Bill Laskin - Wed, 4/20/2011 - 00:00

Sam Samuels, Associate Director, Gift Planning at Smith College, called us not long ago to tell us about a spectacular gift the college had just received. An alumna who recently celebrated her 50th reunion has created two $10 million lead annuity trusts, one with a 15-year term, the other with a 20-year term. Smith will receive over $16 million in payments from the two trusts, “making it dollar-for-dollar the largest individual gift in the college’s history.” Sam observed that “the gift has been an incredible boon to the college not just for its own sake, but also because we are in the second year of the quiet phase of a capital campaign. This is turning out to be a pace-setting gift for this phase of the campaign and has already sparked interest in lead trusts from other potential top-of-the-pyramid donors.”

Sam went on to describe an interesting wrinkle to these trusts. “The trusts were established as annuity trusts, but not with level payments. Each year, the payouts will increase by 20% over the prior year. While the first year’s payout is relatively low (a mere $153,000!), in year 15 the combined trusts will pay nearly $2 million. After that, the 15-year-trust will have terminated, but the 20-year trust will continue to disburse rising payments that will top out at $1.4 million.” Sam explained that the payment amounts were set so that the donor would be allowed a 100% charitable deduction for each trust. This way, there would be no taxable gift.

**The Step Lead Trust**

The variation on the standard charitable lead annuity trust that will benefit Smith College for the next 20 years is often called a “step” lead trust because the trust payments increase in steps. An escalating payment scheme like the one above is okay with the IRS because the exact amount of each payment is ascertainable at the time the trust is created. The IRS made clear in Revenue Procedure 2007-45, which provides annotated sample trust instruments for inter vivos charitable lead annuity trusts, that this sort of payment schedule meets the requirements of a charitable lead annuity trust. Notably, the revenue procedure stops short of providing suggested wording for such a payment arrangement.

**Why a Step Lead Trust?**

We’ve had a number of calls from clients about step lead trusts in the past few months, far more than we're used to getting about such an esoteric gift plan. Why the spike in interest?

A charitable lead annuity trust is a way for a wealthy donor to pass assets on to heirs at little or no gift or estate tax cost while providing a generous gift to one or more charities at the same time. During its term, the lead trust makes payments each year to the charity(ies). Whatever assets remain in the lead trust when it terminates are distributed to individuals named by the donor, typically family members. Unlike a charitable remainder trust, which is tax-exempt, a charitable lead trust is a taxable entity, so trust investments need to be managed with this in mind.

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 its heirs completely free of gift and estate tax. The more of this growth that occurs, the more the trust transfers to heirs and the more gift and estate tax is potentially avoided.

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

1. The IRS discount rate is still very low. Although it has risen substantially from its record low of 1.8% in December 2010, it is still only 3.0% as of April 2011. In effect, the IRS is saying that a charitable lead trust will earn only a 3% total return on its investments. As a result, the payout rate necessary for a lead annuity trust to earn a 100% deduction is historically very low. If the payout rate is low, the trust will be able to retain more of its earnings and will more likely increase in value in the years to come. In the case of a lead annuity trust, this growth will be entirely to the benefit of the trust's ultimate beneficiaries (with a lead unitrust, the charity and ultimate beneficiaries share the benefit of any trust growth).
2. Stock prices fell dramatically in late 2008 and 2009. While they have recovered significantly since then, many investors feel that we still have a period of above average growth in stock prices to look forward to as the recovery continues.

The potential for above average asset growth rates in the near term coupled with the low IRS discount rate has created ideal circumstances under which a charitable lead trust can grow in value over time, ultimately to the benefit of the its beneficiaries. The step lead trust aims to leverage these benefits even more than a standard charitable lead trust does.

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 inherits the cost basis of the donor. The trust's ultimate beneficiaries, the donor's heirs, inherit the cost basis of 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 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.

**Step Lead Trust Example**

A step lead trust can be constructed so that payment amounts in the early years of the trust are very low, yet the trust still earns a 100% charitable deduction. For example, a 20-year $1,000,000 step lead trust that increases its payments 20% each year can earn a 100% charitable deduction by distributing just $8,405 to charity in its first year. That's an initial payout rate of only 0.8405%. A standard lead annuity trust would require a payout of $67,216 every year to achieve the same 100% deduction. The step lead trust won't pay that much until its thirteenth year.

See the linked charts for details. (Note: these charts were created using a spreadsheet.)

By enabling such a low starting payout rate, a step lead trust can reinvest and accumulate much more of its investment income and appreciation in its early years than a standard lead annuity trust can. This early accumulation ultimately can lead to more assets remaining for the benefit of the donor's heirs.

If we assume the step lead trust returns a total of 8% in income and appreciation each year, the step lead trust principal will be worth about $2.12 million when it terminates 20 years later. In contrast, a standard lead annuity trust with a 6.72% payout rate with identical investment performance will be worth $1.58 million when it terminates. In short, the step lead trust will transfer an additional $500,000 to heirs. What's more, the step lead trust will also distribute more total dollars to charity than the standard lead annuity trust: $1.56 million versus $1.34 million. This is possible because the step lead trust heavily back loads its charitable distributions. In today's dollars, both total distributions equal $1 million if you use a 3% present value rate.

If the trust’s investments do particularly well in the early years, the step lead trust outpaces the standard trust by even a little more. Interestingly, if the trust has a terrible first year, losing 20% of its value, and then earns a steady 7% total return thereafter, the step lead trust performs much better than the standard trust, distributing nearly $700,000 to heirs while the standard trust distributes less than $250,000. In this case, the step lead trust is able to grow for many years once it gets past the dismal first year, but the standard trust just continues to shrink, albeit at a slower pace than in year one.

See the linked charts for details.

**Note:** The notion of having payments increase by no more than 20% each year is considered a “safe harbor” by many gift planners. It derives not from the revenue ruling mentioned earlier, but rather from a ruling relating to the grantor lead annuity trust, 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 so-called “shark-fin trust,” the IRS could take exception.

**Gift and Estate Taxes**

Many lead trusts have been created by donors whose estates are large enough to pay estate tax, often with a trust term and payout rate that results in a 100% gift tax deduction. It is worth noting that the gift tax exclusion for 2011 and 2012 is $5 million per person and $10 million per married couple, a five-fold increase over its previous level. This means that far fewer donors should need to worry about paying gift tax on transfers they make this year or next.

While the $5 million/$10 million exclusion may continue into 2013 and beyond, extending legislation will need to be passed first. Otherwise, this exclusion will return to $1 million per person and $2 million per couple. The high gift tax exclusion level through 2012, and the uncertainty thereafter, should encourage wealthy donors to make taxable transfers in 2011 and 2012 that take full advantage of the $5 million/$10 million exclusion. These transfers could include the creation of charitable lead trusts structured to earn a deduction of less than 100%.

**Conclusion**

The step lead trust is an interesting variation 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. 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. It also would be well worth your while to review your top-of-pyramid prospects, as Sam Samuels and his colleagues are doing at Smith, and consider whether any of them might be a good candidate for a step lead trust.

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