to the extent they have made other taxable gifts in the past, only donors who plan to transfer taxable amounts above these very substantial thresholds need to worry about paying gift tax on transfers they make this year.

The big question is what will happen next year and beyond? Without action by Congress, the $5.12 million/$10.24 million exclusion will expire at the end of this year and return to $1 million per person and $2 million per couple. Moreover, the top gift and estate tax bracket will increase from the current 35% to 55%. If that happens, reducing or eliminating gift and estate taxes through a charitable lead trust will become much more valuable to many more donors. On the other hand, if the current transfer tax exclusion and schedule is extended instead, and many practitioners feel that this is a more likely outcome, lead trusts will remain attractive gift plans mostly to single donors with estates over $5 million and married couples with estates over $10 million.

It is almost certain that Congress will take no action on transfer taxes until after the November elections. The lack of clarity about what will happen with transfer taxes in

2013 and beyond has caused some planners to take a wait-and-see stance toward creating lead trusts. Others assume that some level of estate taxation is likely to remain in place and so are enthusiastic about advising their wealthy, philanthropically motivated clients to take advantage of today’s extremely low IRS discount rate by creating a charitable lead annuity trust.

Conclusion

The step lead trust and shark fin lead trust are interesting variations on the standard charitable lead annuity trust that may offer particular advantages in the current economic environment. While lead trust donors are uncommon, they are also uncommonly generous and well worth pursuing. If you have mentioned the lead trust to any of your donors in the past, consider mentioning the step lead trust to them or their advisors. Since a step lead trust will provide funds to your charity sooner than a shark fin trust, we suggest that you bring up the shark fin lead trust only if a specific donor discussion evolves in that direction.

It also would be well worth your while to review your top-of-pyramid prospects and consider whether any of them might be a good candidate for a step lead trust. While your charity might prefer the steady payments of a standard lead annuity trust over the escalating payments of a step lead trust or the single balloon payment of a shark fin lead trust, the step lead trust and shark fin lead trust present creative opportunities to attract very significant gifts that otherwise might not happen at all.