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We have responded to many more client inquiries about charitable lead trusts over the past two years than any other two year period in our 25-year history. We have also noticed a flurry of articles on lead trusts during this same period.

A particular lead trust variation that has received considerable attention lately is what some practitioners are calling the "Shark Fin" lead trust. You may have also seen the term "Balloon" lead trust mentioned. Two names, same trust.

This article reviews what a Shark Fin lead trust is and then examines its potential benefits and pitfalls to help you identify the role this creative gift planning concept might play in your planned giving program.

Lead trust basics

Before we focus on Shark Fin lead trusts specifically, let's review a few basics about lead trusts generally.

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. The trust can offset its taxable income each year to the extent it makes distributions to charity that year. 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.

Why the increased interest in charitable lead trusts?

The increased interest in lead trusts coincides closely with the sustained very low monthly IRS discount rates, which consistently have been 4.2% or lower during the past two years. They have been 3.0% - 3.4% since July 2009.

Why is there a strong correlation between interest in lead trusts and low IRS discount rates? Because low IRS discount rates translate to high tax deductions for charitable lead annuity trusts (CLATs). During the past two years, in fact, it has been relatively easy to create non-grantor CLATs that earn a 100% gift tax deduction.

The chart below shows that a 20-year CLAT must pay 6.72% of its initial value to achieve a 100% deduction when the IRS discount rate is 3% (the rate in January 2010), but 8.00% of its initial value when the IRS discount rate is 5% (the rate in December 2007), and 10.19% when the IRS discount rate is 8.0% (the rate in July 2000).

IRS Discount Rate	Deduction % for 5% CLAT	100% Deduction Payout Rate
3.0%	74.4%	6.72%
4.0%	68.0%	7.36%
5.0%	62.3%	8.00%
6.0%	57.3%	8.72%
7.0%	53.0%	9.44%
8.0%	49.1%	10.19%

Transfers into a non-grantor CLAT are subject to federal gift tax on the way in, but if a CLAT earns a 100% deduction, there is no taxable gift. This means that a non-grantor CLAT that earns a 100% deduction enables the donor to pass the assets that remain in the CLAT when it terminates to heirs completely free of transfer taxation. This elimination of transfer taxes is very appealing to some donors.

In addition to the tax benefits of low IRS discount rates, many planners believe that the steep decline in stock values during the recent "Great Recession" has only enhanced the potential benefits of funding a non-grantor CLAT. Their reasoning goes like this: having fallen so precipitously, stock values are likely to rise at greater than historical rates in coming years (this certainly was true in 2009), or at very least at rates greater than the 3.0% - 3.4% IRS discount rates of the last six months. If this increase in value occurs within the confines of a lead trust and is then passed on to heirs, that growth can be transferred free of tax.

The economy is still far from robust, of course, and stocks values could decline significantly again in the shorter term. A CLAT that has the misfortune of being created near the beginning of a slide in stock values will have to make payments while its value is depressed, initiating a downward spiral that may be difficult to pull out of. Many charitable remainder annuity trusts have spiraled toward exhaustion in the last few years for just this reason.

Enter the Shark Fin lead trust.

The Shark Fin lead trust

The Shark Fin lead trust takes advantage of a nuance of the tax law governing charitable lead trusts that was little appreciated until recently: the payment amounts of a charitable lead annuity trust must be known at the time that the trust is created, *but* they do not have to all be the same. It is possible to include as part of the trust document a schedule of future payment amounts that calls for the payments to change over the term of the trust. (Treas. Reg. Secs. 20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi)).

Planners take advantage of this option when constructing a Shark Fin lead trust. A Shark Fin lead trust is simply a charitable lead annuity trust with a schedule of small payments for all years of the trust except the last, and a large payment in the final

year. If you graph this payment pattern – and squint a little – the final payment looks something like a shark's dorsal fin slicing through the water.

Keeping the payments of the trust very low until its final year minimizes 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, there should be sufficient funds accumulated in the trust by the final year both to make the balloon payment that year and leave significant assets to the donor's heirs.

Example

An example will help clarify the risks and rewards of the Shark Fin lead trust strategy.

Mr. Martin has significant assets, but due to the current investment climate many of these assets have lost significant value. Despite his losses, Mr. Martin is confident that these investments will recover and appreciate significantly in future years. He funds a non-grantor charitable lead trust with $6,000,000 in assets for a term of 10 years. In years one through nine the trust pays just $1,000 per year to charity. In year 10, however, the trust makes a balloon payment of $8,053,035, the amount necessary for the trust to earn a 100% gift tax deduction using January 2010's IRS discount rate of 3%.

How can the trust afford the balloon in year 10? Given the small payments in years one through nine, the trust is able to grow rapidly during these years if it has consistent investment returns of 8%, or even 6%. Since the trust's deduction is based on an IRS discount rate of 3%, any average investment return above 3% will allow enough growth to cover the balloon payment. The greater the excess over 3%, the more will be left over for the heirs.

In the chart below, we compare the results for the Shark Fin trust described above under three different investment returns: a consistent 8% return (6% appreciation, 2% income), a consistent 6% return (4% appreciation, 2% income), and a bad timing case where the investment return is -10% in year one followed by a consistent 6% in years two through ten.

	11.723% Charitable Lead Annuity Trust	**11.723% Charitable Lead Annuity Trust**	**11.723% Charitable Lead Annuity Trust**
Gross Principal	$6,000,000	$6,000,000	$6,000,000
Annuity to Charity years 1 to 9	1,000	1,000	1,000
Annuity to Charity in year 10	8,053,035	8,053,035	8,053,035
Gift Tax Deduction	6,000,000	6,000,000	6,000,000
Gift Tax (Paid 2010 by donor)	0	0	0
Investment Return, Year 1	8%	6%	-10%
Investment Return, Years 2-9	8%	6%	6%
Total Income Tax Paid	497,144	456,623	391,760
Principal after 10 Years	4,169,080	2,074,460	536,291
Benefit to Family	4,169,080	2,074,460	536,291
Total Distributed to Charity	8,062,035	8,062,035	8,062,035

In each case, the charity receives the same $8,062,035, almost all of which is distributed in the trust's final year. The benefit to the family, on the other hand, changes dramatically with the investment fortunes of the trust. Their share ranges from $4.1 million when the trust earns a healthy 8% every year, to $2.0 million when it earns 6% every year, to a relatively paltry $536,000 when the trust suffers a 10% decline in it first year.

Compare these results to a 10-year $6 million non-grantor CLAT that pays $703,380 each year, under the same array of investment assumptions, which is illustrated below. The $703,380 payout rate is the minimum necessary to earn the trust a 100% deduction.

	11.723% Charitable Lead Annuity Trust	11.723% Charitable Lead Annuity Trust	11.723% Charitable Lead Annuity Trust
Gross Principal	$6,000,000	$6,000,000	$6,000,000
Annuity to Charity	703,380	703,380	703,380
Gift Tax Deduction	6,000,000	6,000,000	6,000,000
Gift Tax (Paid 2010 by donor)	0	0	0

Investment Return, Year 1	8%	6%	-10%
Investment Return, Years 2-9	8%	6%	6%
Total Income Tax Paid	0	0	0
Principal after 10 Years	2,763,992	1,473,979	820,972
Benefit to Family	2,763,992	1,473,979	0
Total Distributed to Charity	7,033,800	7,033,800	6,885,879

Assuming a consistent investment return of 8%, the family will receive about $2.7 million using this approach compared to $4.1 million using the shark fin approach. If the trust earns a consistent investment return of 6%, the family gets just short of $1.5 million using this approach compared to $2.0 million using the shark fin approach. In the bad timing case, the standard CLAT exhausts its principal in its final year, reducing its final payment to charity to the $536,000 remaining in the trust and leaving nothing for the family. In contrast, the shark fin trust is able to recover sufficiently from its initial decline to make its full balloon payment and pass over $500,000 to the family.

From the family's perspective, the shark fin trust outperforms the standard CLAT over a range of investment assumptions. Why is this? Consider the two trusts from the charity's perspective. With the standard CLAT, the charity receives just over $700,000 each year, starting in year one. These are funds that the charity can put immediately to use furthering its mission. With the shark fin trust, the charity must wait for ten years before receiving a significant payment. If you compute the value of the two payment streams in today's dollars by discounting at the IRS discount rate of 3%, the two payment streams are of equal value to the charity. That's why both trusts earn the same 100% gift tax deduction, even though the shark fin trust will distribute $1 million more to charity than the standard CLAT.

Given the choice between these two payment streams, however, most (all?) charities will prefer the steady stream of equal payments starting immediately to the single huge payment ten years hence. In addition to getting significant funds sooner, it is also arguable whether the two payment streams are actually of equal value, despite their equal valuations for tax deduction purposes. For example, if you discount the payment streams at 6%/year to account for the opportunity cost to the charity of not being able to invest payments for a 6% return until they are received, the value of the standard CLAT payments becomes $5,177,000 versus $4,500,000

for the shark fin trust. The higher the discount rate you use, the greater the difference in these values will be.

Another issue worth noting is that the shark fin trust pays greater income taxes during its term than a standard CLAT will. This is because a lead trust is fully taxable on earned income and realized capital gain that exceed its distributions to charity. Since Mr. Martin’s shark fin trust is making very small payments to charity in years one through nine, there is very little offsetting deduction to reduce the 2% income we assume the trust will earn each year. The result is $400,000 - $500,000 of income taxes paid by the trust over its 10 years. In contrast, our standard CLAT example pays no income tax during its term under any of the three investment scenarios because it always pays more to charity each year than it earns in income.

Conclusion

The shark fin lead trust is an interesting wrinkle on the standard charitable lead annuity trust that tends to preserve more assets for its remainder beneficiaries, typically family members, than a standard charitable lead annuity trust. In today's financial climate, where many assets have lost significant value over the past few years and the near term financial outlook is uncertain, the shark fin lead trust can be an attractive planning tool for a donor who is interested in passing assets to heirs *and* making a substantial charitable gift. That's what financial planners and estate planners have been reading lately. While your charity might prefer the steady payments of a standard CLAT over the single balloon payment of a comparable shark fin CLAT, the shark fin CLAT presents an opportunity to attract a very significant gift where otherwise a gift might not happen at all.