

**INCREASING THE INCOME TAX SAVINGS AND THE ESTATE TAX
BENEFITS OF CHARITABLE LEAD TRUSTS AND TRAPS TO AVOID**

by

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Topics to be covered

1. **GRAT equivalent.** A CLAT accomplishes the same wealth shifting objectives as a GRAT except that the annuity is payable to charity instead of retained by the person who established the trust. One of the the CLAT's favorable features is that there is no exposure to estate taxation if the grantor dies during the term of the lead interest. A CLAT is another estate freeze opportunity. Can discounted limited partnership interests be contributed?
2. **Increasing the wealth shifting effectiveness of CLATs:** Using increasing annual amounts instead of level annual amounts.
3. **Increasing the amount passing to descendants:** For individuals who make significant charitable donations on a continuing basis in their individual capacity, accomplish the same giving by the use of the CLAT to accomplish an estate freeze.
4. **Avoiding the inability to use the charitable income tax deduction:** Making sure that the CLAT can use the charitable income tax deduction after the donor dies.
5. **Unintended income tax gains:** Using appreciated assets to satisfy the trust's annual charitable obligation. It does not matter that the CLAT is a grantor trust.
6. **Private Foundation Restrictions:** Beware of the excess business holdings trap under § 4943 if the 60% safe harbor under § 4947(b)(3)(A) is exceeded. Does it cover the contribution of a limited partnership interest even though the limited partnership's only assets are passive investments?
7. **The TCLAT:** Use of testamentary CLATs to zero out the estate tax.
8. **Beware of the § 170(f)(10) trap.**
9. **Increasing the income tax benefit of the individual's charitable income tax deduction by properly managing the investment portfolio in the grantor CLAT.**
10. **Recapture if the grantor dies during the grantor CLAT term.** The deduction is not lost. It is just transferred to the non-grantor CLAT.
11. **Grantor or Non-Grantor CLATs:** Factors to consider.
 - a. Advantages in reducing an individual's adjusted gross income.
 - b. Deducting charitable contributions in excess of the annual 50%/30%/20% of adjusted gross income limitations.
 - c. Obtaining a charitable income tax deduction for gifts to foreign charities.

The sophisticated estate planning professional is well-versed in the charitable giving techniques commonly used. The purpose of this presentation is not to introduce you to techniques you are not already familiar with. And, we will not cover new developments or introduce you to the newest charitable giving variations. Rather, the primary purpose of this presentation is to demonstrate how one can communicate a well-established charitable giving technique to a potential donor in a manner that is quick and understandable.¹ This can be especially important where the potential donor is inclined to give to charity but has not made any commitments. A brief and clear presentation may be just what is needed so that the potential donor becomes an actual donor. And, sometimes the ability to quickly and clearly communicate the tax and financial benefits of a particular charitable giving program may convince someone who is not charitably inclined to make charitable donations.

Another purpose of today's presentation is to show that one can end up passing more on to the next generation if one's charitable giving is done through the use of a charitable lead trust than if the exact same charitable contributions are made directly by the individual.

Potential donors are more likely to commit, or increase their charitable giving, if your introduction can communicate that what you are actually giving to the charity is 90% of the monies you would otherwise pay in income, gift and estate taxes. And, that with charitable giving in trust, you are better off financially as the other 10% of the monies you would otherwise pay in taxes can be retained by you or pass to your descendants.

Essentially, we will address questions most often heard from clients. The first thing the client wants to know is how much can I save in taxes and what are the financial benefits of my proposal. Therefore, we prepared sample financial illustrations one can use as part of this communication process.

A. Charitable Lead Annuity Trust

For someone who intends to make annual charitable contributions, the use of a Charitable Lead Annuity Trust can increase both the income tax savings from these charitable contributions and the amount that can be passed on to the next generation. The illustrations below summarize² the amounts that can be passed on to one's descendants:

- (i) if no charitable contributions are made,
- (ii) if annual charitable contributions are made directly by the individual and
- (iii) if the annual charitable contributions are made through a Charitable Lead Annuity Trust.

The same assumptions were used for all of the alternatives. The assumptions used are:

- The individual is age 62 and is divorced. Her life expectancy is 23 years.³

¹ It is often said that if you cannot communicate the point you are trying to make in five minutes, that is all the time you will have to get the attention of the potential client. Instead of being verbose or too technical, we will examine how to meet the five-minute test, *that is*, how to communicate the objectives and illustrate the financial benefits all within the first five minutes you spend with the potential client.

² Detailed spreadsheets can be provided at your request.

³ For a person age 62 with a 23-year life expectancy, there is a 50% probability that she will still be alive at age 85.

- An annual 8% rate of return on the investments: (i) 70% capital gains and/or dividends, (ii) 20% ordinary income and (iii) 10% tax-free interest.
- All income, after the payment of income taxes, is reinvested in the same investment portfolio. The value of the investment account compounds over the 20-year period used for these projections.
- The Federal gift and estate tax rate is 45%. The Federal income tax rates are 15% on long-term capital gains and dividends. All other income is taxed at the 35% marginal Federal income tax bracket. The projections assume that the 20% capital gains rate and the 39.6% ordinary income rate apply after the lower rates expire in 2010.
- The individual is a resident of a state with no state income taxes.
- The Section 7520 rate for the current month is 5.8%.⁴

	<u>Alternative</u>	<u>Net to Children at the end of 20 years</u>	<u>Total to Charity over a 20-year period</u>	<u>Total</u>
1.	No charitable contributions are made	\$4,681,220	none	\$4,681,220
2.	The individual makes level annual charitable contributions	1,922,832	4,288,717	6,211,548
3.	Grantor CLAT with level annual payments	2,772,552	4,288,717	7,061,268

The first thing to communicate is that one can generally pass on more wealth to the family after gift and estate taxes if there is no charitable giving. The objective is to illustrate to the potential client interested in charitable giving, such as to the family's private foundation, that the beneficiaries are both the family and the charity. If the charity is viewed as a beneficiary of one's wealth, charitable giving through the use of charitable lead trusts easily increases the amount one's intended beneficiaries can receive.

In Row 1, the individual does not make any charitable contributions and gives everything accumulated at the end of 20 years to the children. In that situation the children will net \$4,681,220 after the payment of gift taxes.

In Row 2, the individual contributes \$214,435 each year to a charity over a 20-year period. At the end of 20 years the children will net \$1,922,832 after the payment of gift taxes, and the charity will net \$4,288,717. The total of \$6,211,548 given to the children and to the charity far exceeds the amount the children would receive in Row 1. But, when compared to just the amount the children will receive, Row 2 is less than Row 1.

In Row 3, the individual commits in advance to the same \$214,435 annual charitable giving by committing the funds that will generate the earnings that will be donated to a charitable lead annuity trust, characterized as a grantor trust for Federal income tax purposes. The charity receives the same \$4,288,717,

⁴ The § 7520 rate for February 2008 is 4.2%.

but the use of the grantor CLAT increases the amount the children will receive to \$2,772,552. Thus, the aggregate amount passed on to the children and the charity is now \$7,061,268.

B. Proposed Gift to Charitable Lead Annuity Trust.

Once the client understands the benefits of using a charitable lead trust, the following is an illustration of how the proposal would be described to a client

You would contribute an asset worth \$2,500,000 to a Charitable Lead Annuity Trust (“CLAT”). The CLAT can be set up as a grantor trust or a non-grantor trust. Moreover, the annuity payments could be structured as level annual payments or annually increasing payments.

If the CLAT is a grantor trust, the contribution entitles you to an immediate charitable income tax deduction equal to the present value of the annuity payments that will be given to the charity. That charitable income tax deduction is designed to be equal to the value of the assets contributed to the CLAT (*i.e.*, \$2,500,000).⁵ Since you are entitled to report the charitable income tax deduction on your individual income tax return, the CLAT cannot take a charitable deduction as it makes the annual charitable payments. An individual may not be able to use the entire charitable income tax deduction all in the year of contribution because of certain limitations on how much of the charitable deduction can be used in any one tax year.⁶ However, any unused charitable income tax deduction may be carried forward and reported by an individual on that individual’s income tax returns for an additional five years. If the CLAT is funded with an appreciated marketable securities and appreciated assets are given to the charity to satisfy the annual charitable annuity, any potential gain inherent in the appreciated asset is not subject to Federal income tax. As a grantor trust, the taxable income of the CLAT in all years is reported by you. Since the CLAT is not entitled to a charitable income tax deduction, the CLAT’s taxable income each year is generally equal to the income it earns each year.

If the CLAT is a not a grantor trust, the contribution of the assets to the CLAT would **not** entitle you to a charitable income tax deduction. Rather, the CLAT would be entitled to charitable income tax deductions each year equal to the charitable annuity payment made by the CLAT. Because the CLAT is not a grantor trust, the CLAT’s taxable income is computed after its charitable deduction is subtracted from its income. A trust’s charitable deduction is not subject to the limitations on how much of the charitable deduction can be used in any one year that is applicable to individuals. Therefore, the trust’s entire charitable deduction can be used to offset the income reported by the CLAT during the same taxable year.

If you die while the CLAT remains in existence, there is no estate tax inclusion

Pursuant to the terms of the CLAT agreement, a public charity or private foundation receives an annuity payment from the CLAT each year for a period of twenty (20) years.⁷ The amount paid to the charity each year is fixed and is based on a percentage of the CLAT’s assets using the value of these assets at the time they are transferred into the CLAT.

⁵ The term of the CLAT and its payment amounts to the public charity or private foundation are coordinated so that the present value of the annuity interest is equal to the contribution to the CLAT, which reduces the value of the remainder interest to zero. The gift of the annuity interest to the charity qualifies for the charitable deduction. There is no tax on the gift of the remainder interest to the children as its value is zero.

⁶ In general, an individual can only use a charitable deduction up to an amount equal to 50% of the individual’s income for the year. Assume that an individual has adjusted gross income before itemized deduction of \$1,000,000 and contributes \$600,000 that year to a charity. For the year of contribution, the individual can only use \$500,000 of the \$600,000 charitable deduction and the \$100,000 excess can be carried forward and used in the following year.

⁷ Alternatively, the term of the annuity interest can be based on your life.

The assets in the CLAT should be invested in a manner to provide the cash flow needed to make these annual annuity payments. If the income in any one year is less than the required annual annuity payment, then there must be an invasion of principal to make up the difference. At the end of the 20-year term, any assets remaining in the CLAT pass to your children, or in trust for your children, free from all gift and estate taxes.

The projections below⁸ use annual payments to charity for a fixed 20-year period.

Alternative No. 1: *No Planning and no charitable donations.*

You invest \$2,500,000 based on the investment assumptions above and make no charitable contributions. At the end of 20 years, the amount accumulated in the investment account is gifted to your children or to a trust for the benefit of your children. The net amount the children or the trust receives reflects the payment of a 45% Federal gift tax on the amount gifted.

Alternative No. 2: *No Planning and Level annual charitable donations.*

You invest \$2,500,000 based on the above investment assumptions and contribute \$214,435 each year to charity. The taxes saved by the annual charitable contribution deduction offset 35% of the cost of each charitable contribution. At the end of 20 years, your accumulated investments are gifted to your children or to a children's trust. The net amount the children or the children's trust receives reflects the payment of a 45% Federal gift tax on the amount gifted.

Alternative No. 3: *No Planning and Increasing annual charitable donations.*

Same as Alternative No. 2 above, except that your annual charitable contribution starts at \$31,102 the first year and increases by 20% each subsequent year. At the end of 20 years the last annual charitable contribution is \$993,652.

Alternative No. 4: *Grantor CLAT with level annual charitable contributions*

You contribute \$2,500,000 to a grantor CLAT. The trust agreement for the CLAT provides that the trust contributes \$217,961 annually to charity, and that at the end of the 20-year term, whatever is left in the trust passes to your children directly or in trust for their benefit. You would be entitled to a \$2,500,000 charitable income tax deduction in the year the trust was formed. The \$2,500,000 deduction saves you \$875,000 in Federal income taxes. You continue to pay the income taxes on the CLAT's income during the next 20 years. The CLAT would not be entitled to any charitable income tax deduction even though the trust make the annual charitable contributions.

Alternative No. 5: *Grantor CLAT with increasing annual charitable contributions.*

Same as Alternative No. 4 above, except that the CLAT's annual charitable contribution starts at \$31,952 the first year and increases by 20% each subsequent year.

Alternative No. 6: *Non-grantor CLAT with level annual charitable contributions.*

Same as Alternative No. 4 above, except that the CLAT is a non-grantor CLAT. Because the CLAT is treated as a separate taxpayer for Federal income tax purposes, you are not entitled to a charitable income tax deduction upon the contribution to the CLAT nor do you pay the income taxes on the CLAT's income. Rather, the CLAT reports all of its income and is entitled to annual charitable income tax deduction as it makes its annual charitable contributions. The CLAT would pay the income taxes on its taxable income.

⁸ All projections are for illustrative purposes only.

Alternative No. 7: *Non-Grantor CLAT with increasing annual charitable contributions.*

Same as Alternative No. 6 above, except that the CLAT's annual charitable contribution starts at \$31,952 the first year and increases by 20% each subsequent year.

C. Comparisons

The comparisons in the table below illustrate how the use of leverage can further enhance the amounts passing to the children and to the charity. Like a GRAT, the annual charitable contributions are not the same each year. Instead, the annual charitable contribution starts at a relatively low figure and increases 20% each year. Thus, the same asset can eventually generate more to the charity and more to the children. The comparisons also show the results if the CLAT is not a grantor trust.

	<u>Alternative</u>	<u>Net to Children at the end of 20 years</u>	<u>Total to Charity over a 20-year period</u>	<u>Total</u>
1.	No planning	\$4,681,220	none	\$4,681,220
2.	Level annual charitable contribution without CLAT	1,922,832	4,288,717	6,211,548
3.	20% increasing annual charitable contribution without CLAT	2,040,735	5,806,405	7,847,140
4.	Grantor CLAT with level annual payments	2,772,552	4,288,717	7,061,268
5.	Grantor CLAT with 20% increasing charitable contributions	3,247,976	5,806,405	9,054,384
6.	Non-grantor CLAT with level annual payments	2,457,761	4,288,716	6,746,477
7.	Non-grantor CLAT with 20% increasing charitable contributions	3,052,272	5,806,205	8,859,117

Annual Cash Flow and Payments				
Type of Trust			Term	
Annuity Payment Rate for first year			1.24409%	
Annuity Payment Period			Annual	
Payments Made at Beginning or End of Period?			End	
Annuity Increase Percentage			20.0%	
Annuity Payment First Year			\$31,102	
Years of Trust Duration (Term)			20	
Cumulative Annuity Payments			\$5,806,205	
Year	Beginning Principal	Annual Growth	Annual Payment	Ending Principal
1	2,500,000	250,000	31,102	2,718,898
2	2,718,898	271,890	37,323	2,953,465
3	2,953,465	295,346	44,787	3,204,024
4	3,204,024	320,402	53,745	3,470,682
5	3,470,682	347,068	64,493	3,753,257
6	3,753,257	375,326	77,392	4,051,191
7	4,051,191	405,119	92,871	4,363,439
8	4,363,439	436,344	111,445	4,688,338
9	4,688,338	468,834	133,734	5,023,438
10	5,023,438	502,344	160,480	5,365,302
11	5,365,302	536,530	192,576	5,709,255
12	5,709,255	570,926	231,092	6,049,089
13	6,049,089	604,909	277,310	6,376,688
14	6,376,688	637,669	332,772	6,681,585
15	6,681,585	668,158	399,327	6,950,417
16	6,950,417	695,042	479,192	7,166,266
17	7,166,266	716,627	575,030	7,307,863
18	7,307,863	730,786	690,036	7,348,613
19	7,348,613	734,861	828,044	7,255,430
20	7,255,430	725,543	993,652	6,987,321

I. Types of Charitable Lead Trusts

A. Charitable lead annuity trust. The lead interest is payable to a charity and is in the form of a fixed amount for the term of the lead interest.

B. Charitable lead unitrust. The lead interest in the charity need not be a guaranteed annual amount as long as it is a fixed percentage of the value of the trust assets, such value determined annually.

C. Rules common to both charitable lead annuity trusts and charitable lead unitrusts. In both the charitable lead annuity trust (a CLAT) and the charitable lead unitrust (a CLUT), the annual payment is not based on the income of the trust. Instead, the annual payment to a charity is based on these other criteria. Thus, an annual payment to the charity is required even if the trust has no income. This means that if the trust's current income is insufficient to make the required annual payment, the shortfall must be made up out of an invasion of the trust principal. Likewise, if the current income exceeds the required annual payment, it need not be paid over to the charity. Instead, excess income is accumulated and added to trust corpus.

The lead interest payable to the charity must be irrevocable and must be payable at least annually. And, the lead interest cannot be based on the income of the trust. Because the lead interest must be either a fixed annuity or a fixed percentage of the value of trust assets, it cannot be the lessor of the two.

The lead interest in a charitable lead annuity trust and a charitable lead unitrust can be for a fixed term of years. And, unlike a charitable remainder trust, the fixed term can be indefinite,⁹ while the maximum fixed term for a charitable remainder trust is 20 years. Since a charitable lead trust (a CLT) can be for any term the settlor desires, it is not uncommon for the CLT term to be for 25 or more years. The lead interest can also be measured by the life of any existing individual or the joint lives of any existing individuals. The only restriction on measuring the lead interest is that the individual(s) must be living and ascertainable at the time the property is transferred into the trust. In addition, the term of the trust can be for the life of an individual plus a term of years. **Caution:** Limit the term to 21 years after the death of the measuring life to avoid violation of the rule against perpetuities.

Charitable lead trusts are not subject to the minimum payout requirements associated with charitable remainder trusts. Accordingly, any guaranteed annuity amount or fixed payout percentage will suffice. Thus, there is no 5% minimum payout for a CLT.

⁹ § 170(f)(2)(B).

II. The Income Tax Charitable Deduction: Grantor CLT v. Non-Grantor CLT

A. Grantor taxable on trust income. The grantor is permitted to take an income tax deduction in the year of the transfer in trust for the discounted present value of the charitable lead interest *only if the grantor is taxable on the income of the trust as it is earned*.¹⁰ In other words, the settlor of the trust must be treated as the owner of the income interest in the trust under the grantor trust rules. See §§ 671-678.

B. Grantor ceases to be income taxable. If the grantor ceases to be taxable on the trust income for any reason, even through death, to the extent that the income tax charitable deduction previously allowed exceeds the discounted present value of the trust income actually taxable to the settlor, such excess is recaptured and is reported as income by the settlor at that time, typically on the settlor's final income tax return.

C. Limitations on the income tax deduction.

1. Charitable gifts in general. The general rule is that the charitable contribution deduction cannot exceed 50% of adjusted gross income. But, any unused charitable deduction can be carried forward to the next five years.¹¹

2. Charitable lead trust exception. A gift made to a charitable lead trust is considered a gift *for the use of* rather than *to* the charity. Therefore, such gifts are subject to a 30% of adjusted gross income limitation¹² (or the 20% limitation if the trust is funded with long-term capital gain property and the charity is a private foundation¹³).

3. Foreign charities. The income tax charitable deduction for individuals is restricted only for gifts to domestic charitable organizations. Because there is no such restriction for charitable gifts made by trusts, an individual who desires to make a gift to a foreign charity can indirectly do so by the use of a charitable lead trust if the settlor is not taxable on the trust income under the grantor trusts rules.

4. Settlor of the trust is not taxable on trust income. If the settlor is not treated as the owner under the grantor trust rules, the settlor cannot take a current income tax deduction for the discounted present value of the charitable lead interest, and cannot take a charitable income tax deduction in the years the trust income is reported.¹⁴ Instead, the trust itself is taxed on the trust income, and each year the trust is allowed an unlimited charitable deduction for the actual payments to the charitable

¹⁰ § 170(f)(2)(B).

¹¹ § 170(d).

¹² § 170(b)(1)(B).

¹³ Reg. § 1.170A-8(c)

¹⁴ § 170(f)(2)(B).

beneficiary.¹⁵

There are other income tax advantages if the settlor does not have to report the trust's income. This exclusion from reporting the income lowers an individual's adjusted gross income that limits the use of the medical deduction, the phaseout of miscellaneous itemized deduction under § 67, the phaseout of itemized deductions under § 68, the phaseout of the personal exemption under § 151(d)(3) and exposure to the alternative minimum tax.

5. Phase out of itemized deductions under § 68. Under § 68, an individual's itemized deductions are reduced by the lesser of:

- (1) 3% of the excess of adjusted gross income over \$100,000 (indexed for inflation after 1991), or
- (2) 80% of the amount of the individual's itemized deductions.

Example For the current tax year H and W have an adjusted gross income of \$2,000,000, a charitable deduction in the amount of \$100,000 and no other itemized deductions. Under § 68, \$60,000 of their charitable contribution deduction (3% x \$2,000,000) is disallowed.¹⁶

D. Special requirements.

1. The two-year rule. If there is a sale of any trust property by the charitable lead trust within two years of its transfer in trust, the trust is taxable on the realized gain at the settlor's marginal income tax rate. This is no longer a concern because trusts now reach the top rate bracket at a low threshold of taxable income.

2. Early termination: Prepayment of the charitable lead interest. The trustee may want to accelerate the distribution of the remainder interest by prepaying the amounts under the charitable lead interest. Such a prepayment provision disqualifies the eligibility of the charitable deduction for the income, gift and estate taxes.

3. Private foundation rules. Because charitable lead trusts are characterized as private foundations for purposes of certain restrictions placed on such organizations, they are subject to the private foundation excise tax provisions.¹⁷ These provisions can impose onerous excise taxes¹⁸ if

¹⁵ A non-grantor CLT is allowed an unlimited fiduciary income tax charitable deduction for any payments out of its income that it makes to charity. § 642(c).

¹⁶ If T had other itemized deductions of at least \$60,000, then the charitable deduction would not be reduced. In a state with a state income tax rate of at least 3%, the itemized deduction for state income taxes should shelter the charitable deduction from the § 68 phaseout.

¹⁷ § 4947(a)(2).

¹⁸ See §§ 4941(a), 4941(b), 4943(a) and 4943(b). In some cases, § 4947(b)(3)(A) may ameliorate the effect of two of the prohibited transactions rules.

specified prohibited transactions occur. Therefore, the governing trust instrument must contain specific prohibitions against (i) self-dealing; (ii) excess business holdings; (iii) jeopardy investments; and (iv) taxable expenditures.¹⁹

E. Practical applications:

1. Requirements for the income tax charitable deduction. The settlor must be taxable on the income of the trust if the settlor wants to take an income tax deduction for the charitable lead interest. However, this trade-off is an income tax benefit only if the value of the current income tax deduction is greater than the present value of the future income tax obligations that result from reporting the trust income as it is earned by the trust. And, given the potential phase-out of itemized deductions under § 68, it is possible that a portion of the current income tax charitable deduction may be eliminated, and if so, that reduction must be taken into account.

2. Advantage in foregoing the income tax deduction. It may be best that the settlor is not taxable on the trust income, thereby foregoing the income tax deduction. The reason for this alternative is that the limitations on the charitable deduction under § 68 can result in a far greater amount being reported in gross income in future years than the resulting allowable charitable deduction.

3. The settlor can use the monies saved from the immediate income tax deduction. The tax savings can provide the settlor with funds that can be used for other purposes, such as an investment opportunity. Therefore, the settlor is willing to be taxable on the trust income in the future.

4. Illustrative examples.

An individual is a Florida resident (no state income tax) and is in the top marginal income tax bracket (assume an income top rate of 35%). The individual owns a corporate bond, paying \$80,000 interest annually. Her adjusted gross income is \$2,100,000 annually.

Example (1) No charitable trusts. The taxpayer continues to own the bond and, each year for the next 10 years, she contributes all \$80,000 of the interest received on the bond to a charity. The individual must report \$80,000 of interest income each year. If she has no other itemized deductions, such as property taxes and mortgage interest, then \$60,000 of her available \$80,000 charitable deduction is phased out under § 68 (3% x \$2,000,000). Consequently, the income she reports (\$80,000) and the allowable charitable deduction (\$20,000) increases her taxable income each year by \$60,000. At a 35% tax rate, this costs her an additional \$21,000 in income taxes each year. Using the 5.8% § 7520 rate, the present value of this additional income tax cost for the next 10 years is \$156,037.

Example (2) Charitable lead trust, grantor taxable on trust income. The individual transfers the bond into a grantor charitable lead annuity trust, paying a public charity a guaranteed amount of \$80,000 annually for the next ten years. Her current income tax charitable deduction is equal to the discounted present value of the charitable lead interest. The amount of the charitable deduction is \$594,426. However, \$60,000 of her charitable deduction is phased out under § 68. So, the net income tax savings is only **\$187,049** (35% x \$534,426).

¹⁹ §§ 4947(a)(2) and 508(e).

The advantage in reporting the entire charitable deduction all in one year is that only one \$60,000 phaseout is incurred instead of ten separate annual \$60,000 phaseouts.

Example (3) Using a non-grantor CLT to further increase the amount of the charitable income tax deduction. The same facts as in example (2) above, except that the CLAT is not a grantor trust. Because she does not report the trust income, she is not allowed a charitable income tax deduction. The effect of this treatment is to give her, although indirectly, a useable income tax deduction equal to the entire amount of the interest income from the bond. In other words, *by excluding the trust income from income taxation, the settlor effectively obtains a current income tax charitable deduction that otherwise would be reduced by the phaseout under § 68.* Therefore, for income tax purposes, she saves the additional \$21,000 of income taxes she paid in Example (2) above.

III. An empirical analysis: Selected Illustrations.

A. No tax planning.

Facts: T owns a \$1,000,000 corporate bond, paying \$64,331 annual interest, all taxable as ordinary income. T is a resident of Virginia. The combined Federal and state income tax rate is 40%.

If T does no tax planning, and reinvests all net income after taxes at the same 6.43% rate of return for the next 20 years, T will have accumulated \$2,024,521.

If T gifts that accumulated amount to his children at the end of 20 years, and assuming a 40% estate tax rate, the gift taxes would be \$869,808. Thus, the children would net \$1,214,713.

B. Installment Sale to a Grantor Trust.

T contributes the \$1,000,000 bond to a family limited partnership in exchange for a limited partnership interest. Using a conservative 25% valuation discount, the value of T's limited partnership interest is \$750,000.

T sells the limited partnership interest valued at \$750,000 to a grantor trust for a 20-year installment note, payable annual interest only, with all principal due at the end of the rate term. The December 2006 long-term APR is 4.9%.

Immediately after the note is paid, T gifts the principal received to children, taxable at 40%. Adding the value in the grantor trust, the children would net \$1,740,319 after 20 years.

Therefore, the estate tax benefit of this technique over doing nothing is that the kids have an additional \$525,606 after 20 years.

C. Income Tax Treatment of Grantor CLAT

1. Estate tax benefit of a CLAT.

T contributes the bond to a CLAT. The annual annuity payable to a charity is \$64,331 a year for 20 years. The present value of the charitable annuity is \$750,000, using the December 2006 §7520 rate of 5.8%. So, the value of remainder interest is \$250,000. Assume T immediately gives the remainder interest to his children. So, for a \$250,000 taxable gift (and \$100,000 payment of gift taxes using a 40% gift tax rate), children will have a \$1,000,000 asset at the end of 20 years. But, the true transfer tax benefit is far less if compared to situation A above where children net \$1,214,713. If T contributes the discounted limited partnership interest (valued at \$750,000) to the same CLAT, the

value of remainder interest is zero and no gift tax paid. So the children have a \$1,000,000 asset at the end of 20 years. But the true transfer tax benefit is far less if compare to situation B above where children net \$1,740,319.

2. Income Tax Benefit of a Grantor CLAT.

T contributes the bond to a CLAT, which is required to pay an annual annuity to charity of \$64,331 for the next 20 years. At the 5.8% §7520 rate for December 2006, the present value, and the §170 charitable income tax deduction, is \$750,000. At a 40% combined state and Federal income tax rate, the immediate tax savings is \$300,000.

But, as a grantor trust, T must report annual income of \$64,331 for the next 20 years, paying \$25,732 in income taxes each year. At the same 5.8% §7520 rate, the present value of this future annual income tax obligation is \$300,000.

Conclusion: The present value of the future income tax obligations exactly equal the current tax savings obtained from the charitable deduction. So, if using ordinary income to fund the CLAT annuity, the acceleration of the income tax deduction is income tax neutral.

3. How can we improve on the Grantor CLAT Technique?

Reduce income tax rate on future income generated by the trust principal.

a. Suppose the \$1,000,000 was invested to produce capital gains and dividend income, taxable at the 15% Federal rate. If all \$64,331 of annual income was capital gains and dividends, the annual income taxes, Federal and Virginia, would be \$13,349 (a combined effective tax rate of 20.75% after state income taxes). At the 5.8% §7520 rate, the present value of this future annual obligation is only \$155,629.

Since the present value of the future income tax obligations are less than the current tax savings obtained from the charitable deduction, the taxpayer has achieved a \$144,371 income tax savings.

b. Suppose the \$1,000,000 of principal was invested to produce \$64,331 of tax-free income such as in municipal bonds.²⁰ Since there would not be any income taxes on the trust's future income, the grantor CLAT has created a \$300,000 income tax savings. The obstacle is that it is unlikely than a safe municipal bond would generate a 6.43% rate of return. It is more likely that municipal bonds would yield only 4% annually.

c. Is there any other investment that can produce tax-free income and provide a rate of return greater than the rate of return from municipal bonds? *Consider § 170(f)(10) if life insurance is purchased by the CLAT!*

d. Are level annual payments required for a CLAT? Although seldom used, there is no prohibition in the Internal Revenue Code or the Regulations that prohibits different guaranteed annual annuity payments.²¹

TESTAMENTARY CHARITABLE LEAD TRUSTS: A CASE STUDY

²⁰ P.L.R.s 84-27-022 and 84-39-091.

²¹ P.L.R. 91-12-009 sanctioned the use of \$10,000 annually for the first 4 years, other fixed amounts for years 5 through 17 and \$30,000 annually for years 18 to 20. [Add cite to the Mienicki & Gopman article.]

A. INTRODUCTION.

A charitable lead trust (“CLT”) is a split interest trust which provides payments to one or more charities for a specified term and upon the expiration of the term interest any remaining assets of the trust pass either outright or in further trust to designated beneficiaries, typically the children or grandchildren of the grantor or testator. A CLT may be established during the lifetime of the grantor or at death. *This presentation will be focusing on the use of a CLT in a testamentary setting.*

EXAMPLE. Assume that Jack wishes to leave \$1,000,000 to his favorite charity at his death. If he leaves an outright devise his estate will enjoy a \$1,000,000 charitable deduction and his heirs will be out \$520,000 (assuming a death in 2004 when the marginal estate tax bracket is 48%, this is the net after tax amount available to the heirs if no charitable devise). If, instead, Jack established a CLT at his death to pay \$100,000 per year to the charity for 10 years with the remainder, if any, to pass to his family, then assuming a 7520 rate of 4% and a total return 10%, it would require that the trust be funded with only \$811,090 to produce annual payments of \$100,000. Furthermore, at the end of the trust term his heirs would receive \$510,027 free of transfer taxes, plus an additional \$98,000 at his death (\$1,000,000 - \$811,090 x 52%).

The actuarial value of the term interest being paid to a charity or charities will give rise to an estate tax deduction pursuant to §2055(a) of the Internal Revenue Code of 1986, as amended (hereinafter referred to as the “Code”). During its term of operation, the CLT is not a tax exempt entity and will be taxed in accordance with the provisions of Subchapter J of the Code. In this regard, the CLT will be entitled to an unlimited income tax deduction for the amount of the annuity payment paid each year during the term of the trust to the charitable beneficiaries (Code §642.(c)(1)).

The planning mechanics of a testamentary CLT are usually based upon the following premise: the combined effect of the estate tax charitable deduction and the ability to “grow” the CLT corpus at a rate in excess of the annuity rate will result in the enhancement in value of the ultimate distribution of the trust to or for the benefit of the family members at the end of the trust term. Normally, the “price” to be paid for this benefit is a deprivation in the ability to enjoy the assets of the CLT until the end of the term of the trust.

The case study presented below combines several different planning techniques into an integrated plan that enhances the benefits to the remainder beneficiaries both during and at the end of the term, provides further estate planning benefits for multiple generations and permits the family to begin enjoying the use and benefits of the decedent’s estate that has been set aside in a CLT even during the term of the CLT.

B. SELECTED TESTAMENTARY CHARITABLE LEAD TRUST FEATURES and REQUIREMENTS.

(This presentation is not intended to present an in-depth analysis of all of the features and requirements of a qualified CLT and assumes a general familiarity of this portion of the subject matter. There are a plethora of materials available on the subject.)

1. A CLT created at death is generally referred to as a testamentary charitable lead trust.
2. The CLT may be established as either an annuity trust (“CLAT”) or a unitrust (“CLUT”).

A CLT is a split interest trust which provides a payment to one or more charities for a specified term. At the expiration of the term interest the remainder passes either outright or in further trust to designated beneficiaries. During the term of the CLT the remainder beneficiaries have no enjoyment of the trust assets. (Code §§170(f)(2), 2055(e)(2)(B) and 2522(c)(2)(B)). There are two basic types of CLT:

- a. Charitable Lead Annuity Trust (“CLAT”). A CLAT provides for the payment of a fixed

dollar amount each year to one or more charitable lead beneficiaries, which sum may be stated as a percentage or fraction or formula for determining the fixed dollar amount determinable at the inception of the trust. There is no minimum payout required as in the case of a charitable remainder trust. In addition, the actual amounts of the payments each year can vary so long as they are determinable at inception (Treas. Reg. 20.2055-2(e)(2)(vi) and PLR 9112009).

- b. Charitable Lead Unitrust (“CLUT”). A CLUT provides for the payment of a specified percentage each year of the net fair market value, determined annually, of all of the trust property to one or more charitable lead beneficiaries. The methodology of annual valuation need not be limited to determining fair market value on January 1 but it must be the same manner of determination each year. For example, you could specify that the fair market value be an average of the quarterly fair market values.
3. Code Section 2055(e)(2)(B) contains the statutory requirements to obtain an estate tax charitable deduction for all or some portion of the amount placed in a qualified CLT. It simply requires that the charity’s interest be in the form of a guaranteed annuity (CLAT) or a fixed percentage, distributed annually, of the fair market value of the trust property, determined annually (CLUT).
 4. The Treasury Regulations (hereinafter referred to as “Treas. Reg.”) contain numerous other requirements (See, e.g., Treas. Reg. 20.2055-2).
 5. All charitable beneficiaries of a qualified CLT must be a charity contributions to which are deductible under Code Section 2055. This permits non-domestic charities to qualify as well as private foundations. In fact, the trust need not identify any specific charity or charities as long as the trustee can only select from qualified charities (See, Rev. Rul. 78-101, 1978-1 C.B. 301 and PLR 9748009).
 6. The charitable lead term may be a stated number of years, based upon a measuring life or lives, or based upon a combination of both (Treas. Reg. 20.2055-2(e)(2)(vi)(a) and (vii)(a)) or determinable by a formula (See, e.g., PLRs 9631021 and 9840036). Unlike a charitable remainder trust, the charitable term can exceed 20 years but must satisfy the applicable rule against perpetuities. In the case of a measuring life or lives, there was formerly no requirement that those lives have any relationship to the decedent or the trust beneficiaries. This led to the suggestion of a “ghoul trust;” using as a measuring life a young person suffering from a life-ending illness. Regulations were subsequently issued to prevent this technique. The effect of the length of the trust term can be seen in the following

EXAMPLE: Assume Jack dies in January 2004 and his will sets up a \$1,000,000 CLAT with the annual annuity payments set as a formula designed to “zero-out” the remainder interest so that 100% of the CLAT will produce a charitable deduction. If the section 7520 rate is 4%, then the annual annuity payment necessary to zero-out will be the following amounts depending upon the trust term:

<u>Trust Term</u>	<u>Annual Annuity</u>
5	\$221,330
10	\$123,291
15	\$ 89,941
20	\$ 73,582
25	\$ 64,012

This example assumes a 4% growth rate over its charitable term. To the extent that actual total trust return exceeds 4%, the remainder beneficiaries will reap benefits at the end of the charitable term. Conversely, if the trustee is unable to out perform the section 7520 rate (see subparagraph 8, below) there will be little, if anything, remaining for the remainder beneficiaries. If a 25 year term is utilized, the trust would have to achieve almost a 6.5% return just to return \$1,000,000 to the remainder beneficiaries.

7. In order to secure an estate tax charitable deduction for the value of the charitable lead interest, it is necessary for the trust document to contain specific provisions applicable to private foundations (Code Section 508(d)(2) and (e); Treas Reg. 1.508-2(b)(1)(vi)(a)). These provisions deal with prohibitions against self-dealing, retention of excess business holdings, jeopardy investments and taxable expenditures.
8. The estate tax charitable deduction is an amount equal to the actuarial value of the annuity or unitrust interest at the date of the decedent's death. When valuing split interests, the Code employs a presumed interest or discount rate equal to 120% of the Federal midterm rate under Code Section 1274(d)(1), rounded to the nearest 2/10ths of One (1) percent, for the month in which the valuation date occurs or for either of the preceding two months (Code Section 7520(a)). This rate is generally referred to as the section 7520 rate. The lower the section 7520 rate, the higher the value of the charitable lead interest and, coincidentally, the estate tax charitable deduction. The January 2004 section 7520 rate is 4.2% and the November and December 2003 rates are 4% and 4.2%, respectively, so that a January 2004 decedent's CLT could use the lower November 2003 rate. In the last 3 years, the section 7520 rate has been at historic lows, ranging between a high of 6% and a low of 3%. The effect of the section 7520 rate can be seen in the following **EXAMPLE:**

Assume the same facts as in the prior example except that Jack sets the trust charitable lead interest at 10 years. Now, based upon varying section 7520 rates the annuity payment necessary to zero-out will be as follows:

<u>Section 7520 Rate</u>	<u>Required Annuity</u>
3%	\$117,231
4%	\$123,291
5%	\$129,505
7%	\$142,377
9%	\$155,819

9. In the case of a CLUT, the section 7520 rate do not significantly effect the valuation of the split interests. In fact, it has no effect when the unitrust amount is payable annually with a payment date the same as the annual valuation date.
10. It should be evident that in the case of a CLAT, the charitable interest does not benefit from any growth in the trust assets which growth all inures solely to the benefit of the remainder beneficiaries at the end of the trust term. On the other hand, the CLUT shares any appreciation (or depreciation) between the charitable and non-charitable interests.
11. A testamentary CLT will not be subject to the generation-skipping transfer tax (GST") at its formation. However, if at the end of the charitable lead interest no non-skip person has an interest in the trust, it will be subject to GST as a taxable termination. In the case of a CLAT, it is virtually impossible to allocate GST exemption to the trust at inception with any degree of certainty necessary to produce an inclusion ratio of zero. This is so because the formula to determine the applicable fraction is based upon the value of the trust property immediately after the termination of the charitable lead interest. On the other hand, in the case of a CLUT, the applicable fraction is

determined under the usual GST rules and can be applied at creation (Code Section 2642(a)(2)). However, it is impossible to zero-out a CLUT actuarially.

C. PRIVATE FOUNDATION ISSUES.

An integral part of the proposed structure outlined below will involve a post death sale of a limited partnership interest by a decedent's revocable trust to a dynasty trust created by the decedent during her lifetime pursuant to an Option Agreement entered into by the trustees of those respective trusts. As outlined earlier, under Code §4947 the CLT would be considered a "private foundation" under Code §4941. Therefore, we must analyze whether the transaction involves an act of "self-dealing" between a "disqualified person" and the CLAT. Self-dealing includes a sale or exchange between the CLT and a disqualified person. Self-dealing also includes lending money or other extension of credit between the CLT and the disqualified person.

Code §4946 defines a "disqualified person" as a "trust or estate" in which a "member of the family" has a greater than 35% beneficial interest. The acquiring trust has beneficiaries that are "members of the family" with a greater than 35% interest and would appear to be a "disqualified person." Therefore, several concerns are raised:

1. (i) Is there a prohibited transaction between the acquiring and selling trusts? and/or (ii) could the Service contend that the transaction is an "indirect" prohibited transaction and deem the note the CLT receives as a sale or exchange of the limited partnership interest between the CLT and the dynasty trust?
2. Assuming either (i) or (ii), above, is present, is there an exception that would cause this transaction to not be subject to the Code §4941 tax?

The actual sale transaction takes place between the dynasty trust and the Revocable Trust (the "RT"). Under Treas. Reg. §53.4947-1(c)(6)(iii), the RT that became irrevocable upon the Grantor's death is not considered a "split trust" under §4947 for a "reasonable period of settlement." Therefore, the RT is not subject to §4941. There is no sale or exchange between the dynasty trust and the CLT. The RT and dynasty trust are separate because the dynasty trust was created in prior years. The CLT merely receives its distribution from the RT. So, facially, there is no "prohibited transaction" predicated upon a "sale or exchange" between the dynasty trust and the CLT.

However, Code §4941 further defines "self-dealing" to include "indirect" sales or exchanges. (Code §4941(d)(1)). Therefore, under Code §4941(d)(1) the Service may try and deem the intermediate step of the sale of the limited partnership interest to lack substance and treat the transaction as occurring between the dynasty trust and the CLT, creating a potential for exposure to a liability under Code §4941.

The Regulations to Code §4941 provide that certain transactions not be considered “indirect self-dealing.”(Treas. Reg. §53.4941(d)-1). Included in the exceptions under the Regulation are “[t]ransactions during the administration of an estate or revocable trust,” if:

- (i) the . . . trustee of a revocable trust [which includes a trust that has become irrevocable because of the grantor’s death] either:
 - (a) possesses a power of sale with respect to the property;
 - (b) has the power to reallocate the property to another beneficiary; or
 - (c) is required to sell the property under the terms of any option, . . .
- (ii) such transaction is approved by . . . court having jurisdiction over the trust;
- (iii) such transaction occurs before . . . a revocable trust . . . is considered subject to §4947 . . .; and
- (iv) the . . . trust . . . receives an amount which equals or exceeds the fair market value of the [trust’s] interest . . .; and
 - (a) results in the [trust] . . . receiving an asset as liquid as the one it gave up;
 - (b) results in the foundation receiving an asset related to the active carrying out of its exempt purposes; or
 - (c) is required under the terms of any option which is binding on the . . . trust. Treas. Reg. §53.4941(d)-1(b)(3).

This only technically provides a safe harbor for §4941. There is some argument that the Service could try and invoke the “step transaction doctrine” to treat the transaction as a “direct sale or exchange” within Code §4941. However, the lack of discussion of these applications in the Regulations and in PLR’s would seem to suggest that the safe harbor of Code §4941 would be conclusive. Furthermore, the step transaction doctrine is predicated upon the taxpayer engaging in a series of transactions merely to avoid tax consequences. The “steps” in this transaction are not merely to avoid tax consequences; the need to distribute from a Revocable Trust (now irrevocable) would have independent significance. Furthermore, since Code§4941 specifically recognizes the vitality of this kind of transaction, it appears unlikely the Service could undermine the Regulations by merely couching its argument in another framework.

Likewise, it appears unlikely that the Service could re-characterize this transaction under Code §482 which allows the Service to reallocate income, deductions, etc., among entities controlled directly or indirectly by the same interests. It is not clear whether Code §482 would even have application in a Code §4941 setting. In any event, reallocation is not appropriate in this transaction because it is the “nature” of the transaction that is at stake and not the amounts of the payments, income, etc.

Our inquiry is not complete upon the conclusion that we have no sale or exchange for Code §4941 purposes because the CLT will be funded with a note payable by the dynasty trust when the RT implements the terms of the RT after its reasonable period of administration. Even assuming the sale or exchange component of the “prohibited transactions” can be avoided under Treas. Reg. §53.494(d)-1, would the continuing obligation to pay by the dynasty trust to the CLT be considered a prohibited transaction because of the debtor/creditor relationship created by the acquisition of the dynasty trust note by the CLT?

Again, Code §4941(d)(1)(B) would include an extension of credit between a private foundation

(the CLT) and a disqualified person (the dynasty trust). However, Treas. Reg. 53.4941(d)-2(c)(1) excludes notes received pursuant to a Treas. Reg. 53.4941(d)-1(b)(3) transaction. (See, e.g., PLR 8006029 and PLR 200124029). If the transaction otherwise qualifies under Treas. Reg. 53.4941(d)-1(b)(3) it should escape self-dealing under either the sale or exchange component or the creditor component

D. FACTUAL PATTERN.

Grandma is an eight-eight year old widow with one adult child, five adult grandchildren, and several great-grandchildren. Her gross estate is estimated at approximately \$90,000,000.00 and consists principally of shares of stock of International Widgets, Inc. ("IW"), a publically traded company, the shares have an income tax basis of \$.03 and are currently trading at approximately \$40.00 per share. Since Grandma is also the beneficiary of various trusts established by now deceased ancestors, and her child and her children are otherwise financially independent and secure, Grandma wishes to gift shares of IW worth \$9,000,000 to each of her Grandchildren. Grandma has previously made substantial gifts and has utilized her unified credit and all but \$10,000 of her generation skipping tax exemption.

Grandma's advisors explain to her that the gift tax and generation skipping tax ("GST") on such gifts would cost her over \$6,500,000.00. Furthermore, the Grandchildren will get a carryover basis in the IW shares. Grandma suggests changing her will (or revocable trust) to simply devise the IW shares to the Grandchildren at her death. Again, Grandma's tax advisors point out to her the impact of both the estate tax and GST and the shrinkage that will occur to the Grandchildren's inheritance.

One of the Grandchildren, "Granddaughter" is wealthy in her own respect and will not be in need of the use of any inheritance from Grandma. Granddaughter wishes to minimize any transfer taxes, obtain some income tax step-up in basis to the IW shares and be able to control and enjoy this inheritance and provide further transfer tax savings to her estate.

E. PLAN STRUCTURE.

1. Formation of Limited Partnership ("Granddaughter LP").

(This presentation is not intended to present an analysis of the features and requirements of a Limited Partnership and assumes a general familiarity of this portion of the subject matter. There are a mass of materials available on the subject as well as significant case law that is still developing.)

- a. Grandma and Granddaughter form a corporation to act as the general partner of the limited partnership, fund the corporation with \$100,000.00 each, and equally own the corporation ("GP"). In light of *Strangi*, it may be more appropriate for Granddaughter to own all of GP.
- b. GP forms a limited partnership ("LP"), contributing \$180,000.00 in exchange for a 2% interest, and Grandma contributes \$8,820,000.00 in the form of shares in IW in exchange for a 98% limited partnership interest.
- c. It is anticipated that Grandma will make present interest gifts of limited partnership interest in LP each year to Granddaughter and her family in amounts equal to the annual exclusion (Code §2503(b)).

2. Formation of Granddaughter Family Trust ("Family Trust").

- a. Grandma is the grantor of an irrevocable trust for the benefit of Granddaughter,

her spouse (as long as he is married to and living together with Granddaughter), her lineal descendants, and her lineal ascendants (other than Grandma). Granddaughter and Trust Company are the Trustees.

- b. Grandma nominally funds the Family Trust and allocates GST exemption so as to create a zero inclusion ratio (Code §§2631(a) and (c); 2642).
3. Formation of Revocable Trust (“Charitable Trust”).
 - Grandma is the grantor and trustee of a Revocable trust that is funded with her limited partnership interests in LP.
 - At Grandma’s death a testamentary residual charitable lead trust (“CLT”) is created.
 4. Option Agreement.

The trustees of the Charitable Trust and Family Trust enter into an option agreement providing for an option to the Family Trust to purchase from the Charitable Trust all interests in GP and LP owned by the Charitable Trust at Grandma’s death.

 - a. The purchase price is the fair market value of the GP and LP interests as finally determined for federal estate tax purposes in Grandma’s estate.
 - b. The payment terms are based upon a formula tied back to the annual annuity amount determined under the CLT. (See Section F, below.)

F. THE FORMULA CLT.

1. We are considering only the use of a CLAT for the following reasons:
 - a. It is not possible to obtain a zero value for the remainder (non-charitable) interest in a CLUT thereby causing some estate tax (and perhaps future GST) at Grandma’s death.
 - b. Although a CLUT offers an ability to do GST planning with some certainty, the plan described herein avoids GST through another mechanism. (See Code §2642(e).)
 - c. Additionally, because a CLUT annual payment to charity is not fixed based upon the initial net fair market value of the trust at inception, but rather the annual net fair market value, if the trust assets grow in value both the charities and the remainder beneficiaries share in future appreciation. While in a CLAT only the remainder beneficiaries suffer if the trust assets decline in value, our plan freezes the asset by funding the CLT with a promissory note.

2. Variables.

In order to create a CLAT that will produce a 100% charitable contribution at Grandma’s death, we need to determine the following:

- d. Annuity Payment Term. This may be expressed as a fixed term of years, without any limitation, or for the life or lives of a person or persons in being at Grandma’s death (Treas. Reg. §20.2055-2(e)(2)(vi)(a)).
- e. Valuation Date. This is either the date of Grandma’s death or the alternate valuation date if an election is made under Code §2032. (See Treas. Reg.

§20.2055(h).)

- f. Applicable Federal Rate. The value of the charitable and remainder interests in a CLT is dependent upon an interest rate factor determined under Code §7520 and is 120% of the federal midterm rate (rounded to the nearest two tenths of one percent) in effect under Code §1274(d)(1) for the month in which the valuation date falls or for either of the two months preceding such month.
 - g. Guaranteed Annuity. A determinable amount to be paid periodically, but no less often than annually, for the annuity payment term, which amount may be expressed in terms of a fraction or a percentage of the net fair market value, as determined for estate tax purposes, of the value of the trust assets on the appropriate valuation date (Treas. Reg. §20.2055-2(e)(2)(vi)(a)).
 - h. The applicable federal rate and the defined annuity payment are the most important variables which determine the ultimate charitable deduction to be claimed for the charitable lead interest. The most favorable of the §7520 rates among the month in which the valuation date occurs and the preceding two months is that rate which is lowest. However, when planning now for an event that does not take place for an indeterminate period of time (i.e., Grandma's death) requires the use of a formula provision to define the annuity payment necessary to produce the smallest remainder interest value. (See, e.g., PLR 199927031, PLR 9631021, PLR9128051, PLR 9118040, and PLR 9846022.)
3. Formula Example. (The author gratefully acknowledges the contributions of Jonathan Gopman, Esq. who has worked extensively with CLT planning and for his permission to incorporate materials produced by him in this example.)
- c. As previously noted, in valuing the interests in a CLAT an estate is permitted to elect to use the most favorable of the § 7520 rates available for the month in which the valuation date falls or for either of the two preceding months. Unfortunately (or fortunately), as previously discussed the § 7520 rate fluctuates from month to month. Thus, the same annuity payment used in a CLAT may produce differing charitable deductions depending on when the donor dies. Fluctuations in the § 7520 rate also alter the other variables which are used to calculate the value of the lead and remainder interests in a CLAT.
 - d. The solution to the problem caused by fluctuations in the § 7520 rate when drafting a CLAT to be established under a will or revocable trust is to utilize a formula provision to define the annuity payment necessary to produce the desired value of the remainder interest. (See sample form at F. 4., below.)
 - e. In PLR 9631021, T executed a will containing CLATs which use a formula provision to define the term and the annuity payment. According to the ruling, the charitable bequest would be funded with one-fourth of T's residuary estate "without reduction for any taxes, fees or other expenses of administration." The will grants T's daughter, D, a special power of appointment to choose to fund one of two CLATs (trust "C-I" or trust "C-II") with the charitable bequest. This special power must be exercised within nine months of T's death. If D is not living when T dies or is mentally or physically incapacitated, another individual is given the special power to select to fund either trust C-I or trust C-II. In the event the special power is not exercised or if the CLAT selected does not qualify for a charitable contribution deduction, the will directs that the entire charitable bequest be transferred directly to certain charities designated in the will. The will also states that it is T's intention that the power holder choose to fund the CLAT which would result in charitable deduction for estate tax purposes as

close as possible to the value of the trust.

- f. The formula provisions determined the annuity amount by multiplying the amount passing to the CLAT selected by the power holder by the applicable § 7520 rate plus either 1% if trust C-1 is selected or 2% if trust C-II is selected. The formula mandated the use of the § 7520 rate equal to the lowest of the interest rates under § 7520 for the month in which the applicable valuation date falls or either of the two months preceding the month in which the applicable valuation date falls. As previously explained, use of the lowest applicable § 7520 rate produces the largest deduction with the lowest annuity amount. Based on the defined annuity amount the formula provision calculated the term necessary to produce the lowest possible remainder interest as follows:
 - i. In calculating the term, the formula provided that the annuity amount should be multiplied by the appropriate adjustment factor found in Table K of IRS Publication 1457 to reflect the frequency of payments mandated in the instrument, i.e., in the ruling quarterly payments paid at the end of each calendar quarter.
 - ii. The amount used to fund the CLAT is then divided by the result of the preceding calculation.
 - iii. The term-of-years annuity factors between which falls the result determined in (ii) above are obtained from Table B of IRS Publication 1457. Table B provides the annuity factors for valuing term interests. (See Publication 1457, Actuarial Values Aleph Volume, Table of Contents at p.1.)
 - iv. The result determined in (ii) above is then interpolated between the two term-of-years annuity factors, to determine the additional number of whole months the CLAT must be in effect for the amount of the charitable deduction to be equal (or as nearly equal as possible) to the value of amount used to the fund the CLAT. The result produces the term of the CLAT.
- g. The taxpayer requested rulings on several issues including whether the CLAT satisfied the requirements under Code § 2055(e)(2)(B) (and the regulations thereunder) to qualify for an estate tax deduction for the value of the charitable lead interest.
- h. The ruling approved the use of the special power of appointment to choose the CLAT to fund because both CLATs "will yield the same charitable deduction."
- i. The Internal Revenue Service approved the use of the formula provision used in the letter ruling to define the term and the annuity because "the amount of the annual annuity payment [would] be a determinable amount, ascertainable as of the date of the taxpayer's death" and so the formula provision established a "specified term" within the meaning of Treas. Reg. § 20.2055-2(e)(2)(vi). (It is important to remember that although indicative of the position which might be taken by the IRS in certain circumstances, private letter rulings may not be used or cited as precedent (Code § 6110(j)(3)).
- j. By plugging in some numbers, one can see how the formula in PLR 9631021 operates:
 - i. Assume either CLAT would be funded with **\$1,000,000**, i.e., one fourth

of the residuary estate without reduction for any taxes, fees or other expenses of administration.

- ii. Assume the lowest § 7520 rate for the three month period is 6.4%.
- iii. To determine the **annuity amount** for trust C-1 multiply the amount passing to this trust by 6.4% (the applicable § 7520 rate) plus 1%:

$$1,000,000 \times 7.4\% = \mathbf{74,000}$$

- iv. To determine the **annuity amount** for trust C-11 multiply the amount passing to this trust by 6.4% (the applicable § 7520 rate) plus 2%:

$$1,000,000 \times 8.4\% = \mathbf{84,000}$$

- v. Multiply the annuity amount by the appropriate adjustment factor in Table K to reflect the frequency of payments mandated in the instrument, *i.e.*, quarterly payments:

$$\text{For trust C-I} \quad 74,000 \times 1.0237 = \mathbf{75753.8}$$

$$\text{For trust C-II} \quad 84,000 \times 1.0237 = \mathbf{85990.8}$$

- vi. Divide the amount used to fund trust C-1 by the result of the preceding calculation related to the trust:

$$1,000,000/75753.8 = \mathbf{13.200657}$$

Divide the amount used to fund trust C-11 by the result of the preceding calculation related to the trust:

$$1,000,000/85990.8 = \mathbf{11.629151}$$

- vii. Obtain the terms-of-years annuity factors between which falls the result determined for trust C-1 from Table B:

$$30 \text{ years} = \mathbf{13.1952}$$

$$31 \text{ years} = \mathbf{13.3413}$$

Note: If a thirty year term is used in trust C-I the remainder interest would be valued at **\$413.46** and if a thirty-one year term is used the remainder interest would be valued at **-\$10,654.17**. Thus, the term will be closer to 30 years if trust C-I is selected.

- viii. Obtain the terms-of-years annuity factors between which falls the result determined for trust C-11 from Table B.

$$21 \text{ years} = \mathbf{11.3784}$$

$$22 \text{ years} = \mathbf{11.6338}$$

Note: If a twenty-one year term is used in trust C-11 the remainder interest would be valued at **\$21,562.28** and if a twenty-two year term is used the remainder interest would be valued at **-\$399.77**. Thus, the term will be closer to 22 years if trust C-11 is selected.

- ix. Interpolate the result determined in vii. between the two terms-of-years annuity factors which it falls to determine the additional number of whole months trust C-I must be in existence for the amount of the charitable deduction to equal (or be nearly as equal as possible) to the value of amount used to the fund the trust. This will result in an annuity factor of approximately **13.20065789**. ($13.20065789(74,000) \times 1.0237 = 999,999.99$).

(Algebraic equation (TB = "Table B Factor"): $TB(74,000) \times 1.0237 = 1,000,000$)

- x. Interpolate the result determined in viii. between the two terms-of-years annuity factors which it falls, to determine the additional number of whole months trust C-11 must be in existence for the amount of the charitable deduction to equal (or be nearly as equal as possible) to the value of amount used to the fund the trust. This will result in an annuity factor of **11.62915103**. ($11.62915103(84,000) \times 1.0237 = 1,000,000$)
(Algebraic equation: $TB(84,000) \times 1,0237 = 1,000,000$)

Once the Table B annuity factor is determined an actuary or the Internal Revenue Service can provide the exact term of the charitable lead interest or you can calculate it yourself.

- k. Note that it is possible to manipulate the concepts found PLR 9631021 to meet a client's disparate objectives. For instance, a client might feel more comfortable *knowing* the maximum number of years the charitable lead term will run before the CLAT distributes its remainder interests outright or in further trust for the benefit of family members. By identifying the variables which become fixed at a donor's date of death, an algebraic formula can be developed to satisfy such a client's estate planning objectives. The variables which will become fixed on a donor's date of death can be identified as follows:

- i. The value of the fund to be distributed to a CLAT must become fixed on the date of a donor's death or the alternate valuation date. For instance, this may be a portion or all of a donor's residuary estate or a specific bequest of an asset such as stock or an interest in a partnership.
- ii. The value of the desired remainder interest is known, *i.e.*, the client wants his or her estate to be able to claim as close to a one hundred percent charitable deduction as is possible for the value of the fund to be distributed to the CLAT (or some other predetermined amount, *e.g.*, such as the amount of property that can pass free of estate tax at the testator's death).
- iii. The value of the lead interest also becomes a fixed variable because it will equal the value of the fund minus the value of the desired remainder interest.
- iv. The applicable § 7520 rate is fixed (this should be the lowest rate of the three month period).
- v. The remaining variables are the annuity payment, the annuity factor and the adjustment factor.

- (a) The annuity factor and the adjustment factor are provided by

reference to the appropriate tables in IRS Publication 1457. As previously explained, a term-of years annuity factor is obtained from Table B of IRS Publication 1457 and the adjustment factor is obtained by appropriate reference to Table K in the same Publication 1457. For instance, in the example set forth below an 8.2% § 7520 rate is assumed with a thirty year mandated term. To obtain the Table B annuity factor for the equation in the illustration reference is made to the Table B factors in Publication 1457 to the tables for an 8.2% interest rate. (This can be found in Section 3 on page number 3-16 of Publication 1457). After the appropriate table is located the next step is to locate column "(1)" labeled "Years" and find row number "30" for the Table B factors for a thirty year term. After this column is located the appropriate annuity factor can be found one row over in the adjacent column number "(2)" labeled "Annuity." The adjustment factor can also be found in Publication 1457 by reference to Table K. Table K is found in Section 4 of Publication 1457. Assume that the governing instrument in the example set forth below mandates that the annuity payment is made on the last day of the year. Thus, the first column of Table K is based on the interest rate used to value the lead and remainder interests. Every other column represents adjustment factors for the number of payments to be made on an annual basis. The adjustment factor for an annual payment with an 8.2% interest rate is found one row over in the column marked "Annually." Note that throughout Table K the adjustment factor in this column (*i.e.*, for one payment) for any interest rate is always "1.00".

- (b) The remaining variable, the annuity payment, can be determined by the use of an algebraic formula.
- (c) The variables which must be used in this formula can be stated as set forth in the following example and an algebraic equation formulated to determine the unknown, *i.e.*, the annuity payment (1) *F* = Fund; (2) *T* = Term; (3) *R* = §7520 Rate; (4) *AP* = Annuity Payment; (5) *REM* = Remainder Value; (6) *TB* = Table B Factor; (7) *TK* = Table K Factor; and (8) *CLI* = Charitable Lead Interest.
- (d) Take the following example where: (1) *F* = \$234,772,727; (2) *T* = 30 years (3) *R* = 8.2% (the AFR rate); (4) *AP* = (the unknown until solved); (5) *REM* = -0- (the client's desired actuarial result); (6) *TB* = 11.0486; (7) *TK* = 1; and (8) *CLI* = \$234,772,727.

$$F - REM = CLI \quad (234,772,727 - 0 = 234,772,727)$$

$$TB(AP) \times TK = CLI \quad (11.0486(AP) \times 1 = 234,772,727)$$

$$11.0486AP = 234,772,727$$

$$AP = 234,772,727 / 11.0486$$

$$AP = \underline{\underline{21,249,092.82}}$$

4. Sample Form: (Note: I take no responsibility for individual use of this sample provision.)

You use it at your own risk!

Calculating the Value of the Charitable Lead Interest.

- a. In determining the value of the charitable lead interest and the value of the noncharitable remainder interest for federal estate tax purposes, it is my intention that the value of the noncharitable remainder interest, as determined in the federal estate tax proceeding relating to my estate, will be equal to, or as nearly equal as possible to zero
- b. In calculating the value of the charitable lead interest and noncharitable remainder interest, I direct that the following provisions shall apply:
 - i. The “**Termination Date**” shall mean the date which is the Thirtieth (30th) anniversary of the date of my death
 - ii. The term “**§7520 rate**” shall refer to the applicable interest rate determined under §7520 of the Code which is equal to the lowest of the interest rates determined under §7520 of the Code for the month in which the valuation date occurs or either of the two months preceding the month in which the valuation date occurs. For purposes of the preceding sentence, the term “**valuation date**” shall mean the date on which any property passing under the provisions of this Article shall be valued for purposes of the federal estate tax proceeding relating to my estate.
 - iii. The “**Annuity Amount**” shall mean that amount determined by applying the following formula based on the Termination Date:
 - (a) Determine the amount of the trust fund (hereinafter referred to as amount “**F**”). Amount F shall equal the amount by which the trust established under this Article is to be funded (valued and composed as finally determined in the federal estate tax proceedings relating to my estate). The amount by which the trust established under this Article is to be funded is set forth in Article **** of this Will/Trust Agreement.
 - (b) Determine the annuity factor in Table B of IRS Publication 1457 for the applicable §7520 rate (hereinafter referred to as “**TB**”).
 - (c) Determine the Table K adjustment factor for the frequency of payments of the Annuity Amount and the §7520 rate (hereinafter referred to as “**TK**”).
 - (d) Divide 1 by TB (1/TB). The result of this equation will produce the zeroed out target percentage variable (hereinafter referred to as amount “**TP**”).
 - (e) Multiply TP by F (TP x F). The result of this equation will produce the Unadjusted Annuity Amount (hereinafter referred to as “**UAP**”).
 - (f) Multiply TK by UAP (TK x UAP). The result of this equation will produce the Annuity Amount.

G. CONCLUSION.

Creative planning with CLT's can produce significant opportunities to satisfy a client's charitable desires while still preserving significant wealth for the family. The formula CLT requires intensive number testing which will involve the use of software programs and fairly regular monitoring of the changes in the applicable federal rate.