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Why you should consider Charitable Lead Annuity Trusts for estate planning

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Charitable lead annuity trusts or "CLATs" are a popular estate planning vehicles used to move assets to the next generation with little to no gift or estate taxes while also benefitting a charity. Although around for almost fifty years, with historically low interest rates, the ability to back load charitable payments, and use of valuation discounts, CLATs are a very powerful means to pass wealth to the next generation.

Basics of a CLAT

A CLAT is a split interest trust where one or more charities receive a specified percentage of the *initial* value of the trust's assets each year (e.g., 6% of the initial fair market value of the trust's assets) during the initial years of the trust, and non-charitable beneficiaries receive the assets that remain in the trust after the initial charitable term. The charitable term can last for a specified number of years, for the life or lives of one or more individuals, or a combination of these.

During the initial charitable term, the assets can pass to a specific charity, including a private family foundation, or to one or more charities as designated by the client or as selected by the trustees over the term of the charitable term. When the charitable term ends, any remaining assets in the trust pass to the remainderman of a CLAT, who can be any one or more individuals a client wishes to benefit, including their children (note that because generation-skipping transfer tax exemption cannot be allocated to the CLAT until the termination of the charitable lead term, it is best to use this type of trust to benefit children rather than grandchildren).

The present value of the charitable lead interest is the amount that is considered to

be passing for the use of a charity for purposes of the charitable deduction. It is calculated by using the applicable §7520 rate (a rate published monthly by the IRS) in effect at the time of the CLAT is funded—this is the date of transfer for lifetime CLATs and the date of death for testamentary CLATS).[1] A CLAT can even be set up so that it is so called "zeroed out" CLAT—where the present value of the charitable lead interest is equal to the entire initial fair market value of the property contributed to the CLAT. As a result, the entire contribution to a zeroed out CLAT will qualify for the estate or gift tax charitable deduction leaving any remaining property free of gift or estate tax to the beneficiaries.

The payments made to the charity from the CLAT can be structured so that the amount passing to charity in the first year of the CLAT is relatively small and gradually increases each year over the term of the CLAT.[2] By making smaller distributions to charity in the initial years of the CLAT, the trust principal has additional time to grow before larger distributions must be paid out to the charity in later years. Assuming a steady growth rate, this gives the assets within the CLAT more time to appreciate and thereby increases the amount that may ultimately pass free of gift and estate tax to the individual beneficiaries. Additionally, the amount paid to the charity each year is based on the initial fair market value of the trust assets. Thus, for closely held business assets which are typically subject to minority or lack of marketability discounts, the amount passing to the charity will also be based on this discounted value. Ultimately, this may also serve to increase the assets which pass free of gift and estate tax to the non-charitable

[1] Under Reg. §25.7520-2(a)(2) you are permitted to use the current §7520 rate or choose from the §7520 rates for the two prior months if it yields a better result.

[2] Some commentators advocate a so-called "shark-fin" CLAT where the charity payments in the initial years are deminimis and only spike in the final years of the CLAT; however, there are serious risks that such payments to charity would not be considered an annuity and thereby invalidate the CLAT. Conversations with the IRS in connection with a private letter ruling indicated that they would only recognize an increase of the annuity by 20% (which is also allowed for annuity payments with GRATs).

beneficiaries.

Lifetime CLATs

CLATs can be established and funded during life. One threshold issue in establishing a lifetime CLAT is the income tax treatment of the CLAT. There are two types of lifetime CLATs—a "grantor" CLAT, where the client is treated as the income tax owner of the trust, and a "non-grantor" CLAT, where the trust is a separate taxpayer for income tax purposes.

The benefit of a grantor CLAT is that the client would receive an immediate income tax charitable deduction. By funding a grantor CLAT with cash, the income tax deduction would equal the amount of cash contributed subject to a cap of 30% of adjusted gross income. By funding a grantor CLAT with long term capital gain property, the charitable deduction would be capped at 20% of adjusted gross income. Although grantor CLATs afford clients this immediate income tax deduction, going forward the client would be responsible for paying the income tax liability of the CLAT each year from his own assets.[3] Although this ongoing income tax liability further reduces the assets in the client's taxable estate, it is the client's personal assets that must be used to pay these taxes. One strategy used to avoid an ongoing income tax liability of a grantor CLAT is to invest in assets that are not subject to income taxes, such as a life insurance policy. However, because Section 170(f)(10) of the Code prohibits an income tax deduction if a charity directly or indirectly pays premiums on certain life insurance, care must be taken to avoid §170(f)(10).[4]

With a non-grantor CLAT, the client does not receive an income tax deduction for

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[3] In the event the client should pass away during the charitable lead term of a grantor CLAT, the CLAT changes from a grantor CLAT to a non-grantor CLAT. As a non-grantor CLAT, the trust will receive income tax deductions as annuity payments are made to charity each year; however, to prevent a double charitable deduction, a portion of the initial income tax charitable deduction that the client initially received upon funding the CLAT will be realized as income by the client in the year of the client's death.

[4] Note that each year the CLAT must file Form 5227 with the IRS which asks at question 80 whether or not the CLAT has directly or indirectly paid life insurance premium payments.

his initial contribution, however, as payments are made to charity each year to satisfy the charitable annuity payment, the CLAT receives an unlimited charitable deduction for gross income paid to charity.[5] Thus, while there is no initial income tax benefit upon funding a non-grantor CLAT, the client also does not have the continuing obligation to pay the trust's income tax liability each year during the charitable term.

Testamentary CLATs

CLATs can also be established at a client's death in their will or revocable trust. The estate tax benefit of using a testamentary CLAT is that the client's estate will receive an immediate estate tax charitable deduction equal to the value of the charitable lead interest. If a will or revocable trust leaves all assets in excess of the remaining estate tax exemption to a zeroed out CLAT, the estate will owe no estate tax. In addition to this estate tax savings, using a zeroed out testamentary CLAT may also have an ancillary effect of disincentivizing the IRS to audit the estate, since regardless of the value of the estate, no additional estate taxes will be due to the IRS as everything passes to the CLAT and qualifies for the charitable estate tax deduction. This may be of particular interest for clients with closely held businesses where lack of marketability and minority discounts may present the potential for valuation disputes with the IRS.

Additionally, many clients with closely held businesses have life insurance trusts with large policies set aside to pay the estate taxes. With a zeroed out testamentary CLAT since there will be no estate tax, all the life insurance can immediately be used by or held in trust for the beneficiaries while they wait out the CLAT term to receive any remaining assets in the CLAT.

For example, if a 20 year zeroed-out CLAT is funded using the Section 7520 rate in effect for May 2015 of 1.8% with an increasing annuity payment of 20%, assuming a

[5] No deduction is allowed for any income that is considered unrelated business income.

steady 5% growth, for every $1 million of assets that is contributed to the CLAT, $978,526 will remain and pass free of estate and gift tax to the remainderman at the end of the CLAT term. The chart below illustrates the CLAT payments.

Year	Beginning Principal	5.00% Growth	Charity Payment	Assets Remaining
1	$1,000,000	$50,000	$7,040	$1,042,960
2	$1,042,960	$52,148	$8,448	$1,086,660
3	$1,086,660	$54,333	$10,138	$1,130,855
4	$1,130,855	$56,543	$12,165	$1,175,233
5	$1,175,233	$58,762	$14,598	$1,219,397
6	$1,219,397	$60,970	$17,518	$1,262,849
7	$1,262,849	$63,142	$21,021	$1,304,970
8	$1,304,970	$65,249	$25,225	$1,344,993
9	$1,344,993	$67,250	$30,271	$1,381,972
10	$1,381,972	$69,099	$36,325	$1,414,746
11	$1,414,746	$70,737	$43,590	$1,441,894
12	$1,441,894	$72,095	$52,307	$1,461,681
13	$1,461,681	$73,084	$62,769	$1,471,997
14	$1,471,997	$73,600	$75,323	$1,470,274
15	$1,470,274	$73,514	$90,387	$1,453,400
16	$1,453,400	$72,670	$108,465	$1,417,606
17	$1,417,606	$70,880	$130,156	$1,358,328
18	$1,358,328	$67,916	$156,189	$1,270,056
19	$1,270,056	$63,503	$187,427	$1,146,132
20	$1,146,132	$57,307	$224,912	**$978,526**

Private Foundation Rules

CLATs are subject to the same rules as private foundations. To understand these rules, it is helpful to note two of the policy considerations surrounding private foundations. The first is that unlike a public charity which receives its donations from the public at large, private foundations are funded by one or a small group of individuals. Because of this difference, private foundations do not undergo the same level of public scrutiny that public charity do. For example, if a public charity like the American Cancer Society misuses its assets, the public will simply stop making donations and it will not

survive. Thus, there is less of a need for rules and government oversight with public charities. In contrast, private foundations do not have this built-in oversight with only one or a small group of private donors funding it. As such, stricter rules and penalties apply to ensure that private foundations carry out their charitable purpose. The second consideration is that unlike a for-profit company, which pays normal income tax rates on it its earnings, private foundations are exempt from income tax and pay excise tax on certain income at a much reduced rate. As such, it would be unfair for tax-paying for-profit companies to compete for business against tax exempt foundations which, by virtue of paying no or less taxes, have more assets at their disposal and a greater advantage in business. Thus, to ensure that private foundations do not have an unfair advantage against for-profit companies, there are limitations on the activities and transactions that private foundations can undertake.

With these two police considerations as a background, below is a brief summary of the various rules and regulations applicable to private foundations and by extension, to CLATs.

1. Self-Dealing

Section 4941 of the Code is designed to prevent insiders of the private foundation (referred to as "Disqualified Persons") from engaging in transactions where property is exchanged with a private foundation. Any such act—known as "self-dealing"—will result in a tax of 10% of the value of the property exchanged in the transaction[6] and an additional tax of 200% if the act of self-dealing is not corrected in time.[7]

<u>Who is considered a Disqualified Person</u>?

The founders and those in charge of the private foundation such as managers, trustees or directors are all Disqualified Persons. Also any person that contributes (or any

[6] §4941(a)(1).
[7] §4941(b). However, this second tier tax is capped at $20,000 with respect to any one act of self-dealing.

person that owns more than 20% of an entity or trust that contributes) more than $5,000 and 2% of a foundation's contributions in a given year is a Disqualified Person.[8] Additionally, family members[9] of the aforementioned persons are also Disqualified Persons. Lastly, a corporation, partnership, trust or estate which is 35% owned or controlled (directly or indirectly) by any of the aforementioned persons or their family members are Disqualified Persons.[10] In the case of a CLAT, the grantor and the grantor's family members are all Disqualified Persons.

What Transactions Constitute Self-Dealing?

Any exchange of property or financial transaction between a private foundation and a Disqualified Person will be an act of self-dealing unless a certain exception applies. This is the case even when the terms of the financial transaction are favorable to the private foundation. For example, if a Disqualified Person leases office space to the private foundation at a rate well below what other tenants pay, this is nonetheless an act of self-dealing that would trigger an excise tax. An exception to this, however, is if no rent at all is charged to the private foundation for the office space—this would be permissible and no excise tax would result.

Direct or indirect lending of money or extension of credit between a private foundation and a Disqualified Person and furnishing of goods and services between a Disqualified Person and a private foundation are acts of self-dealing.[11] There is a limited exception to this rule which provides that general banking services provided by a Disqualified Person to a private foundation will not constitute self-dealing.[12]

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[8] §507(d)(2)(A).

[9] §4946(d). For purposes of this rule, family members are a person's spouse, ancestors, children grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren. As such, a person's siblings are not considered family members.

[10] Thus, a client, his descendants, his trusts, and companies where the client controls or owns more than 35% would all typically be considered Disqualified Persons. As such, any transaction between them and the private foundation would require a self-dealing analysis.

[11] §4941(d)(2)(C).

[12] §4941(d)(2)(E).

Additionally, certain transactions will not be self-dealing if it can be shown that (i) the transaction results from a business relationship that existed before the act constituted self-dealing, (ii) the transaction is at least as favorable to the foundation as an arm's-length transaction with an unrelated party, and (iii) the company controlled by the foundation could engage in the transaction with another company only at a severe economic hardship to the company or because of the unique nature of the service of product or service of the company the Disqualified Person could not have hired another management company or would have incurred a severe economic hardship had it done so.[13]

There is another important exception to the self-dealing issue which allows a private foundation to be redeemed out of a corporation. A transaction between a private foundation and a corporation that is a Disqualified Person, pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, is not an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.[14] While this exception is applicable only to corporations, the IRS has blessed the redemption of a private foundation's interest from a partnership in two private letter rulings.[15] As such, under this exception it is possible for a closely held company to redeem out a foundation's or CLAT's interest.

There is also an important exception to self-dealing during the administration of an estate which is helpful for testamentary CLATs. If (i) the executor or trustee of a revocable trust either has the power to sell the property or reallocate it to another beneficiary, (ii) the transaction is approved by the probate court, (iii) the transaction occurs before the estate is considered terminated for federal income tax purposes, (iv) the

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[13] Reg §53.4941(d)-1(b)(1).
[14] §4941(d)(2)(F).
[15] PLR 9237032 and PLR 200734023 (which dealt with a real estate partnership).

estate receives an amount equal to its fair market value, and (v) the transaction either (a) results in the foundation receiving and interest at least as liquid as the one it gave up or (b) is required under the terms of an option that is binding on the estate, then it will not be considered self-dealing.[16] This exception allows a family who wishes to avoid the negative implications of owning a closely held business in a CLAT to purchase the business from the estate in exchange for other property before the CLAT is even funded with the family business.

This transaction was contemplated and approved by the IRS in Private Letter Ruling 200124029.[17] In this ruling the decedent's will gave the estate (which consisted mostly of investment real estate) to a marital trust and directed that upon the spouse's death the remaining assets pass to 3 separate zeroed out CLATs. In the ruling, the IRS permitted the estate to sell the real estate to a family company in exchange for a promissory note secured by the real estate for its fair market value with the probate court and the state attorney general approving the sale. In the ruling, the will did not direct the sale so the estate needed to demonstrate why the promissory note received by the trust would not be less liquid than the real estate it would have received. However, as set forth in prong (v) of the above test, if the sale of the business would have been directed in the will, the client would not need to meet this prong.

2. Excess Business Holdings

Charities are not permitted to run active businesses that are not connected to their exempt purpose. The so-called "excess business holding" rule in Section 4947 of the Code is designed to ensure that this does not happen. If a private foundation together with its Disqualified Persons own more than a 20% interest in a "business enterprise"

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[16] Reg §53.4941(d)-1(b)(3).

[17] This was Laura Peebles's PLR.

which is not substantially related to the foundation's charitable purpose, it will be subject to a 10% excise tax followed by a 200% excise tax if it fails to timely correct it.

For closely held businesses that are active in a trade or business this rule will likely be implicated. One area, however, where family businesses generally do not run afoul of this rule is with real estate companies since real estate is considered a passive investment for these purposes. So long as 95% of the business's income is from passive sources, including the rental of real property, it is not considered a business enterprise and the excess business holding rule does not apply.[18]

However, even for real estate clients, care must be taken to ensure that the rents from real estate are truly passive in nature. For example, if rents are based in any part on the income or profits derived by the tenant *other than* an amount based on a fixed percentage of receipts or sales, then excess business holdings applies.[19] Thus, if rent payments is based on the profit (and not just sales) of the tenant, then excess holding rule would apply. Additionally, if the company also actively engages in a business while renting real estate, such as renting out the top floors of a building but operating the garage on the ground floor, then the excess business holding rule will also apply.

3. Jeopardizing Investment

The jeopardizing investment rule in Section 4944 of the Code is designed to prevent a private foundation from investing its assets in a risky venture and causing the foundation to lose some or all of its assets and no longer be able to pursue its charitable purpose. An investment will be considered a so-called "jeopardizing investment" if the foundation managers fail to exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment to provide for the long and

[18] §4943(d)(3)(b).
[19] §512(b)(3)(1)(ii).

short term financial needs of the foundation to carry out its exempt purpose.[20] In making this determination, the managers should take into account the risks, expected return, and need for diversification.[21] Although the rule is targeted to risky and speculative ventures — such as trading on margin, trading in commodity futures, investments in oil and gas wells[22] — there are rulings that find jeopardizing investments where the foundation invests significant portions of their assets in one company.[23]

An important exception to this is that this rule does not apply to property that the private foundation receives by a gift or inheritance since the donor and not the foundation makes the investment.[24] Thus, this rule is not an issue if a CLAT is funded with a concentrated position in a company. However, if an inherited asset requires a subsequent additional investment by the foundation of a CLAT, then this rule would apply to that additional investment.[25]

4. Private Inurement

Section 501(c)(3) provides that "no part of the net earnings of which inures to the benefit of any private shareholder or individual" may be exempt under Section 501(c)(3). Thus, any transaction between a Disqualified Person as a private foundation or any joint venture between them must be analyzed for this. For example, going into a new business or making an additional capital contribution to a company may be best for the family, but it may not be best for the foundation's charitable purpose. Thus, this may be viewed as private inurement and care should be taken.

5. Unrelated Business Taxable Income

[20] Reg §53.4944-1(a)(2)(i).
[21] See TAM 9205001.
[22] Reg §53.4944-1(a)(2)(i) provides that although no investment is per se a violation, these specific types are closely scrutinized.
[23] See TAM 9205001 where the foundation invested a significant portion of its assets in a company that operated a hotel; GCM 39537 where the foundation borrowed funds to purchase stock in a non-blue-chip company which constituted 75% of its assets.
[24] *See* Reg §53.4944-1(a)(2)(ii)(a).
[25] *See e.g.*, Rev-Rule 80-133 where the foundation's continued payments of premiums for a whole life policy that was donated to the foundation was ruled to be a jeopardizing investment.

Section 511 of the Code imposes a tax on so-called "unrelated business taxable income" or "UBTI." UBTI is the gross income earned from an unrelated trade or business regularly carried out by it, less allowable deductions directly connected with the carrying of such trade or business.[26]

There is, however, an important exception to this rule in the case of property gifted or devised at death to a foundation. In that case, there is generally available a ten year grace period which the private foundation can sell the property or retire the mortgage without being subject to UBTI.[27] This exception is rather technical and does not apply if either the organization in order to acquire the property assumes and agrees to pay the debt (which is a facts and circumstances test) or if the organization made any equity payment for the property.[28]

6. Taxable Expenditures

The Taxable Expenditures rule in §4945(d) prohibit private foundations from engaging in certain acts such as lobbying and attempting to influence legislation or the outcome of a public election, as well as amounts paid as certain grants. The excise tax imposed on taxable expenditures is 20% of the amount involved. The tax imposed on trustees who knowingly participate in or approve the foundation's taxable expenditure is 5% (not to exceed $10,000). If the taxable expenditure is not corrected, there is an additional tax of 100% of the amount of the expenditure.

Conclusion

For clients who are considering making a significant donation to charity—whether during life or at death—rather than making that donation outright, the client should consider using a CLAT to leverage the charitable deduction to allow for assets to

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[26] §512(a)(1).
[27] §514(c)(2)(B).
[28] Reg §1.514(c)(2)(B).

pass free of estate and gift taxes to their children or other beneficiaries. Even for clients who are not primarily motivated by charitable contribution, lifetime grantor CLAT's can offer an immediate income tax deduction while leaving the potential for assets to eventually pass free of estate and gift taxes. Finally, for clients with closely held businesses who already have substantial assets outside of their estates for their heirs in life insurance trusts or otherwise, they may consider using a zeroed out CLAT in their will to eliminate all estate taxes.

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