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# Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse

*Paul S. Lee, Turney P. Berry, and Martin Hall\**

*In this article, the authors outline the benefits of Charitable Lead Annuity Trusts (“CLATs”) as an estate planning tool. Special attention is focused on designing CLATs without level payment streams, but with “back-loaded” or “shark-fin” annuity patterns that “zero-out” the value of the gift of the remainder interest and leverage historically low interest rates. The authors discuss the tax advantages and disadvantages if the CLAT is a non-grantor or grantor trust, if the CLAT is inter-vivos or testamentary, and if the charitable lead interest is a term of years or based upon a measuring life. The article outlines a number of technical issues that must be considered in the design of a CLAT, including the tricky endeavor of choosing which retained powers will provide grantor trust status without causing the assets of the trust to be includible in the estate of the grantor, and the income tax consequences of a termination of grantor trust status. In addition, they compare CLUTs and CLATs today if the remainder beneficiaries are skip-persons for GST tax purposes, and they review the application of the private foundations rules, the investment implications of a back-loaded annuity CLAT, and the planning implications surrounding the choice of different charitable and non-charitable beneficiaries. They conclude the article with a number of planning examples that illustrate the flexibility now afforded estate planners, including CLATs holding private equity interests, concentrated stock positions, life insurance policies, and family limited partnerships holding commercial real property or publicly-traded securities.*

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## BACK-LOADED ANNUITY AND “SHARK-FIN” CLATS

## A. Introduction

With § 7520 rates<sup>1</sup> (and applicable federal rates or “AFRs”<sup>2</sup>) at near all-time lows, as illustrated in the diagram below,<sup>3</sup> estate planners should reconsider the benefits of the charitable lead annuity trust (hereinafter, “CLAT”).<sup>4</sup> Although a CLAT is appropriate only for a client with some charitable intent, there are significant wealth transfer benefits as well. Two 2007 revenue procedures have confirmed that a CLAT may be structured with unequal annuity payments.<sup>5</sup> Structuring a CLAT with payments to charity weighted more heavily toward the end of the CLAT term (a so-called “back-loaded” annuity has greatly increased the attractiveness of CLATs.

With interest rates likely to increase from this point forward,<sup>6</sup> based on the projections of Bernstein’s Wealth Forecasting System as indi-

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<sup>1</sup> I.R.C. § 7520.

<sup>2</sup> I.R.C. § 1274.

<sup>3</sup> The I.R.C. § 7520 rate for July 2011 is 2.4%, and the short-, mid-, and long-term AFRs are 0.37%, 2.00% and 3.86% respectively (compounded annually). Rev. Rul. 2011-14, 2011-27 I.R.B. 31. The 2.4% I.R.C. § 7520 rate for July 2011 will be available through September 2011 because of the 3 month election for charitable trusts. I.R.C. § 7520(a) of the Code provides that if I.R.C. § 7520 is being used to determine the value of a charitable income, gift or estate deduction (for example, for contributions to charitable lead trusts and charitable remainder trusts), “the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls for purposes of paragraph (2).” I.R.C. § 7520(a). Paragraph (2) provides the I.R.C. § 7520 rate is 120% of the Federal midterm rate rounded to the nearest 2/10ths of 1 percent. See also Treas. Reg. §§ 1.7520-2(b), 20.7520-2(b), 25.7520-2(b).

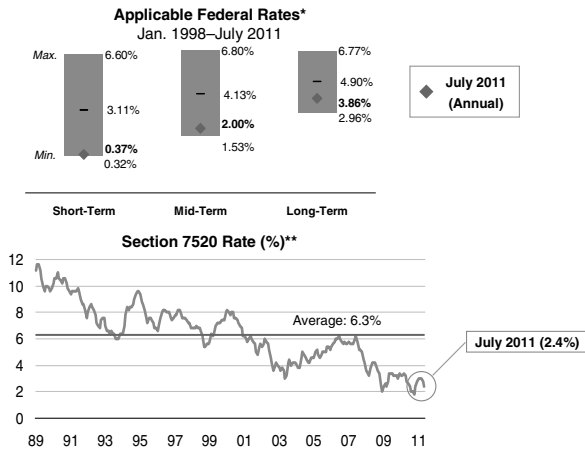
<sup>4</sup> For purposes of this article, a CLAT will refer to a “split-interest” trust that provides for an annual (or more frequent) payment to a charitable organization that qualifies as a “guaranteed annuity” for income, gift, and estate tax purposes under I.R.C. §§ 170(f)(2), 2055(e)(2)(B) and 2522(c)(2)(B), for a term of years (or the life or lives of a permissible individual or individuals), as defined under Treas. Reg. §§ 1.170A-6(c)(2), 20.2055-2(e)(2), and 25.2522(c)-3(c)(2), with the remainder interest passing to or for the benefit of non-charitable beneficiaries (other than the grantor).

<sup>5</sup> See Rev. Proc. 2007-45, 2007-29 I.R.B. 89 specifically for inter-vivos CLATs and Rev. Proc. 2007-46, 2007-29 I.R.B. 102 for testamentary CLATs.

<sup>6</sup> Bernstein Wealth Forecasting System forecasts that there is only an 11.6% chance of the § 7520 rate remaining as low as 2.4% (July 2011) in 10 years. See Paul S. Lee, *Chomping Your Taxes in Half with Shark-Fin CLATs*, BERNSTEIN GLOBAL WEALTH MANAGEMENT, available at [http://www1.ctbar.org/SectionsAndCommittees/Sections/EstatesAndProbate/D\\_SharkFinClats.pdf](http://www1.ctbar.org/SectionsAndCommittees/Sections/EstatesAndProbate/D_SharkFinClats.pdf). Since July 2011, interest rates have continued to trend downward, and November’s § 7520 Rate dropped to 1.4%. Rev. Rul. 2011-25, 2011-45 I.R.B. 695. Furthermore, on August 9, 2011, the Federal Reserve issued a press release that stated that it would keep interest rates near zero for the next two years. The statement provides,

To promote the ongoing economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today

**Very Low AFR and Section 7520 Rates That Are Rising**



\*Section 1274(d) of the Internal Revenue Code of 1986, as amended (Code)  
 \*\*Code Section 7520, As of July 2011.  
 Source: Internal Revenue Service (IRS) and AllianceBernstein



cated in the diagram below, estate planners should seriously consider a CLAT for those clients who have a modicum of charitable intent and a desire to transfer wealth to non-charitable beneficiaries.

**B. Traditionally Structured CLATs**

In the traditionally structured CLAT, there are two primary reasons that the trust may fail to transfer wealth to the remainder beneficiaries. First, as with a grantor retained annuity trust (hereinafter “GRAT”),<sup>7</sup> if the assets of a “zeroed-out” CLAT<sup>8</sup> do not have a total return that exceeds the § 7520 rate applicable at the time of funding, then the trust assets will be exhausted through payment of the guaran-

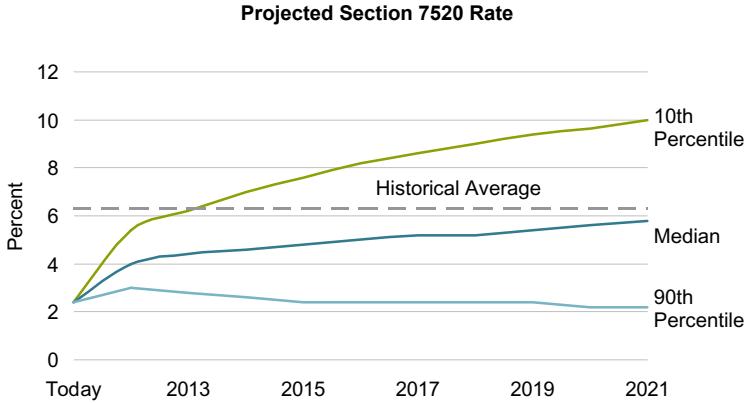
to keep the target range for the federal funds rate at 0 to 1/4 percent. The Committee currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

Press Release, Federal Board of Governors of the Federal Reserve System, 2011 Monetary Policies Releases (Aug. 9, 2011) (on file with author). As such interest rates are likely to remain relatively low over the near term.

<sup>7</sup> For a discussion of GRATs, see, for example, Craig L. Janes, *Grantor Retained Annuity Trusts: Avoiding the Petards in an Otherwise Safe Harbor*, 33 EST. PLAN. 10 (2006).

<sup>8</sup> A “zeroed-out” CLAT is one in which the present value of the charity’s payments under the terms of the CLAT are equal to the amount contributed by the grantor.

## CLATs: The Time Is Now



\*Only 11.6% of forecasted trials resulted in a 7520 rate of 2.4% or less 10 years from now.  
Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed.  
Source: AllianceBernstein

AB Bernstein.com

Shurtz-Fin CLAT Article

teed annuities and nothing will remain at the end of the term for the remainder beneficiaries. In contrast to a CLAT, however, if the assets in a GRAT underperform, the assets are returned to the grantor, who can redeploy them in another GRAT or other planning technique. Redeployment is not available with a CLAT because the lead interest—and consequently all the underperforming assets—will have been paid to charity. Worse, if the CLAT is being used to meet a donor’s charitable obligations, the obligation may not be met in full, depending on the degree of underperformance.

Secondly, even if the CLAT assets have a total return over the term of the trust that exceeds the initial § 7520 rate, the CLAT may fail because of the “path of the return.” Consider a “zeroed-out” \$10 million, 10 year CLAT, created when the effective § 7520 rate is 6.0%. In order to zero-out the \$10 million contribution, a fixed annual payment of \$1.36 million for 10 years will be paid to charity. Ignoring the effect of income taxes, if the assets grow by a compound growth rate of 9.3% per year, then the remaining assets at the end of the 10 year period would be \$3.4 million. In other words, because the trust assets consistently out-perform the assumed 6% return, the grantor could shift \$3.4 million to his or her children or other non-charitable beneficiary without any federal gift tax. Unfortunately, returns in the publicly-traded capital markets

are never straight-line. So, consider two different paths that a 9.3% compound annual growth rate could take:<sup>9</sup>

<b>Year</b>	<b>Return Path 1</b>	<b>Return Path 2</b>
1	10.1%	-22.1%
2	1.3%	-11.9%
3	37.6%	-9.1%
4	23.0%	21.0%
5	33.4%	28.6%
6	28.6%	33.4%
7	21.0%	23.0%
8	-9.1%	37.6%
9	-11.9%	1.3%
10	-22.1%	10.1%
<b>Compound Annual Growth Rate</b>	<b>9.3%</b>	<b>9.3%</b>

If the assets of the aforementioned zeroed-out CLAT experience return path 1, the remainder interest at the end of the term will be worth approximately \$8.0 million. If, instead, return path 2 applies, the remainder interest will be worth zero, and there will be inadequate assets to pay out the year 9 and year 10 annuities. The actual path of return (particularly the return in the early years of the CLAT) is as important as the magnitude of the return. Because there is no way of knowing whether capital market returns will be positive or negative, traditional CLATs—those with level annuity payouts beginning in year one—will quite often fail or perform poorly even when the compound annual returns exceed the § 7520 rate used to determine the annuity payments.

### C. “Back-Loaded” CLATs

Structuring a CLAT so that the annuity payments increase during the term can help manage the path of return problem by allowing the trustee to adjust the mix of investments held by the CLAT over the life span of the trust, and by reducing the outflow of trust assets in the early years of the trust’s administration. Planners have faced the question of whether a guaranteed annuity requires level annual distributions over the term of the trust or whether escalating or back-loaded distributions

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<sup>9</sup> Return Path 1 represents the annual return of the S&P 500 index from 1993-2002 and Return Path 2 is the reverse of those returns.

are acceptable, and if so, the shape that such back-loading may take. Two other types of trusts—the charitable remainder annuity trust<sup>10</sup> (hereinafter, “CRAT”) and the GRAT<sup>11</sup> have provided the backdrop to this inquiry.

### 1. “Annuities” in CRATs

Section 664(d)(1)(A) defines a CRAT as a trust from which *a sum certain* is to be paid, not less often than annually.<sup>12</sup> In case there was any doubt whether “a sum certain” means that the CRAT may vary the annuity paid each year, the Treasury Regulations provide that a sum certain is “a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period.”<sup>13</sup> Consequently, with a CRAT, there is no ambiguity: the annuity payment may not increase during the term.

### 2. “Annuities” in GRATs

Section 2702, and the Treasury Regulations thereunder, set forth the requirements of the payout, in the form of a “qualified annuity interest,”<sup>14</sup> from a GRAT. In pertinent part, the Treasury Regulations provide:

A qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.<sup>15</sup>

A fixed amount means . . . [a] stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or . . . [a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.<sup>16</sup>

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<sup>10</sup> I.R.C. § 664(d)(1).

<sup>11</sup> Trust that provides the grantor with a “qualified annuity interest” under Treas. Reg. § 25.2702-3(b).

<sup>12</sup> I.R.C. § 664(d)(1)(A).

<sup>13</sup> Treas. Reg. § 1.664-2(a)(1)(ii).

<sup>14</sup> I.R.C. § 2702(b)(1).

<sup>15</sup> Treas. Reg. § 25.2702-3(b)(1).

<sup>16</sup> Treas. Reg. § 25.2702-3(b)(1)(ii)(A)-(B).

Therefore, over the term of a GRAT, the annuity distribution does not have to be the same amount each year. Back-loading, however is constrained expressly by the Treasury Regulations; annuity payments cannot increase by more than 20% of the payment made in the immediately preceding year.

### 3. *Revenue Procedure 2007-45*

In 2007, the IRS issued sample trust forms for charitable lead trusts.<sup>17</sup> In those forms, the Service acknowledged that neither the CRAT nor GRAT provisions are controlling in the context of charitable lead trust planning.<sup>18</sup> Instead, in the annotations to its model forms, the Service stated that the requirements of a guaranteed annuity interest in lead trust planning are separated and apart from these analogous vehicles.<sup>19</sup> Revenue Procedure 2007-45<sup>20</sup> provides, in pertinent part:

Guaranteed annuity. To qualify for the applicable estate and gift tax charitable deductions, a non-grantor CLAT must provide for the payment of a guaranteed annuity amount at least annually to a qualified charitable organization for each year during the annuity period. See §§ 2055(e)(2)(B) and 2522(c)(2)(B). A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term of years or for one or more measuring lives. . . . An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer may be ascertained at the time of the transfer to the trust. Sections 20.2055-2(e)(2)(vi)(a) and 25.2055-2(e)(2)(vi)(a). A charitable interest expressed as the right to receive an annual payment from a trust equal to the lesser of a sum certain or a fixed percentage of the trust assets (determined annually) is not a guaranteed annuity interest. See §§ 20.2055-2(e)(2)(vi)(b) and 25.2055-2(e)(2)(vi)(b).<sup>21</sup>

Payment requirements. CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may

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<sup>17</sup> Rev. Proc. 2007-45, 2007-29 I.R.B. 89; Rev. Proc. 2007-46, 2007-29 I.R.B. 102.

<sup>18</sup> Rev. Proc. 2007-45, 2007-29 I.R.B. 89; Rev. Proc. 2007-46, 2007-29 I.R.B. 102.

<sup>19</sup> See Rev. Proc. 2007-45, 2007-29 I.R.B. 89.

<sup>20</sup> Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (discussing inter-vivos CLATs); Rev. Proc. 2007-46, 2007-29 I.R.B. 102 (discussing testamentary CLATs.).

<sup>21</sup> See Rev. Proc. 2007-45 § 5.02(1), 2007-29 I.R.B. 89.



provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The annuity payments may be made in cash or in kind.<sup>22</sup>

The quoted language applies expressly to non-grantor CLATs, but Revenue Procedure 2007-45 provides substantially identical provisions for grantor CLATs.<sup>23</sup>

The annuity distribution requirements for a CLAT are quite distinct from those for CRATs or GRATs. The amount distributed to charity must be ascertainable at the time the trust is funded, but there is no maximum or minimum payout requirement, no requirement that payments be identical from year to year and no upper limit on increases in distributions during the annuity period.<sup>24</sup> For example, one should be permitted to “zero-out” a CLAT, funded with \$10 million, and assuming a § 7520 rate of 2.4%, by making one of the following: (i) twenty level payments of \$635,428; (ii) an initial payment of \$76,999, and then providing for a 20 percent increase in each year thereafter; (iii) an initial payment of \$2,301, and then providing for a 50 percent increase in each year thereafter; or (iv) 19 annual payments of \$1,000, followed by a single payment in the twentieth year of \$16,045,091.

The last annuity stream has been nick-named the “Shark-Fin” CLAT, for the shape that the annuity pattern makes if arrayed horizontally, as illustrated in the diagram below. It may also be thought of as a “Balloon” CLAT, with the rationale of back-loading the annuity payments similar to that for structuring an installment sale to an intentionally defective grantor trust (hereinafter, “IDGT”) with interest payments only until the final year, at which time the full amount of principal is repaid.<sup>25</sup>

However, there are 2 critical differences between the “Shark-Fin” CLAT and an interest-only installment sale. First, the annual payment of \$1,000 is smaller than the annual interest payment that would otherwise be payable on a 20-year installment note (the long-term AFR). Second, the internal rate of return or discount rate with the Shark-Fin

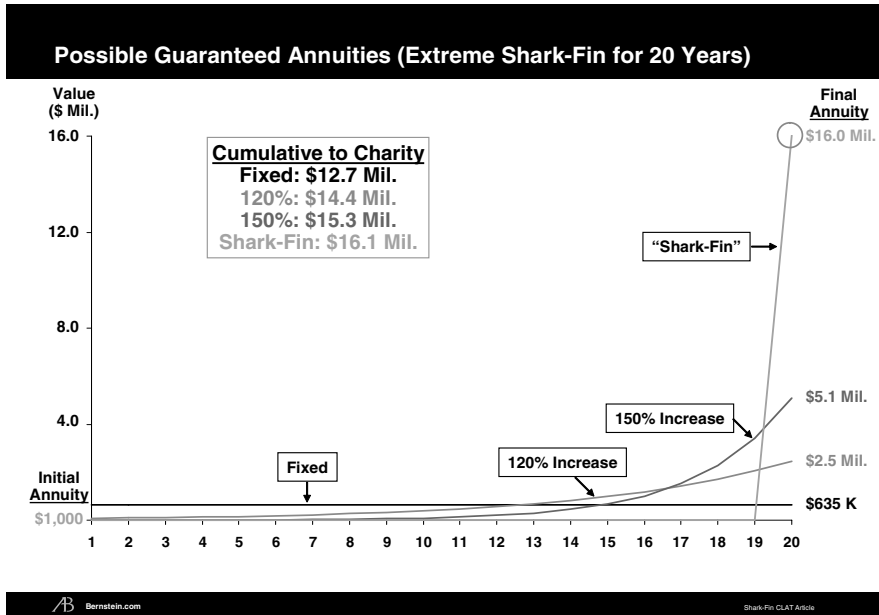
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<sup>22</sup> See Rev. Proc. 2007-45 § 5.02(2), 2007-29 I.R.B. 89.

<sup>23</sup> Rev. Proc. 2007-45 § 8.02(1)-(2), 2007-29 I.R.B. 89. Grantor vs. non-grantor CLATs are discussed beginning in Section VI below.

<sup>24</sup> Rev. Proc. 2007-45 § 8.02(1), 2007-29 I.R.B. 89.

<sup>25</sup> See Michael D. Mulligan, *Sale to Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3 (2006).



CLAT is the § 7520 rate, which, in the current interest environment, is significantly lower than the long-term AFR.<sup>26</sup>

These differences may permit the Shark-Fin CLAT to transfer more wealth than the other less severely back-loaded annuity patterns and possibly more than both an installment sale to an intentionally defective grantor trust (“IDGT”) and a GRAT (which, as mentioned above, is limited to 20% annual increases) over the same period of time, assuming that a donor’s objective is to also transfer assets to charity.

4. *Is a “Shark-Fin” CLAT Allowable?*

Other than Rev. Proc. 2007-45, no other guidance has been issued regarding the ability to and the extent of the back-loading in structuring a CLAT. The Treasury Regulations do, however, specifically allow for changes in the annuity payment. The Treasury Regulations state that an “amount is determinable if the exact amount which must be paid under the conditions specified in the governing instrument of the trust can be ascertained as of the date of transfer.”<sup>27</sup> By way of example, the Treasury Regulations provide that “the amount to be paid may be a stated sum for a term, or for the life of an individual, at the expiration of which

<sup>26</sup> For example, for July 2011, the § 7520 rate is 2.4%, while the long-term AFR is 3.86%, see Rev. Rul. 2011-14, 2011-27 I.R.B 31.

<sup>27</sup> Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(a), and 25.2522(c)-3(c)(2)(vi)(a).

it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index.”<sup>28</sup> In Private Letter Ruling 9112009, the IRS did approve a CLAT where “the ‘minimum’ annuity amount payable varies each year” but the “amount payable each year is specified in the instrument.”<sup>29</sup> However, no other information about how the annuity varied is contained in the ruling.

At least one article has expressed concern about the validity of Shark-Fin CLATs.<sup>30</sup> In it, the authors point to a number of rulings and regulations concerning charitable remainder trusts (“CRTs”)<sup>31</sup> and GRATs<sup>32</sup> to cast doubt on the clear language of Rev. Proc. 2007-45. We

<sup>28</sup> *Id.*

<sup>29</sup> PLR 9112009 (Mar. 22, 1991).

<sup>30</sup> See Richard L. Fox & Mark A. Teitelbaum, *Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance*, 37 EST. PLAN. 3 (2010).

<sup>31</sup> Fox and Teitelbaum point to a number of rulings concerning CRTs that require an annuity or unitrust amount that is “payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c).” Treas. Reg. §§ 1.664-2(a)(3)(i), 1.664-3(a)(3)(i). The authors then cite private letter rulings that state that the amount payable to non-charitable beneficiaries must be more than de minimis under the facts and circumstances. Fox & Teitelbaum, *supra* note 28, at 13. However, Rev. Proc. 2007-45 explicitly provides that “CLATs are not subject to any minimum . . . payout requirements.” Furthermore, the authors’ argument ignores the policy reason for the de minimis requirement for CRT distributions to non-charitable beneficiaries. CRTs are afforded tax-exempt status. The de minimis requirement is meant to ensure that some portion of the underlying assets will be subject to income tax, rather than forever staying in a tax-exempt environment. In other words, trusts that are not truly CRTs are not afforded tax-exempt status. CLATs are, of course, not tax-exempt. Furthermore, in the context of Shark-Fin CLATs, a de minimis requirement does not change the resulting charitable deduction because § 7520 specifically takes into account time value concepts. In fact, as pointed out in this article, back-loading the annuity actually increases the probability that charity will receive the entire amount due to it.

<sup>32</sup> Fox and Teitelbaum state,

[t]he policy concerns expressed by the IRS regarding a lump-sum balloon payment at the termination of a GRAT, a vehicle similar in purpose and operation to a CLAT, and the lack of any guidance from the IRS regarding the extent to which CLAT annuity payments may be increased, clearly raise a question as to the validity of the shark-fin CLAT. Indeed, it is possible that the IRS might view the shark-fin strategy as abusive and, accordingly, seek to limit the CLAT’s charitable payments that may be deferred or, consistent with the GRAT regulations, seek to impose a percentage limitation on year-to-year increases in the annual payments to charity. *Id.* at 12.

Fox and Teitelbaum point to the preamble to the final Treasury Regulations for GRATs that states that allowing a grantor to zero-out a GRAT while effectively transferring the appreciation on all of the property through a balloon payment at the end of the term is inconsistent with the principles of § 2702. *Id.* The preamble provides, “[t]he proposed regulations prohibited increases (in the annual annuity payment) to prevent transferors from ‘zeroing out’ a gift while still effectively transferring the appreciation on all of the property during the term to the remainder beneficiary (e.g., by providing a balloon pay-

note in response that the Treasury and the IRS know how to describe an annuity that may not vary or may vary only in accordance with specified limits and declined to do so with respect to CLATs. Our belief is that there are policy differences that the government has considered, among them that the CRT is a tax-exempt entity and thus deferring annuity payments changes the income tax policy that underlies the general rule requiring mandatory payouts from charitable remainder trusts, and that the GRAT is a no-lose proposition for a donor unlike a CLAT that divides benefits between charity and a donor's non-charitable beneficiaries.<sup>33</sup> In fact, the courts have consistently found a general policy in favor of encouraging gifts to charity,<sup>34</sup> which would be supported by allowing back-loaded CLATs. The back-loading of annuity payments not only encourages gifts to charity because of the wealth transfer benefits afforded the grantor's family, but as discussed below, it provides a higher probability that charity will actually receive the full value of its gift. Regardless, we see no reason to question such a clear and definitive pronouncement.

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ment in the final year of the term). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of section 2702." T.D. 8395, 1992-16 I.R.B. 5 (Feb. 4, 1992). Notwithstanding the dubious truth of Treasury's statement in the preamble, it should be noted that when it was issued in 1992, the Service's position was that grantors could not fully zero-out a contribution to a GRAT. See *Walton v. Comm'r*, 115 T.C. 589 (2000); TAM 200245053 (Nov. 8, 2002) (the National Office stated that the preamble to the final regulations under § 2702 reflected that Congress did not intend to permit the value of the remainder to be very small, such as less than one percent of the fair market value of the property contributed to a GRAT). Fox and Teitelbaum do not point to any specific rulings, regulations, court cases or any other primary sources directly related to CLATs. Also, to state the obvious, the Code provisions for CLATs were enacted under the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969), whereas GRATs were enacted under the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990). To say that the Treasury Regulations for GRATs have direct bearing on CLATs seems a stretch. Presumably the IRS could have adopted the GRAT position when it issued Rev. Proc. 2007-45 but, pointedly, it did not.

<sup>33</sup> Fox and Teitelbaum also contend that the Shark-Fin CLAT structure, which provides for level payments with a single balloon payment at the end of the term, is not permissible because an increasing annuity (each year apparently) is required. Fox & Teitelbaum, *supra* note 28, at 12. A single large annuity payment at the end of the period would seem to meet the requirement of "an annuity amount that is initially stated as a fixed dollar . . . amount but increases during the annuity period." See Rev. Proc. 2007-45, 2007-29 I.R.B. 89. If planners are concerned about the absence of annual increases, then the annuity could be increased by a modest amount each year without altering the positive effects of back-loading (for instance, payments could be \$1,000 in year one, \$1,100 in year two, etc.). To say that the annuity must increase in some manner over the term seems, however, overly picayune.

<sup>34</sup> See, e.g., *Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008); *Estate of Petter v. Comm'r*, TC Memo 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

## II. FORECASTED RESULTS AND PLANNING IMPLICATIONS

### A. Forecasted Results for Non-Grantor CLATs

The latest generation of financial planning tools moves beyond historical averages and takes into account the paths of return and the often random and unpredictable nature of the markets. Generically it is called stochastic or probabilistic modeling. The colloquial term is “Monte Carlo” modeling. For this article, a proprietary analytical tool was used that marries the benefits of stochastic modeling with a proprietary structural model of the capital markets (the “Wealth Forecasting Model”).<sup>35</sup> In each instance the model simulated 10,000 market scenarios or forecasts for the next 20 years, based initially upon the current state of the capital markets (for example, with very low Treasury interest rates resulting in very low AFRs and § 7520 rates). Unless otherwise noted, in each case, the model assumes 100% globally diversified equities and, for purposes of simplicity, a starting contribution of \$10 million of cash.<sup>36</sup> With 10,000 different outcomes, the analytical outputs are probabilistic. In other words, instead of saying, for example, that the remainder value will be \$10 million, the answer will be that there is a 50% chance of the remainder being at least \$10 million or more.

For 20 year “zeroed-out” CLATs, the aforementioned annuity patterns result in median (50th percentile) inflation-adjusted remainder values, after all payments to charity and after the payment of income taxes, as illustrated in the diagram below:

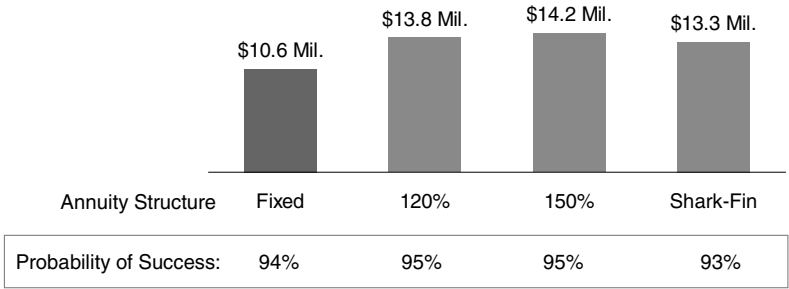
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<sup>35</sup> Unless otherwise noted, all illustrations in this article are based upon Bernstein Global Wealth Management’s proprietary capital markets engine and wealth forecasting model, which uses proprietary research and historical data to create a wide range of possible market returns for many asset classes over the coming decades, following many different paths of return. The model takes into account the linkages within and among different asset classes in the capital markets and incorporates an appropriate level of unpredictability or randomness for each asset class. Paul S. Lee, Turney P. Berry & Martin Hall, *Reeling, Rolling and Reining In “Shark-Fin” CLATs*, 51 TAX MGMT. MEMORANDUM No. 25, 435 (2010).

<sup>36</sup> The allocation to stocks is 35% U.S. Value, 35% U.S. Growth, 25% Developed International, and 5% Emerging Markets. The source of the data is Bernstein Global Wealth Management, a unit of AllianceBernstein, LP, based on Bernstein’s estimates of the range of returns for the applicable capital markets over the next 30 years. The data do not represent any past performance and are not a promise of actual future results. *Id.*

**Back-Loading Increases Wealth Transfer...Only to a Point**

**Median Wealth Transferred\***  
 \$10 Million, 20-Year Term CLAT  
 (Real, \$ Millions)



\*Median inflation-adjusted non-grantor CLAT remainder assuming \$10 million zeroed-out 20-year CLAT funded at the July 2011 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$1,000.

As shown, the Shark-Fin structure actually results in a smaller remainder than both the 120% and 150% back-loaded CLATs over the same period of time. The highest probabilities of success (defined as the probability of a remainder greater than zero) and the highest remainder values peak with 150% back-loaded annuities. The Shark-Fin is only superior to the traditionally structured, fixed annuity CLAT. Despite a very low § 7520 rate and the most extreme benefit of back-loading, the Shark-Fin does not produce the result that one would expect.

This outcome is attributable to the effect of income taxes payable on the return earned by the trust assets. The traditional wealth-transfer CLAT (with the remainder passing to the grantor’s children, for example, rather than reverting to the grantor at the end of the term) is a taxable, complex trust. As such, the trust is entitled to claim a deduction each year under § 642(c) for the payment of the charitable annuity. This section provides,

In the case of an estate or trust (other than a trust meeting the specifications of subpart B), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c) (determined without regard to

section 170(c)(2)(A)). If a charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee or administrator may elect to treat such contribution as paid during such taxable year.<sup>37</sup>

Although § 642(c) does not limit a trust's income tax deduction as § 170 does for an individual (based on the individual's contribution base), it effectively limits the deduction in any given taxable year to the lesser of the taxable income of the trust and the payment to charity for that year. Furthermore, other than the election to treat payments in the following taxable year as having been made in the previous taxable year,<sup>38</sup> there is no mechanism to carry-back or carry-forward unused charitable deductions (in situations where the charitable deduction/payment is greater than the taxable income for the year). Moreover, unused charitable deductions may not be carried out to the remainder beneficiaries in a terminating distribution. The Code specifically limits terminating distribution tax benefits to unused carryover losses and unused deductions other than the charitable deduction and the personal exemption deduction.<sup>39</sup>

The practical result of the foregoing limitations is that a Shark-Fin CLAT pays income taxes on almost all of its income each year until the last taxable year when the large final payment is made. In addition, it is unlikely that the CLAT will have enough taxable income in that final year to use the charitable deduction effectively. Consequently, the income tax benefits from the charitable payments during the term of the trust are minimal. As illustrated in the chart above, the most efficient use of the § 642(c) charitable deduction arises where the CLAT pays 50% annually increasing annuities. It should be noted that the efficacy of the 150% back-loaded annuity CLAT is specific to the investment strategy (global equities), the term of the CLAT (20 years), and the § 7520 rate. A different asset allocation, a longer or shorter term, a § 7520 rate other than 2.4%, or a combination thereof, would likely result in a different back-loaded annuity pattern being the most efficient for wealth transfer.

The efficient use of the § 642(c) deduction is an important component of successfully administering a non-grantor CLAT. In this context, the implications of realizing unrelated business taxable income (hereinafter "UBTI")<sup>40</sup> must be weighed carefully. While punitive excise taxes are not imposed on UBTI earned by a non-grantor CLAT, the CLAT is

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<sup>37</sup> I.R.C. § 642(c).

<sup>38</sup> I.R.C. § 642(c)(1).

<sup>39</sup> I.R.C. § 642(h).

<sup>40</sup> I.R.C. § 512.

not entitled to offset UBTI with a § 642(c) charitable deduction. The Code provides, “[i]n computing the deduction allowable under § 642(c) to a trust, no amount otherwise allowable under § 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year.”<sup>41</sup> The Treasury Regulations provide a methodology for reducing and allocating any remaining deduction between UBTI and other income.<sup>42</sup>

The most common instance in which a CLAT will realize UBTI is if the CLAT has “unrelated debt-financed income” under § 514.<sup>43</sup> In particular, unrelated debt-financed income arises when “acquisition indebtedness”<sup>44</sup> is deemed to exist. That being said, the Code provides,

[w]here property subject to a mortgage is acquired by an organization by bequest or devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of the acquisition. If an organization acquires property by gift subject to a mortgage which was placed on the property more than 5 years before the gift, which property was held by the donor more than 5 years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift.<sup>45</sup>

In Private Letter Ruling 9716023, a non-grantor charitable lead trust took advantage of this provision. Significantly, the IRS ruled that since the trust had a charitable term of less than 10 years, the trust could retain mortgaged property received from the grantor without any loss of its § 642(c) deduction.<sup>46</sup>

The loss of the § 642(c) charitable deduction arising from UBTI may be of minimal consequence in the context of back-loaded annuities (especially the Shark-Fin) because the deduction otherwise allowable is small in the initial years. In the Shark-Fin example above, the maximum allowable deduction for the first 19 years would only be \$1,000. Furthermore, the existence of UBTI is of no consequence if the CLAT is a grantor trust.

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<sup>41</sup> I.R.C. § 681(a).

<sup>42</sup> Treas. Reg. § 1.681(a)-2(b).

<sup>43</sup> See Sanford J. Schlesinger & Dana L. Mark, *Unrelated Business Income and the Charitable Organization*, 27 EST. PLAN. 177, 177 (2000).

<sup>44</sup> I.R.C. § 514(c)(1).

<sup>45</sup> I.R.C. § 514(c)(2)(B).

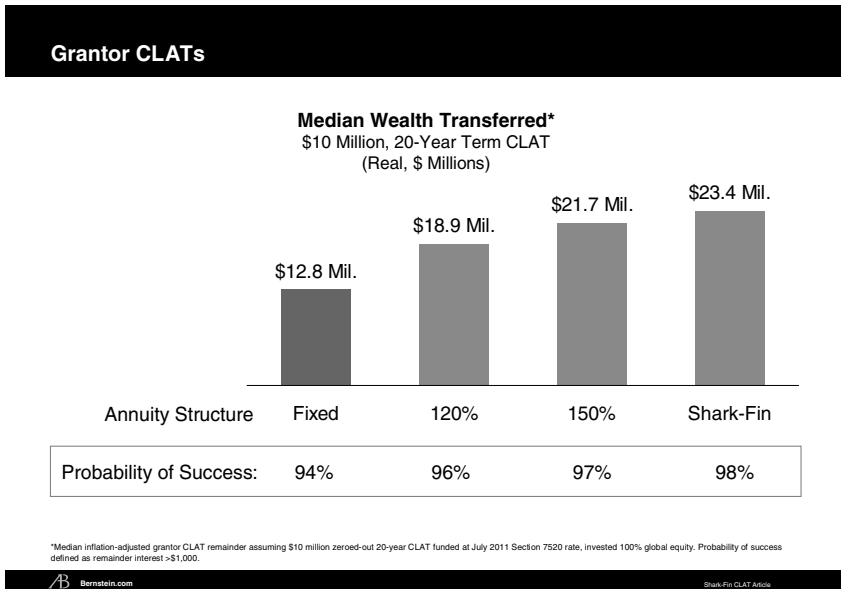
<sup>46</sup> See, e.g., PLR 9716023 (Apr. 18, 1997).



## B. Forecasted Results for Grantor CLATs

If Shark-Fin CLAT benefits are limited by § 642(c), might intentionally making the CLAT a grantor trust<sup>47</sup> create better results? When a grantor makes a contribution to a CLAT that is considered a grantor trust for income tax purposes, the grantor obtains a personal income tax deduction equal to the present value of the charitable contribution (determined under § 7520) in return for taking on grantor trust income tax liability for the trust's assets.<sup>48</sup> Of course, there are wealth transfer benefits to the grantor paying the income tax liability, similar to those associated with an installment sale to an IDGT. There have been a number of rulings addressing this planning technique.<sup>49</sup>

In the grantor CLAT form, the resulting median (50th percentile) inflation-adjusted remainder values after all payments to charity (but ignoring income taxes) are illustrated in the diagram below:



<sup>47</sup> I.R.C. §§ 671-79. Unless otherwise noted, a grantor CLAT for purposes of this article will refer to a CLAT that is a grantor trust for Federal income tax purposes but that is not includible in the estate of the grantor for Federal estate tax purposes. As such, it does not refer to a CLAT where the grantor has retained an interest under § 673 (a reversionary interest equal in value to at least 5% of the corpus as of the date of the transfer) because the CLAT corpus would generally be includible under § 2038 for estate tax purposes.

<sup>48</sup> See I.R.C. § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c).

<sup>49</sup> See, e.g., PLR 200011012 (Mar. 17, 2000); PLR 200010036 (Mar. 10, 2000); PLR 199936031 (Sept. 10, 1999); PLR 199922007 (Jun. 4, 1999); PLR 199908002 (Feb. 26, 1999); PLR 9810019 (Mar. 6, 1998); PLR 9224029 (June 12, 1992).

The grantor Shark-Fin CLAT, unburdened by the limitations of § 642(c), now results in significantly more wealth transfer than all other annuity patterns. In fact, it provides more wealth transfer than an installment sale to an IDGT and a GRAT, as shown in the table below:<sup>50</sup>

INFLATION-ADJUSTED REMAINDER VALUES (MEDIANS) \$10 MILLION INITIAL FUNDING YEAR 20		
Installment Sale to IDGT	GRAT	Grantor "Shark-Fin" CLAT
\$16.7 Mil.	\$18.9 Mil	\$23.4 Mil.

Significantly, even the more gentle-sloping annuity patterns, 20% and 50% annual increases, have wealth transfer figures comparable to or in excess of an installment sale to an IDGT and a GRAT.

### C. Shark-Fin CLATs vs. Sales to IDGTs and GRATs

The grantor Shark-Fin CLAT provides greater wealth transfer than both of the more popular estate planning techniques, but with a number of distinct advantages in its favor that are not reflected in the remainder values above.

First, the remainder value for the installment sale to an IDGT, while based on the same initial funding amount of \$10 million, requires a \$1 million "seed" gift to the IDGT to support \$9 million installment sale.<sup>51</sup> In other words, the installment sale transaction includes a \$1 million taxable gift, either requiring the use of exemption equivalent or the payment of gift tax. The grantor Shark-Fin CLAT, on the other hand, is zeroed-out. Second, while the GRAT results are better than the installment sale, the results assume that the grantor survives the 20 year term. The grantor Shark-Fin CLAT, on the other hand, does not have the same mortality risk. If the grantor of a CLAT dies during the trust's term, the CLAT continues to its expiration with its wealth transfer bene-

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<sup>50</sup> All strategies are assumed to have been funded with \$10 million. The 20 year GRAT is assumed to be funded at the July 2011 § 7520 rate with 20% increasing annuities over the term of the trust. For the installment sale to the IDGT, the numbers assume a \$1 million "seed" gift to the IDGT, and a \$9 million installment sale to that trust, payable with interest only at the appropriate applicable federal rate for July 2011 and a balloon principal payment at the end of the term. All forecasted figures are based on Bernstein Global Wealth Management's proprietary estimates of the range of returns for the applicable capital markets over the periods analyzed. Please see the Notes on Wealth Forecasting at the end of this article for further details. All strategies are modeled assuming 100% global diversified equities (35% US value and 35% US growth, 25% developed international and 5% emerging markets).

<sup>51</sup> See Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 EST. PLAN 35, 36 (2008).

fits intact (although the magnitude of this benefit may be impacted by the loss of grantor trust status).<sup>52</sup> Third, the CLAT figures do not take into account the impact of the \$10 million charitable income tax deduction received by the grantor on the funding of the trust. Neither the installment sale nor the GRAT creates a comparable income tax benefit, but the resulting grantor trust tax liability is the same in all of the foregoing strategies.

The income tax deduction created upon funding a grantor CLAT is limited to 30% of the grantor's contribution base (or 20%, if capital gain tax property is contributed) because the transfer is treated as a transfer "for the use of" charity.<sup>53</sup> In one private letter ruling, the IRS concluded that the 5 year carry-forward for unused current year deductions was unavailable for contributions to grantor CLATs.<sup>54</sup> However, subsequent rulings have ruled otherwise, and it seems that the 1988 ruling is an aberration.<sup>55</sup>

### III. TERM OF THE CHARITABLE ANNUITY

#### A. Term Certain

CRTs are limited to terms of no more than 20 years.<sup>56</sup> On the other hand, CLATs do not have any statutory limitations on the length of a term. The Treasury Regulations simply require that a term CLAT have a "specified term" of years.<sup>57</sup>

If the grantor intends to zero-out the gift to the non-charitable beneficiaries, the longer the term the smaller are the charitable annuity payments. Consequently, a long-term CLAT will potentially transfer more wealth to the non-charitable beneficiaries than would a short-term CLAT. For example, in order to zero-out a \$10 million contribution with a fixed level annuity payment at a 2.4% § 7520 rate, a 10 year term would require an annual payment of approximately \$1,137,000, but a 20 year term would require approximately \$635,000. With smaller charitable annuity payments and a longer period to out perform the § 7520 rate, longer term CLATs should result in more wealth transfer. This turns out generally to be true, as shown below in the tabulation of me-

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<sup>52</sup> See *infra* Part VI.C. and relevant discussion of the consequences of the loss of grantor trust status.

<sup>53</sup> I.R.C. §§ 170(b)(1)(B)(i), 170(b)(1)(D)(i)(I); Treas. Reg. § 1.170A-8(a)(2).

<sup>54</sup> PLR 8824039 (June 17, 1988).

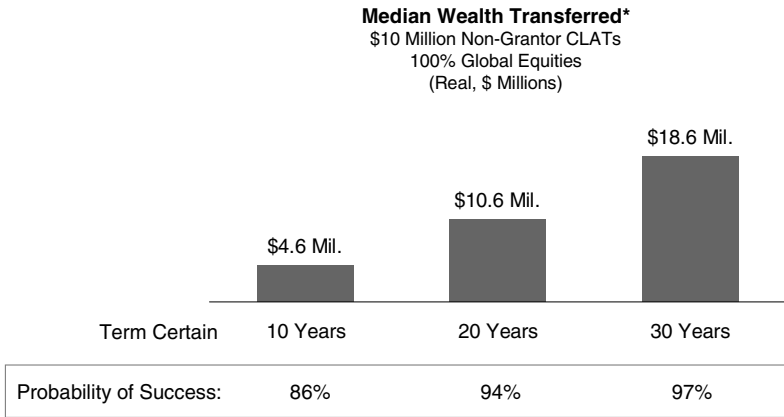
<sup>55</sup> See, e.g., PLR 200010036 (Mar. 10, 2000).

<sup>56</sup> I.R.C. § 664(d)(1)(A) (pertaining to charitable remainder annuity trusts with a similar rule for charitable unitrust interests in I.R.C. § 664(d)(2)(A)).

<sup>57</sup> Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a).

dian inflation-adjusted remainder values for 10, 20 and 30 year non-grantor CLATs that are zeroed-out and that have fixed level annuities.

**Longer Terms Increase Wealth Transfer and Probabilities of Success**



\*Median inflation-adjusted non-grantor CLAT remainder assuming \$10 million zeroed out CLAT funded at the July 2011 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$1,000. Equities defined as 35% US value, 35% US growth, 25% developed international and 5% emerging markets.

From a wealth-transfer standpoint, CLATs do not have the same “mortality risk” as GRATs<sup>58</sup> because if the grantor dies prior to the end of a term certain CLAT, no portion of the assets should be includible in the estate of the grantor. The CLAT will continue to be administered according to the terms of the trust for the remaining years, with the only difference being the conversion from grantor to non-grantor trust status if the CLAT was a grantor trust at the time of grantor’s death.<sup>59</sup> Despite the wealth-transfer benefit of longer CLAT terms, because longer terms defer both the non-charitable remainder beneficiaries’ and, to some extent, the charity’s enjoyment of the trust assets, grantors need to balance the timing of the receipt of the beneficiaries’ interests with the potential wealth transfer benefits.

**B. Benefit of Inter-Vivos Versus Testamentary CLATs**

Many charitable gifts including those made through CLATs are testamentary. In a low interest rate environment like today, there is an

<sup>58</sup> See Treas. Reg. § 20.2036-1(c)(1).

<sup>59</sup> As discussed in Section VI.C. below, the death of the grantor during the term of a grantor trust CLAT may result in a recapture of a portion of the income tax deduction taken by the grantor at the time the CLAT was formed. See I.R.C. § 170(f)(2)(B).

opportunity for grantors to fund these gifts now. The benefits would seem clear: (i) lock in a low § 7520 rate with all of its potential wealth transfer, (ii) if the CLAT is a grantor trust, create a personal income tax deduction that otherwise would have been lost if the charitable contribution had been made at death, and (iii) if the grantor survives the term, allow the grantor to see both charity and the remainder beneficiary enjoy the trust assets. Finally, as discussed in detail below, lifetime term CLATs can be utilized to effectuate testamentary charitable gifts with significant wealth transfer to non-charitable beneficiaries.

### C. Lifetime Terms and Mortality Risk

In addition to a term certain, a CLAT may provide for annual charitable payments “for the life or lives of certain individuals, each of whom must be living at the date of transfer and can be ascertained at such date.”<sup>60</sup> In order to prevent abusive transactions where grantors inflated the charitable deduction by using as measuring lives unrelated individuals who were seriously ill,<sup>61</sup> the Treasury Regulations now limit the allowable measuring lives to the donor, the donor’s spouse, a lineal ancestor of the remainder beneficiaries, and an individual who, with respect to all non-charitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.<sup>62</sup>

#### 1. *Effect of Using a Measuring Life with a CLAT*

The Treasury Regulations provide, in pertinent part,

[a] standard section 7520 annuity factor may not be used to determine the present value of an annuity for. . . the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this pur-

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<sup>60</sup> Treas. Reg. § 1.170A-6(c)(2)(i)(A). *See also* Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a) (containing similar language).

<sup>61</sup> The technique typically involved designating individuals who were seriously ill but who were not “terminally ill” (greater than 50% chance of surviving one year from the date of transfer). *See* Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

<sup>62</sup> *See* Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a). *See also* T.D. 8923, 2001-1 C.B. 485 (stating the same).

pose, it must be assumed that it is possible for each measuring life to survive until age 110.<sup>63</sup>

This provision applicable to lifetime terms, also known as the “110 year exhaustion test” has the practical effect of forcing grantors to either (i) limit the annuity term to the shorter of a term of years (determined by when the fund will be exhausted) or the prior death of the measuring life,<sup>64</sup> or (ii) significantly “over-funding” the trust with additional assets (above the determined charitable amount pursuant to the 110 year exhaustion test).

With the increase of the applicable exclusion amount to \$5 million per individual and the decrease of the top transfer tax rate to 35% under the Tax Relief Act of 2010,<sup>65</sup> the ability to “over-fund” a CLAT at little or no transfer tax cost has dramatically increased. For this reason, in the discussion below, we have assumed the lifetime term CLAT discussed in this article has been “over-funded” with just enough assets to pass the 110 year exhaustion test, but we have ignored possible transfer tax costs and the subsequent reinvestment of such assets (so that can we compare this to a comparable zeroed-out term of years CLAT). As a result, we use the standard annuity factors set out in § 7520 based upon an annuity stream that will be payable for the life of the measuring life.

Assuming the measuring life in question is the donor of the CLAT, the calculation of the charitable deduction is determined by multiplying the amount of the annuity by the appropriate annuity factor found in Table S (for a single life annuity) in IRS Publication 1457, Actuarial Valuations Version 3A (5-2009) (for valuation dates after April 30, 2009)<sup>66</sup> supplemented by Notice 2009-18<sup>67</sup> with factors for § 7520 rates below 2.2%. The annuity factors in Table S of IRS Publication 1457, however, assume a fixed level payment, and cannot be used with an escalating or back-loaded annuity. That being said, the remainder factors

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<sup>63</sup> Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i).

<sup>64</sup> See Treas. Reg. § 25.7520-3(b)(2)(v), Ex. 5; Treas. Reg. § 25.7520-3T(b)(2)(v), Ex. 5. If the CLAT term is limited to the shorter of a term of years and the prior death of the measuring life, the appropriate valuation factors can be found in Table H (commutation factors) of IRS Publication 1457. INTERNAL REVENUE SERVICE, ACTUARIAL VALUES BOOK ALEPH, I.R.S. Pub. 1457, Table H, pp.766-865 (July 1999) available at [http://www.irs.gov/pub/irs-pdf/p1457\\_99.pdf](http://www.irs.gov/pub/irs-pdf/p1457_99.pdf).

<sup>65</sup> Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010).

<sup>66</sup> If IRS Publication 1457 is not directly on point, an annuity factor may be calculated from Table S in Treas. Reg. § 20.2031-7(d)(7) by subtracting the applicable Table S remainder factor from 1.0 and dividing the result by the applicable § 7520 rate (corresponding temporary regulations were finalized and removed without any changes on Aug.10, 2011, T.D. 9540, 76 Fed. Reg. 49570-01). See Treas. Reg. § 20.2031-7(d)(7), Table S [hereinafter TABLE S].

<sup>67</sup> I.R.S. Notice 2009-18, 2009-10 I.R.B. 64.

(used to determine the present value of the right to receive an amount in the future) from Table S can be utilized.

For example, the 10-year term-certain Shark-Fin CLAT described above provided for a \$1,000 annual payment and a \$16,045,991 million payment at the end of year 20 (zeroing-out the \$10 million gift). If instead we assume that the trust term will be the life of a 62 year old donor (who has a 20 year life expectancy based on the 2000 mortality tables), and the annuity will follow a similar distribution pattern, the required final payment to zero-out the funding gift is determined as follows:

<b>Present Value of Annuity for Lifetime</b>	
Annuity Factor from Table S (2.4)	15.0740
x Annuity Amount	\$1,000
Present Value	\$15,074
<b>Present Value of Final Payment at Death</b>	
Remainder Factor from Table S (2.4)	0.63822
x Final Payment	\$15,644,959
Present Value	\$9,984,926
<b>TOTAL CHARITABLE VALUE</b>	<b>\$10,000,000</b>

Keep in mind that both the \$1,000 annuity amount, as prorated to the date of death, and the final payment of \$15,644,959 must be paid. The final payment at death (ignoring any prorated portion of the \$1,000 annuity) is \$400,132 *less* than the final payment that would be paid in the 20 year term certain trust (\$16,045,091) despite the fact that a 62 year old grantor has a 20 year life expectancy. This difference can be seen as the present value of the “mortality risk” associated with lifetime CLATs. However, the mortality risk is different depending on whether the CLAT provides for a fixed level annuity or a Shark-Fin pattern of payments. For example, in order to zero-out a \$10 million contribution to a CLAT for the lifetime of a 62 year old grantor, the charity will receive a fixed level payment of \$663,394,<sup>68</sup> which is \$27,966 per year *more* than the 20 year term annuity of \$635,428. Over 20 years, assuming the grantor survives to his or her actuarial life expectancy, the lifetime CLAT would cumulatively pay \$559,322 more to charity.

This difference reflects the inverse relationship that fixed level-annuity lifetime CLATs have when compared to lifetime Shark-Fin CLATs. If the grantor of a fixed level-annuity CLAT dies significantly before life expectancy, charity receives less than it anticipated and the

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<sup>68</sup> Table S annuity factor for a 62 year old (1.8% § 7520 rate) of 16.1105 multiplied by the annuity (\$620,713) equals \$10 million. See TABLE S, *supra* note 64.

remainder beneficiaries reap the benefit of more wealth transfer. Of course, if the grantor dies long after his or her life expectancy, charity receives more than it anticipated. By contrast, if the grantor of a lifetime Shark-Fin CLAT dies significantly before life expectancy, charity receives final payment earlier than it anticipated and the remainder beneficiaries do not realize as much wealth transfer. In fact, if the grantor of a lifetime Shark-Fin CLAT dies at the very beginning of the term, there is a high probability that the CLAT will not have sufficient assets to pay the \$15.6 million due to charity (with the remainder beneficiaries obviously receiving no assets) unless the “over-funding” required to satisfy the 110 year exhaustion test is sufficiently large to make the payment.<sup>69</sup> As mentioned above, a term-of-years Shark-Fin CLAT actually provides a higher probability of charity receiving its entire share, whereas with a lifetime Shark-Fin CLAT, charity’s share could be at risk if the grantor dies before his or her life expectancy. This mortality risk may be hedged by the CLAT purchasing insurance on the life of the grantor although there are a number of issues regarding the use of life insurance in CLATs, as we discuss later in this article.

## 2. *A Foray into Actuarial Computations*

Based upon the examples provided in Publication 1457, it is not readily evident how to calculate the value of the charitable interest and, thus, zero-out (ignoring any over-funding that may be required to satisfy the 110 year exhaustion test) a contribution to an annually increasing back-loaded CLAT (as opposed to the Shark-Fin CLAT, which is essentially a fixed annuity and a fixed payment at death). For those willing to tackle the challenge of actuarial computations, however, there seem to be a number of different methodologies that can be utilized, one of which we describe below. For the less actuarially inclined, the IRS has a procedure for requesting special actuarial factors.<sup>70</sup> The preamble to the § 7520 Treasury Regulations provide that unusual situations may be “computed by the taxpayer or, upon request, by the Internal Revenue Service for the taxpayer, by using actuarial methods consistent with those used to compute the standard section 7520 actuarial factors.”<sup>71</sup>

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<sup>69</sup> I.R.C. § 25.7520-3 provides that the standard § 7520 annuity factor may not be used if the trust will exhaust itself. *See* Treas. Reg. § 25.7520-3(b)(2)(i). This provision may require that all lifetime term Shark-Fin CLATs must be initially “over-funded” regardless of whether the Shark-Fin would satisfy the 110 year exhaustion test.

<sup>70</sup> *See* I.R.C. § 20.2031-T(d)(4) (corresponding temporary regulations were finalized and removed without any changes on Aug. 10, 2011, T.D. 9540, 76 Fed. Reg. 49570-01); *See also* I.R.C. § 25.2512-5(d)(4) (corresponding temporary regulations were finalized and removed without any changes on Aug. 10, 2011, T.D. 9540, 76 Fed. Reg. 49570-01).

<sup>71</sup> Preamble to the Treasury Regulations applicable to I.R.C. § 7520.



One method that is “consistent with those used to compute the standard section 7520 actuarial factors” uses a standard present value formula and the probability of survival based on the 2000 mortality tables utilized by the IRS.<sup>72</sup> At a § 7520 rate of 2.4%, Table S (single life annuity factors) of Publication 1457 provides an annuity factor of 15.074 for “ordinary” (fixed level) annuities.<sup>73</sup> If, as we have assumed throughout this article, the grantor is zeroing-out a \$10 million contribution, this equates to a \$663,394 fixed level annuity for the life of a 62 year old grantor (\$663,394 x 15.074 = \$10,000,000). In arriving at this figure, the IRS actuaries, in all likelihood, utilized the equations and methodology set out in this diagram:

**Lifetime CLAT Formula: Mortality-Adjusted Present Value**

Standard Present Value (PV) Formula for a Future Sum

$$PV = \frac{FV}{(1+i)^n}$$

FV = Value (annuity) at time n  
 i = interest rate (7520 rate)  
 n = number of periods (years)


Present Value (PV) for Series of Future Payments

$$PV = \sum \frac{FV}{(1+i)^n} = \frac{\$663,394}{1.024} + \frac{\$663,394}{(1.024)^2} + \frac{\$663,394}{(1.024)^3} + \dots + \frac{\$663,394}{(1.024)^{48}}$$

Mortality-Adjusted Present Value (MAPV) for Series of Future Payments

$$MAPV = PV \times P_n = \frac{\$663,394 \times 99.38\%}{1.024} + \frac{\$663,394 \times 98.08\%}{(1.024)^2} + \frac{\$663,394 \times 96.7\%}{(1.024)^3} + \dots + \frac{\$663,394 \times 0.01\%}{(1.024)^{48}}$$

P<sub>n</sub> = Probability of surviving to time n  
 (Table 2000CM)



SHAR-FBI CLAT Article

As the foregoing diagram shows, the value of the charitable deduction under § 7520 for lifetime CLATs is essentially the sum of the present values of each annual payment with each present value then multiplied by the probability of the grantor surviving that year (the

<sup>72</sup> Table 2000CM from IRS Publication 1457 provides, based initially on 100,000 lives, the number of individuals alive at each age. For example, the lx value at age 0 is 10000 and the lx value at age 1 is 99305. Thus, the probability of not surviving from year 0 to 1 year is 0.695% [(10,000 – 99,305)/10,000], which in turn means the probability of surviving from age 0 to 1 is 99.305%. See INTERNAL REVENUE SERVICE, SECTION 7520 ACTUARIAL TABLES, available at <http://www.irs.gov/retirement/article/0,,id=206601,00.html> (last visited Nov. 6, 2011).

<sup>73</sup> See *id.*

“Mortality-Adjusted Present Value”).<sup>74</sup> Based on the foregoing formula, we calculated that in order to zero-out a \$10 million contribution to a lifetime CLAT for a 62 year old grantor using a 2.4% § 7520 rate with annual increases of 20% and 50%, the first payments at the end of the first year would be \$28,158.27 and \$25.20 respectively.

Using these initial payments, a chart could be developed showing annual and cumulative payments over the grantor’s lifetime. Such a chart would show that by the end of year 20 (life expectancy according to the 2000 mortality tables), the level annuity would have cumulatively paid to charity \$13.3 million, whereas the 120% and 150% back-loaded annuities would have paid \$5.3 million and \$167,553 respectively to charity. That difference is startling in terms of amounts paid to charity and, consequently, amounts transferred to the remainder beneficiaries if death occurred at that time. It is not until the 27th year that more would cumulatively be paid in the 120% annuity pattern than the level annuity, and by the 36th year, the 150% annuity pattern would cumulatively pay more to charity than the 120% annuity. However, the probability of the grantor living 36 years, according to the 2000 mortality tables is approximately 4%.<sup>75</sup> In the 36th year, the annual amount payable to charity for the 120% and 150% annuities would be approximately \$16.6 million and \$36.7 million respectively.

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<sup>74</sup> In arriving at the Mortality-Adjusted Present Value, three important adjustments should be noted:

First, inexplicably, to arrive at the exact figures set out in Table S, the probability of survival is not simply the probability of surviving to the end of each year (notwithstanding that all of the Table S figures are based on payments being made at the end of each year). Apparently, in the calculation, the IRS uses a figure that is based on the probability of the grantor dying half-way through the year in question. To arrive at this figure, take the average of the probabilities of (i) living to the end of a year, and (ii) living to the end of the following year, and you have the probability of living to halfway through the first year. Based upon Table 2000CM, the  $l_x$  (number of lives at age  $x$ ) value at age 62 is 85691. The  $l_x$  value at age 65 and 66 are 82224 and 80916 respectively. Thus, the probability of living to age 65 is 95.95% ( $1 - [(85961 - 82224) / 85691]$ ) and the probability of living to age 66 is 94.43% ( $1 - [(80916 - 82224) / 85691]$ ). The probability of living to 65 ½ years of age is the average of those two percentages, which is 95.19%. That equates to year 4 of the CLAT for a grantor who is 62 years of age because by the end of year 4 the grantor is deemed to be age 66).

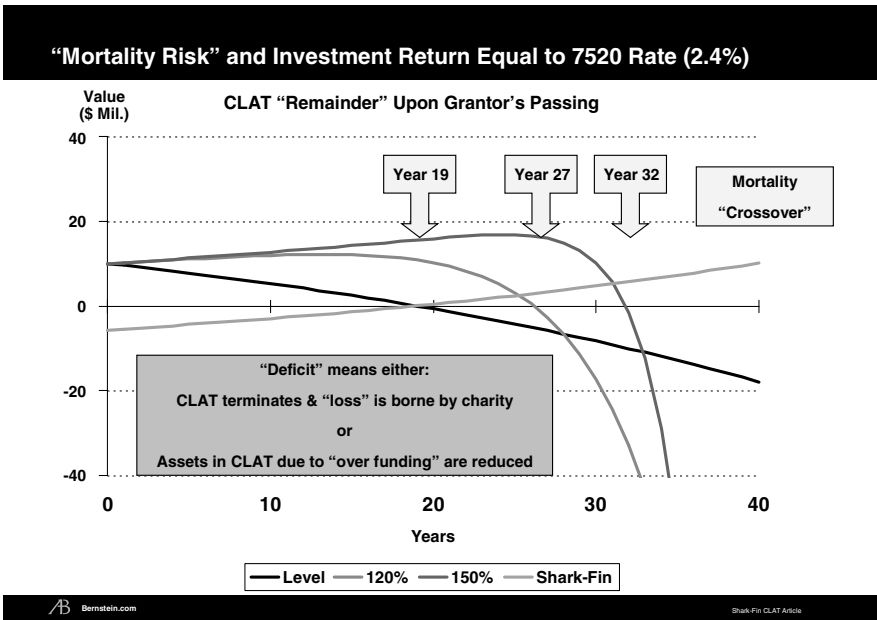
Secondly, the 2000 mortality table assumes no grantor will survive to 110 years of age. As such, the sum of the present value calculations end in the 48th year for a 62 year old grantor.

Finally, because Mortality-Adjusted Present Value calculates the present value of each payment, the payment can vary year-over-year. As such, this formula can be used to calculate an increasing annuity payment or a Shark-Fin, for that matter. *Id.*

<sup>75</sup> Note, the actual probability of a 62 year old living until the end of the 36th year (reaching age 98) is actually less than 3.5%, but the percentage cited above reflects the probability of living half-way through the year in question. *Id.*

3. Implications of Mortality Risk

As illustrated, the “mortality risk” associated with different increasing annuity structures can lead to wildly different amounts being required to be paid to charity over the life of the trust. Of course, this “mortality risk” must be balanced against the wealth transfer benefits to the remainder beneficiaries, which, in turn, is dependent on the investment return of the CLAT prior to the death of the grantor. As a starting point, consider the following diagram, which shows the “remainder” values (again, ignoring any assets from the reinvestment of any “over funding”) that would result if the 62 year old grantor died at some point over the next 40 years and the CLAT assets had an annual compound return exactly equal to the § 7520 rate (the IRS assumption on return) at the time of funding:



There are three significant points in time to consider (mortality “crossover”). First, in Year 19 (very close to life expectancy according to the mortality tables), the level annuity CLAT has exhausted its assets, and the CLAT goes into a “deficit.” Of course, for the grantor this is not truly a “deficit” or a continuing liability. In this instance, either (i) the CLAT will terminate because it does not have any assets and this “loss” is theoretically borne by the charity that otherwise would have continued to receive annual payments if the grantor had survived past this year; or (ii) the additional assets that were reinvested due to an

“over-funding” of the CLAT will begin to be reduced and this “loss” is theoretically borne by the remainder beneficiaries that otherwise would have received these assets if the grantor had died prior to this time. Also by year 19, the Shark-Fin CLAT assets start to exceed the \$15.6 million required payment to charity. The Shark-Fin CLAT, which initially had significant mortality risk, no longer has such risk; the longer the grantor lives past this point, the larger the remainder becomes.

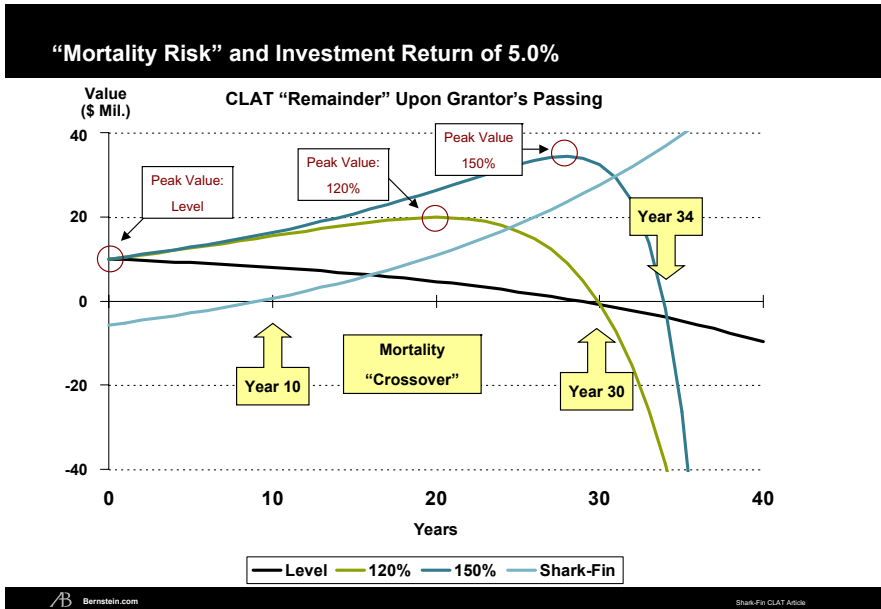
Second, in Year 27 (grantor would be 89 years of age), the 120% back-loaded annuity CLAT goes into deficit. Third, in Year 32 (grantor would be 94 years of age), the 150% back-loaded annuity CLAT goes into deficit. Despite the fact that cumulatively the 150% back-loaded annuity CLAT would not have paid more to charity until the 36th year (as discussed above), if the assets earn exactly the § 7520 rate, mortality “crossover” occurs by year 32. It is also at this point that the Shark-Fin CLAT has more wealth transfer than all of the other CLATs.

It is notable that all of the annually increasing remainder values are above the level annuity CLAT until the CLAT goes significantly into a “deficit.” However, as mentioned above, this “deficit” is a phantom liability with respect to the grantor, and a theoretical loss to the remainder beneficiaries in that they receive less than they otherwise would receive had the “over-funded” assets been given to them. As such, because of the mortality-adjusted formulas used by § 7520, from a wealth-transfer perspective, there are compelling reasons to take advantage of the most severe back-loading possible in lifetime CLATs but perhaps not the Shark-Fin, which has a guaranteed “deficit” in the first few years. Of course, these illustrations have been limited to the annual increases of 20% and 50%. Imagine how far out the mortality “crossover” point would be with a 75% or 100% annual increases.<sup>76</sup>

One hopes and expects that the investments of the CLAT will exceed the § 7520 rate. If the CLAT assets earned 5% per year, “mortality risk” and wealth transfer benefits change significantly, as shown by the following diagram:

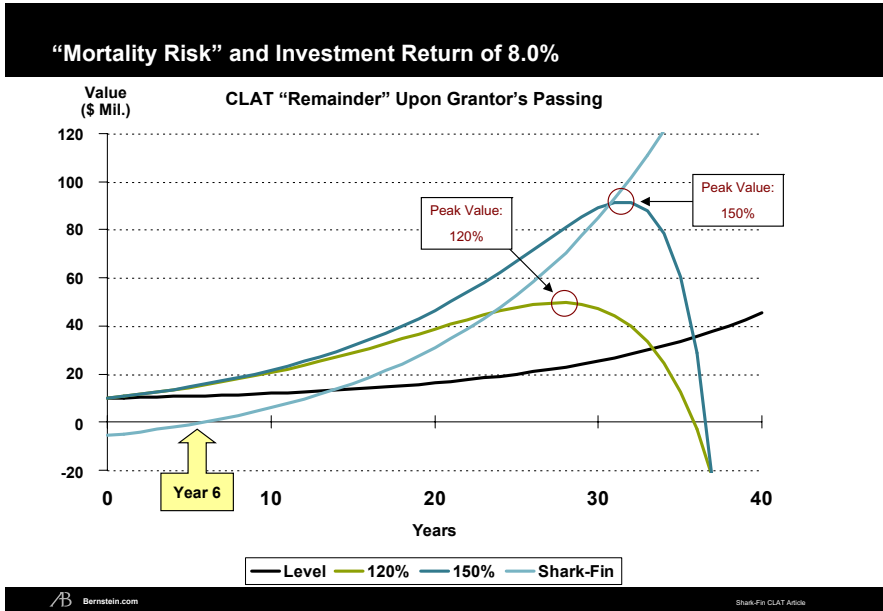
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<sup>76</sup> Based on our calculations mortality “crossover” with a 75% annually increasing payment would occur in year 35 (assuming a compound annual rate of return equal to the § 7520 Rate). *Id.*



As one can see, a very different picture starts to emerge when the assets exceed the § 7520 rate. Notably, in Year 10, the Shark-Fin CLAT has assets that exceed the \$15.6 million charitable payment. From this point forward, if the grantor survives, the remainder value continues to increase and by the 31st year will exceed all of the other CLATs. Next, in Year 30 (grantor would be 92 years of age), the 120% back-loaded annuity CLAT goes into deficit, but the peak remainder value was in the 20th year. However, you will note that the remainder value is never above the 150% back-loaded annuity CLAT. You will also note that by the 29th year, the level annuity CLAT has gone into deficit. This is 10 years past the point it would have gone into deficit at the assumed § 7520 rate, so investment return can significantly change the mortality risk associated with lifetime CLATs by extending the mortality “crossover” point. However, as with the previous rate of return, for level annuity lifetime CLATs, the peak remainder value was at the outset of the term. Finally, in Year 34 (grantor would be 96 years of age), the 150% back-loaded annuity CLAT goes into deficit, but the peak remainder value was in the 28th year. As between the 120% and 150% back-loaded annuity CLATs, grantors who are looking to maximize wealth transfer would always choose the 150% back-loaded annuity because the remainder values are always greater than the 120% CLAT and the “mortality” crossover point is later.

If the investment return is even higher, say 8.0% per year, the “mortality risk” and wealth transfer picture changes even more. Consider the following diagram:



As one can see, when the investment return is 8% per year, “mortality risk” becomes largely irrelevant and what annuity structure a grantor may choose is largely dependent on the outlook for his or her longevity. Thus, in Year 6, the Shark-Fin CLAT has assets that exceed the \$15.6 million charitable payment. Perhaps more significantly, it is not until the 36th year when the grantor will be 98 years of age that the Shark-Fin remainder will be greater than the 150% annually increasing CLAT. The probability of the grantor living to that age is 4.1%, according to the methodology used by the IRS. In contrast, the traditional level-annuity CLAT has no mortality risk at all (unlike all of the other annuity patterns). At this rate of return, regardless of how long the grantor survives, the assets continue to grow. In Year 37 (grantor would be 99 years of age), both the 120% and 150% back-loaded annuity CLATs go into a “deficit.” Peak remainder values are in Years 28 and 32 respectively. As with the other rates of return, if the grantor seeks to maximize wealth transfer to the non-charitable beneficiaries, and the grantor is opting for an annually increasing annuity, the grantor should always choose the higher annual increase (in this case, 150%).

The “mortality risk” (whether defined in relation to maximum wealth transfer or the point that the CLAT will go into “deficit”) associated with each of these annuity patterns has a number of significant planning implications for Shark-Fin, annually increasing, and level-annuity CLATs. The lifetime Shark-Fin CLAT has significant mortality risk but only at the outset of the CLAT when the probability of death is the lowest. While higher rates of return would reduce that risk, it would not fully eliminate it (unless one assumed astronomical rates of return). Interestingly, regardless of the assumed rates of return, the Shark-Fin CLAT will have the most wealth transfer only by Year 32 (based upon a grantor who is 62 years of age), so unless the grantor has confidence that he or she will survive to that point, an annually increasing CLAT is probably a better choice. Because of this dynamic, life insurance would be the optimal investment to consider because mortality costs would be the smallest in the first few years, and the need for insurance would minimize over time. However, as discussed later in this article, life insurance in a CLAT may be problematic. Thus, planners might want to consider holding the life insurance outside of the CLAT, perhaps in an irrevocable life insurance trust for the benefit of the CLAT’s non-charitable beneficiaries to avoid a number of those issues.

With annually increasing lifetime CLATs, because a “deficit” is borne by charity (and under some circumstances, the remainder beneficiaries) and does not become an obligation of the grantor, grantors should choose higher annual increases if maximizing wealth transfer is the primary goal. As the foregoing discussion and diagrams show, higher annual annuity increases provide higher remainder values and more extended mortality “crossover.” We have limited the discussion in this article to 50% annual increases, but larger increases should be considered. Because the remainder value is greatest with 150% back-loaded CLATs for 32 years in this example (62 year old grantor), regardless of investment return, a complementary estate planning strategy that planners might consider in conjunction with this CLAT is a series of zeroed-out GRATs (longer term or short-term “rolling” or both) because GRATs are most successful when the grantor has longevity.

With level-annuity lifetime CLATs, the only time it has substantial wealth transfer benefits over the other annuity patterns is when the investment return far exceeds the § 7520 rate. Even when the investment return is 5% (significantly greater than the § 7520 rate), the CLAT collapses in the 29th year. With an investment return of 5%, the grantor would have been better off with a 150% back-loaded annuity CLAT, which collapses in the 34th year, but during the entire period its remainder values exceed the level annuity CLAT. If the investment return far exceeds the 7520 rate (8% in the diagram above), there is no mortality

risk (even in the first few years when the Shark-Fin CLAT is more vulnerable).

As mentioned above, the 110 year exhaustion test typically requires either an “over funding” of the CLAT, or limiting the term to the shorter of a term of years (determined by when the fund will be exhausted) or the prior death of the measuring life. Up to this point, we have assumed an “over-funding” sufficient to allow the CLAT term to be set for the life of the grantor (the measuring life). From a planning standpoint, however, practitioners should consider limiting the term to the earlier of the death of the measuring life, or a term of years. In the example above with the 62 year old measuring life, if the CLAT is a 150% increasing annuity, the term of years limitation should be set at approximately 30 years because the remainder values peak at or near that point at both the 5% and 8% assumed rates of return and also for the forecasted returns (shown below). Limiting the term to 30 years significantly reduces the amount of required “over funding” (the measuring life is assumed to live until 92 rather than 110 years), and it eliminates the problem of going severely into a “deficit” for both charity and the non-charitable beneficiaries.<sup>77</sup>

Notwithstanding the “mortality risk” statistics and discussion above, it should be noted that the mortality tables used in § 7520 tend to over-estimate the probability of death for most grantors for several reasons. For example, the statistics are based on the 2000 census data.<sup>78</sup> As such, the data are already 10 years old, and life expectancies have lengthened since then. In additions, the statistics are sex neutral, and female grantors have longer life expectancies than their male counterparts. In addition, the statistics are based on the total population. Generally, grantors of CLATs tend to be wealthier than the general population, and studies have shown that wealthier individuals have longer life expectancies.<sup>79</sup> Finally, the statistics do not take into account self-selection. In other words, grantors who wish to maximize the amount of wealth transfer to non-charitable beneficiaries but who are

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<sup>77</sup> Of course, those figures ignore the commutation valuation factors in Table H (commutation factors) of IRS Publication 1457, but 30 years is a sufficiently long period of time that they would not substantially change the conclusion. *Id.*

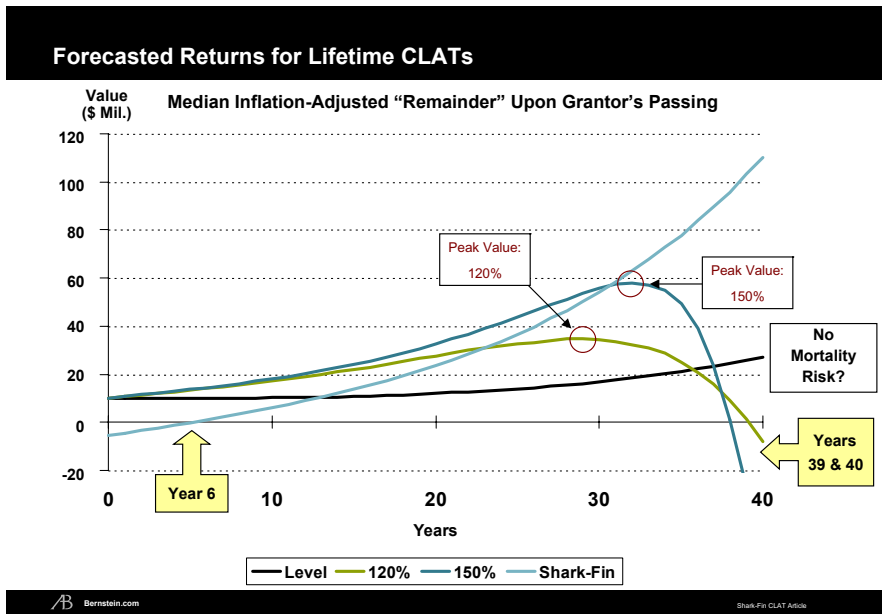
<sup>78</sup> IRS Publication 1457 provides the factors and tables are taken from the “Life Table for the Total Population appearing as Table 1, in ‘U.S. Decennial Life Tables for 1999-2001’ published by the U.S. Department of Health and Human Services, Public Health Service, National Center for Health Statistics.” INTERNAL REVENUE SERVICE, ACTUARIAL VALUATIONS VERSION 3C, p. 3 (May 2009) available at <http://www.irs.gov/pub/irs-pdf/p1459.pdf>.

<sup>79</sup> See, e.g., Kim Painter, *Can Wealth Affect Health?* USA TODAY, Mar. 24, 2008 available at [http://www.usatoday.com/news/health/painter/2008-03-23-your-health\\_N.htm](http://www.usatoday.com/news/health/painter/2008-03-23-your-health_N.htm) (last visited Nov. 6, 2011).



healthy and have a family history of longevity are less likely to create lifetime CLATs because they are more likely to live longer (and pay more to charity) than the mortality tables assume.

Furthermore, the discussion above assumes a constant rate of return. As we have discussed, the path of the investment returns are just as important as the overall magnitude of the returns. Based upon Bernstein’s forecasts of investment returns for global equities, the median inflation-adjusted remainder values over the next 40 years for these lifetime CLATs are in the diagram below:

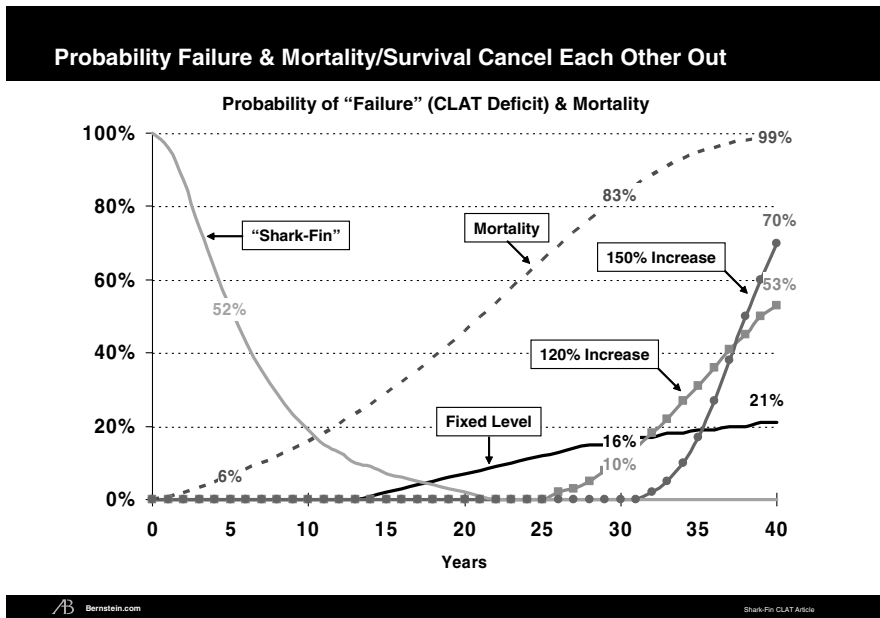


As one can see, based upon this forecast of returns, the mortality risk profile is similar to the assumed 8% annual return above (although these are inflation-adjusted values, so the nominal returns are on average greater than 8%).<sup>80</sup> However, “mortality risk” for all of the lifetime CLAT annuities is greatly minimized. For the Shark-Fin CLAT, mortality crossover is expected to occur by Year 6, and by Year 31, the remainder values will exceed those of the other CLATs. For the 150% back-loaded CLAT, peak value occurs in Year 32, and the CLAT is not expected to go into a deficit until Year 39 (at which point the grantor

<sup>80</sup> Based on Bernstein’s forecast of returns, global equities will have a median compound annual growth rate of slightly higher than 9% over the next 40 years. [https://www.alliancebernstein.com/abcom/segment\\_homepages/private\\_client/us/pcus.htm](https://www.alliancebernstein.com/abcom/segment_homepages/private_client/us/pcus.htm) (last visited Nov. 6, 2011).

would be 101 years of age). In contrast to the 5% assumed rate of return, the 120% back-loaded CLAT has virtually no mortality risk, but peak value is expected to occur in Year 28. As with the previous diagram, the level annuity CLAT has no mortality risk

These are, of course, median or 50th percentile results, and although the chart implies that both the 120% and level annuity CLATs have little or no mortality risk, the real probabilities of “failure” (the CLAT going into a “deficit”) due to investment returns and death occurring at different times is illustrated below:



The solid lines (both smooth and with markers) show the probability of each lifetime CLAT exhausting its assets, but assumes the grantor survives for 40 years. The dotted line shows the probability of the grantor passing away over the next 40 years. These two variables tend to cancel each other out because when probability of failure (due to investment returns and the cumulative charitable payments) is high, the probability of mortality or survival is quite low.

By way of example, consider three specific time periods. In Year 5, there is a 52% chance that the Shark-Fin CLAT will go into a “deficit” but the probability of death occurring at this point is only 6% according to the mortality tables (as computed by the IRS). There is no chance, according to these forecasted returns, that any of the other CLATs will be in a “deficit” at that point. In Year 30, the level annuity and the

120% back-loaded CLATs have a 16% and 10%, respectively, chance of being in a deficit at such time. However, there is an 83% chance that the grantor has already passed away at that point. Thus, there is only a 17% chance that the CLAT will still be in existence for those probabilities of failure to occur. Finally, in Year 40, all of the lifetime CLATs (other than the Shark-Fin) have probabilities of failure that range from 21% to 70%. However, there is only a 1% chance that the grantor has survived to that point (102 years of age).

From a probability-weighted standpoint, there does not seem to be a clear winner in terms of which CLAT structure provides the most wealth transfer and the highest probability of the grantor's mortality working for the benefit of the non-charitable beneficiaries. That being said, of the lifetime CLAT structures considered in this article, most practitioners will likely opt for the 150% back-loaded annuity lifetime CLAT. It provides the highest remainder values of all of the other CLATs for 30 years and does not significantly fall under the Shark-Fin values until Year 34. The probability that the grantor will survive to Year 34, according to the mortality tables, is only 7%. As mentioned above, practitioners will likely limit the term to a term of years (set around 30 years of age) and the prior death of the measuring life. Again, we have limited our discussion to an annual increase of 50%; practitioners may want to consider how this mortality risk discussion would be altered if the annual increase exceeded 50%, and how that will likely limit the term of years if a lifetime term is not utilized.

#### D. Purchasing the Charitable Lead Interest

If a Shark-Fin CLAT is created with a very long term, the remainder beneficiaries may want to consider purchasing the lead charitable interest from the charity. The rationale for considering this purchase is the reasonable assumption that charity would prefer to receive a smaller amount today, rather than having to wait a considerable amount of time for the bulk of the trust assets, particularly if the charity estimates that it can invest those assets at higher rate of return than the prevailing § 7520 rate. Under these circumstances, the remainder beneficiaries could conceivably purchase the charitable lead interest at a significant discount to the actual assets held in the CLAT at the time of purchase. Thus, assuming the state law applicable to the trust provides for the merger doctrine,<sup>81</sup> the remainder beneficiaries could purchase the interest, which would collapse the trust and accelerate the transfer of the assets to them.

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<sup>81</sup> See UNIF. TRUST CODE § 402(a)(5) (2005); RESTATEMENT (THIRD) OF TRUSTS § 69 (2003); RESTATEMENT (SECOND) OF TRUSTS § 341 (1959).

To illustrate, consider the following, perhaps extreme, example. In a month when the § 7520 rate is 2.4%, if a grantor contributes \$10 million to a 100 year Shark-Fin CLAT that provides for a \$1,000 annual payment for 99 years, then a fixed payment of \$106,747,065 would be required at the end of the 100th year in order to zero-out the gift. Charity's present right to receive the \$107 million in 100 years may be worth considerably less than the \$10 million contributed. For instance, if charity invested its assets at a 5% compound annual return, the present value of that last payment is worth only \$873,177 (also including \$1,000 each year for the next 99 years). As a result, the remainder beneficiaries might negotiate the purchase of charity's lead interest for, say, \$1 million. The remainder beneficiaries would thus net \$9 million (assuming exactly \$10 million of assets in the trust at the time of purchase).

The self-dealing rules applicable to private foundations (discussed in more detail below) would, in most cases, prohibit the purchase of the charitable lead interest by the remainder beneficiaries if the charity selling the lead interest is a private foundation. The private foundation rules would not apply, however, if (i) the charity in question is a public charity and (ii) the CLAT trustee is an unrelated, independent trustee who is not involved in the negotiation of the transaction and not a party to the transaction.

Commutation clauses are generally prohibited in CLATs. Revenue Procedure 2007-45 provides, "a charitable lead annuity interest is not a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the annuity period."<sup>82</sup> At least in form, if the CLAT trustee is not a party to the transaction and the collapsing of the trust under the merger doctrine is forced upon the trustee by the remainder beneficiaries, this transaction would not constitute a commutation. A CLAT with a term so long that a reasonable grantor would not have created the CLAT but for the expectation that the charitable interest would be purchased may be more subject to attack than a CLAT of shorter term.

#### IV. WHAT ABOUT HIGHER § 7520 RATES?

All of the figures in this article are based on today's § 7520 rate of 2.4%. The obvious question that must be addressed is if interest rates rise from this point, are Shark-Fin or other back-loaded annuity CLATs still compelling? Quite simply, in higher interest rate environments,

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<sup>82</sup> Rev. Proc. 2007-45 § 5.02(1), 2007-29 I.R.B. 89, citing Rev. Rul. 88-27, 1988-1 C.B. 331; See PLR 9844027 (Oct. 30, 1998), where the IRS allowed for prepayment of the charitable lead interest where the payment was an undiscounted amount of all distributions and where the trust was prepaying the charitable lead interest to avoid the imposition of an excise tax under the excess business holdings rules.

Shark-Fin or other back-loaded CLATs become even more important, although the amount of wealth transfer will likely be less than it is when interest rates are very low. CLATs shift wealth whenever the investment returns of the trust exceed the § 7520 rate. The § 7520 rate is currently very low, and forecasted investment returns of global equities (the assumed investment) are relatively high.<sup>83</sup> It is not just the § 7520 rate that determines whether a CLAT will result in significant wealth transfer. While the § 7520 rate determines the size of the annuity required to “zero-out” a contribution, it is the magnitude of the return in excess of the § 7520 rate that is more determinative of the resulting wealth transfer. Interest rates and equity returns are correlated. Equity returns have a historical premium above fixed income returns (the equity risk premium). However, there are times when interest rates are very low but expected equity returns are also very low. In that type of environment, even with a low § 7520 rate, a CLAT will result in little or no wealth transfer. Conversely, there are other times when interest rates are high, but expected equity returns are significantly higher. Thus, even with high § 7520 rates, a CLAT would still be compelling in that type of environment.

In order to see how different CLAT annuity structures might perform in a higher interest rate environment, consider the following forecasted results from September 2008 when the prevailing § 7520 rate for CLATs was 4.2%.<sup>84</sup> For 20 year “zeroed-out” CLATs, the median inflation-adjusted remainder values were forecasted as follows:<sup>85</sup>

As with the current forecasts, for non-grantor CLATs, the Shark-Fin does not produce the most efficient wealth transfer (120% back-loaded CLAT does), but for grantor CLATs, the Shark-Fin results in the highest remainder values and probabilities of success. However, when compared with the current forecasts, the remainder values are approximately 40% lower, and the probabilities of failure are significantly higher. As mentioned above, failure with a CLAT means that no assets return to the grantor (as with a GRAT, for example), and no wealth passes to the non-charitable beneficiaries. As such, having the highest probability of success is critical. For grantor CLATs, the highest remainder values and probabilities of success result when the back-loading is the steepest. Thus, in higher interest rate environments, back-loading

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<sup>83</sup> Based on Bernstein’s forecast of returns, global equities will have a median compound annual growth rate of over 9% over the next 40 years. [https://www.alliancebernstein.com/abcom/segment\\_homepages/private\\_client/us/pcus.htm](https://www.alliancebernstein.com/abcom/segment_homepages/private_client/us/pcus.htm) (last visited Nov. 6, 2011).

<sup>84</sup> *Section 7520 Interest Rates for Prior Years*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/businesses/small/article/0,,id=204934,00.html#2008> (last visited Nov. 6, 2011).

<sup>85</sup> Martin Hall & Paul S. Lee, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse*, SS045 ALI-ABA 809, 842 (June 2011).

<b>Median Wealth Transferred \$10 Million, 20-Year Term CLAT (Real)</b>				
	<b>Fixed</b>	<b>120%</b>	<b>150%</b>	<b>Shark-Fin</b>
<b>Non-Grantor CLAT</b>	\$7.4 Mil.	\$10.3 Mil.	\$10.5 Mil.	\$9.9 Mil.
<b>Probability of Success</b>	87%	90%	89%	86%
	<b>Fixed</b>	<b>120%</b>	<b>150%</b>	<b>Shark-Fin</b>
<b>Grantor CLAT</b>	\$8.1 Mil.	\$13.0 Mil.	\$15.6 Mil.	\$17.2 Mil.
<b>Probability of Success</b>	87%	93%	94%	95%

becomes even more critical for both charitable and non-charitable beneficiaries. The only way to improve on these results to a point that they would be comparable to the current 20 year forecasts is to extend the term to, for example, 30 years, as seen below:

<b>Median Wealth Transferred \$10 Million, 30-Year Term CLAT (Real)</b>				
	<b>Fixed</b>	<b>120%</b>	<b>150%</b>	<b>Shark-Fin</b>
<b>Non-Grantor CLAT</b>	\$13.8 Mil.	\$19.9 Mil.	\$20.2 Mil.	\$19.2 Mil.
<b>Probability of Success</b>	94%	96%	94%	93%
	<b>Fixed</b>	<b>120%</b>	<b>150%</b>	<b>Shark-Fin</b>
<b>Grantor CLAT</b>	\$17.5 Mil.	\$32.4 Mil.	\$36.5 Mil.	\$38.3 Mil.
<b>Probability of Success</b>	94%	>98%	>98%	>98%

### V. IS A SHARK-FIN CLAT ADVISABLE?

Notwithstanding the superior wealth transfer results with grantor Shark-Fin CLATs, there are number of reasons why most grantors should not choose the Shark-Fin annuity, but rather should consider annually increasing annuities (like 120%, 150% or greater back-loading). First, as discussed above with lifetime term CLATs, the Shark-Fin is virtually guaranteed to fail if the grantor (or other measuring life) dies in the first few years. Although very high returns would shorten that time period, those high returns result in more wealth transfer with the annually increasing annuities than the Shark-Fin (unless the grantor or other measuring life lives far beyond life expectancy).

Second, although term CLATs do not have the same type of mortality risk as lifetime terms, as discussed later in this article, if the grantor dies during the term of a grantor CLAT, the trust becomes a non-grantor trust, resulting in recapture of a portion of the grantor’s income tax deduction taken when the CLAT was formed. We have already seen that the Shark-Fin does not produce the most wealth transfer when the

CLAT is a non-grantor trust because of the inability to efficiently use the charitable deduction under § 642(c). If, in our 20 year grantor Shark-Fin CLAT example, the grantor dies in the first year, the non-charitable beneficiaries would ultimately receive more with a 150% back-loaded annuity than with the Shark-Fin. Although the probability of the grantor dying so early in the term is probably quite low, estate planners are likely to choose 150% back-loaded annuities today because doing so ensures the best results if the grantor dies unexpectedly and provides for remainder values that are comparable to a Shark-Fin if the grantor does survive the term (\$27.1 million vs. \$28.9 million, inflation-adjusted median remainder values).

Although we do not currently see any technical or policy reasons why a Shark-Fin annuity pattern should not be allowable in a CLAT, some practitioners feel that nominal payments each year with a large payment at the end of a term may be pushing the envelope.<sup>86</sup> For these practitioners, annually increasing annuities of 20%, 50% or greater each year “feels” better than a Shark-Fin. As illustrated above, in today’s interest rate and economic environment, annually increasing annuity CLATs provide results comparable to Shark-Fin CLATs.

There are at least a couple of circumstances when a Shark-Fin annuity pattern would be advisable. First, the nature of the asset (illiquidity, volatility, lack of marketability, etc.) may require a severely back-loaded annuity pattern. Second, for testamentary charitable bequests, a lifetime grantor Shark-Fin CLAT is a superior way of fulfilling that gift. Not only would the Shark-Fin CLAT satisfy the charitable gift, it would likely provide significant wealth transfer and an income tax deduction that the donor would otherwise have foregone. Other than situations similar to these, most planners will likely choose annually increasing annuities over the Shark-Fin.

## VI. GRANTOR CLATS

If much of the wealth transfer benefit afforded to the Shark-Fin CLAT is predicated on the trust having grantor trust status over the entire trust, but not also having the trust assets be includible in the estate of the grantor for estate tax purposes, it is crucial that tax planners carefully consider which grantor trust power to use with a CLAT.

### A. What Grantor Trust Power?

The typical power used to achieve grantor trust status for a CLAT is one described under § 675(4)(C), namely giving the grantor, or a per-

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<sup>86</sup> Paul S. Lee, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse*, SS002 ALI-ABA 1, 12 (Mar. 2011).

son other than the grantor, the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.<sup>87</sup> In Rev. Proc. 2007-45, the promulgated CLAT forms suggest giving someone other than the grantor the power of substitution. Specifically, the Revenue Procedure provides,

[d]uring the Donor's life, [an individual other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1)] shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value.<sup>88</sup>

In Private Letter Ruling 9224029, a person who was neither a trustee nor a § 672(a) adverse party had the substitution power exercisable in a non-fiduciary capacity, without the approval or consent of fiduciary. The IRS determined that the CLT was a grantor trust under § 675(4) without discussing any possible self-dealing issue.<sup>89</sup> The IRS also ruled that the grantor was entitled to a § 2522(a) charitable gift tax deduction equal to the present value of the charitable interest and that no part of the trust property would be includible in the grantor's estate for estate tax purposes.<sup>90</sup> More recently, however, the IRS has declined to affirmatively rule on the grantor trust status of trusts under § 675(4)(C) saying that such a determination is dependent on all the facts and circumstances.<sup>91</sup>

Giving the grantor the retained power of substitution is not, in and of itself, a violation of the private foundation rules (discussed below). However, given the steep penalties for engaging in a self-dealing transaction (as the exercise would be), the IRS could argue that this power is not a bona fide power, and as such, should be ignored for grantor trust purposes. Thus, giving someone other than the grantor the power would seem to be an important safeguard. Some practitioners will want to go further and include additional bases for establishing grantor trust status.<sup>92</sup>

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<sup>87</sup> I.R.C. § 675(4).

<sup>88</sup> Rev. Proc. 2007-45 §7(11), 2007-29 I.R.B. 89.

<sup>89</sup> PLR 9224029 (June 12, 1992).

<sup>90</sup> *See id.*

<sup>91</sup> *See, e.g.*, PLR 199908002 (Feb. 26, 1999).

<sup>92</sup> Additional powers, not otherwise discussed in this article, that potentially achieve grantor trust status without causing includibility for estate tax purposes include: (i) permitting the income of the trust, without the approval or consent of an adverse party, to be "applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse." I.R.C. § 677(a)(3); and (ii) using a foreign-situs CLAT because a foreign trust created by a U.S. grantor with one or more U.S. beneficiaries is a grantor trust under § 679. In each case, the facts and circumstances of the client situation should



The IRS has ruled favorably on the grantor trust status of a CLAT involving the application of § 674.<sup>93</sup> The grantor's children were the remainder beneficiaries of the trust, but the trustees had the power to add one or more charities as remainder beneficiaries eligible to receive trust corpus upon termination of the term. The grantor had a power to remove the trustees and to appoint successor trustees who were not related or subordinate to the grantor or to any person having a trustee removal power. Neither the grantor nor the grantor's spouse could serve as trustee. The trustees were non-adverse parties under § 672(b). The IRS ruled that the grantor was the owner of the trust under § 674(a).<sup>94</sup>

### B. Using Appreciated Property to Pay Charity

With respect to non-grantor CLATs, the IRS takes the position that the satisfaction of the annuity payment with appreciated property is a taxable event, thereby triggering capital gain.<sup>95</sup> Citing Revenue Ruling 83-75,<sup>96</sup> the IRS forms provide, “[i]f the trustee distributes appreciated property in satisfaction of the required annuity payment, the trust will realize capital gain on the assets distributed to satisfy part or all of the annuity payment and the trust will be allowed a § 642(c)(1) deduction for the realized capital gains.”<sup>97</sup>

Surprisingly, with respect to grantor CLATs, the IRS takes the same position, notwithstanding that if the grantor “owned” the appreciated property and gave the same property to charity (whether in satisfaction of an enforceable pledge or not), no capital gain would be

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be carefully evaluated. For example, with respect to the payment of premiums on life insurance on the life of the grantor or the grantor's spouse, it should be noted that the CLAT needs to have an insurable interest for state law purposes. *See, e.g.*, PLR 9110016 (Mar. 8, 1991) (citing N.Y. Ins. Law § 3205(b)(2) (McKinney 2011)). In this PLR, the Service ruled that the taxpayer who sought to transfer a life insurance policy to a charitable entity would be denied a charitable deduction, in large part, because New York state law would not provide the charitable entity sufficient insurance interest in the policy. PLR 9110016 was later revoked by PLR 9147040 (Nov. 22, 1991) because New York state law was subsequently amended to allow the immediate transfer of an insurance policy to charity, and allowing the charitable entity to obtain an insurable interest. Thus, the taxpayer indicated to the Service that it was not going to proceed with the transaction in question and the earlier PLR was revoked.

<sup>93</sup> PLR 199936031 (Sept. 10, 1999). The IRS did point out that the exception to § 674(a) under § 674(c) does not include a power held by non-adverse parties to add to the beneficiaries who are entitled to receive trust corpus.

<sup>94</sup> *Id.*

<sup>95</sup> *See* Rev. Proc. 2007-45 § 5.02(2), 2007-29 I.R.B. 89.

<sup>96</sup> Rev. Rul. 83-75, 1983-1 C.B. 114.

<sup>97</sup> Rev. Proc. 2007-45 § 5.02(2), 2007-29 I.R.B. 89.

triggered and the grantor would be entitled to a charitable income tax deduction.<sup>98</sup>

In Private Letter Ruling 200920031, the IRS ruled that the annual payment to a private foundation by a CLAT each year for 20 years would result in the recognition of gain by the grantor because the trustees of the CLAT intended to satisfy the annual payment requirement with appreciated securities rather than income.<sup>99</sup> The CLAT was a grantor CLAT because the grantor had the “right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value.”<sup>100</sup> The IRS cited as support for its position *Kenan v. Commissioner*,<sup>101</sup> which dealt with the satisfaction of a non-charitable beneficiary’s interest in trust assets, and two Revenue Rulings,<sup>102</sup> one that discussed a non-grantor CLAT and the other the IRS’s own inter-vivos CLAT form.

The IRS distinguished Revenue Ruling 55-410, which concluded that “satisfaction of a mere pledge to charity with property that has either appreciated or depreciated in value does not give rise to a taxable gain or deductible loss,”<sup>103</sup> on the ground that “a pledge to charity is not a debt,” whereas in a CLAT, the charity has a claim against the CLAT assets.<sup>104</sup> Finally, the IRS pointed out that the grantor received a charitable deduction when the CLAT was created and before any annuity payments were made to the charity, but an individual would not be entitled to a charitable deduction upon making a pledge to charity.<sup>105</sup> As a result, the IRS ruled that the grantor would recognize gain on the distribution of appreciated securities in satisfaction of the annuity amount.<sup>106</sup>

The supporting authority cited by the IRS position could be distinguished because it deals with non-charitable beneficiaries and non-grantor trusts.<sup>107</sup> Enforceable pledges are bona fide claims that can be enforced against the donor, and that the grantor received a charitable deduction upon contribution would not seem to be significant because the grantor was not claiming an additional charitable deduction for the payment to charity.<sup>108</sup> Furthermore the perceived abuse of receiving an

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<sup>98</sup> See generally I.R.C. § 170(a), (e).

<sup>99</sup> PLR 200920031 (May 15, 2009).

<sup>100</sup> I.R.C. § 674(5) (substitution power of administration).

<sup>101</sup> *Kenan v. Comm’r.*, 114 F.2d 217 (2d Cir. 1940).

<sup>102</sup> Rev. Rul. 83-75, 1983-1 C.B. 114; Rev. Proc. 2007-45, 2007-29, I.R.B. 89.

<sup>103</sup> Rev. Rul. 55-410, 1955-1 C.B. 297.

<sup>104</sup> PLR 200920031 (May 15, 2009).

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> See I.R.C. § 20.2053-4(d)(5).

initial income tax deduction upon contribution and not realizing sufficient taxable gain during the term of the CLAT is covered by the recapture rules of § 170(f)(2)(B), as discussed in more detail later in this article. Nonetheless, the IRS position is clear: the satisfaction of a charitable annuity in a grantor CLAT with appreciated assets triggers capital gain.

### C. Grantor to Non-Grantor Trust Status

When a grantor either relinquishes the power that affords him or her grantor trust status or dies during the term of the CLAT, the trust becomes a non-grantor trust. Under those circumstances, three significant consequences must be considered:

- Income tax consequences resulting from the change in status;
- Recapture of the original income tax deduction; and
- The ongoing § 642(c) deduction from that point forward.

#### 1. *Income Tax Consequences*

The termination of grantor trust status during the lifetime of the grantor is treated as the transfer by the grantor of the trust assets to a non-grantor trust (separate taxpayer) in exchange for any consideration given to the grantor for the transfer.<sup>109</sup> Typically, the simple relinquishment of grantor trust powers does not involve any consideration. Thus, unless the trust holds property encumbered with debt in excess of the adjusted tax basis (which will cause the grantor to realize gain on the constructive transfer),<sup>110</sup> there should be no income tax consequence upon a change in tax status. Assuming no debt, the constructive transfer will result in a gratuitous transfer for income tax purposes, with the trust receiving assets with a carryover basis under § 1015.

The income tax treatment of the termination of grantor trust status as a result of the grantor's death is less clear because there is no court case, Treasury Regulation or ruling that directly addresses this issue. In all likelihood, a change in grantor trust status will not be considered a taxable event.<sup>111</sup> Notwithstanding the foregoing, the IRS may take the

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<sup>109</sup> See *Madorin v. Comm'r.*, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222.

<sup>110</sup> Treas. Reg. § 1.1001-2.

<sup>111</sup> See generally *Crane v. Comm'r.*, 331 U.S. 1 (1947) (holding that upon death of grantor, the beneficiary was still allowed to exclude deductions from consideration in computing a gain); Rev. Rul. 73-183, 1973-1 C.B. 364 (finding that the passing of property upon descendant's death does not constitute a realization of income, even if the value of such property has appreciated since acquired by decedent); Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor*

position that the termination should be treated as a constructive transfer (like a change in status during lifetime, as discussed above). As mentioned above, generally, this will not be an issue under most circumstances and, even if debt existed on the property, the basis adjustment rules of § 1014 would seemingly apply.

In the unusual circumstance where a non-grantor CLAT is converted to a grantor CLAT,<sup>112</sup> the conversion will not be considered a transfer for income tax purposes.<sup>113</sup>

## 2. *Recapture*

The Code provides, in pertinent part:

[i]f the donor ceases to be treated as the owner of such an interest for purposes of applying section 671, at the time the donor ceases to be so treated, the donor shall for purposes of this chapter be considered as having received an amount of income equal to the amount of any deduction he received under this section for the contribution reduced by the discounted value of all amounts of income earned by the trust and taxable to him before the time at which he ceases to be treated as the owner of the interest. Such amounts of income shall be discounted to the date of the contribution.<sup>114</sup>

Effectively, this Code provision provides at the time of relinquishment or death, an amount of income may be included on the grantor's income tax return to "recapture" the benefit of the original income tax deduction if the grantor has not effectively given back that benefit in terms of realized income over the time that the trust was a grantor trust. Interestingly, while the Code calculates the recapture amount in terms of "income earned by the trust and taxable to the" grantor, the Treasury Regulations calculate the recapture amount in terms of amounts paid to charity. The Treasury Regulations provide:

[i]f for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be

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*Trust Status by Reason of the Grantor's Death*, 96 J. TAX'N 149, 149-151 (2002); Elliot Manning & Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST. GIFTS & TR. J. 3, 21-26 (1999) (arguing that upon death, neither the grantor nor his estate recognize gain on death and therefore it is not a taxable transaction).

<sup>112</sup> This would occur if there is an appointment of related or subordinate trustee to replace an independent trustee. See I.R.C. § 674(c). There are other circumstances where this would occur but they would likely be considered self-dealing transactions under the private foundation rules.

<sup>113</sup> I.R.S. Chief Counsel Advice 200923024 (June 5, 2009).

<sup>114</sup> I.R.C. § 170(f)(2)(B).

treated as the owner of such interest for purposes of applying section 671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under section 170 for the contribution of such interest reduced by (ii) the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest.<sup>115</sup>

As such, there remains the possibility that as long as amounts that are “required to be, and actually were, paid” to charity in a grantor CLAT, no recapture of the income tax deduction will occur, even if little or no income becomes taxable to the grantor. In fact, § 170(f)(2)(B) provides that “[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subparagraph.”<sup>116</sup> As such, the Treasury Regulations may not be in conflict with the Code but rather are an alternative method of avoiding recapture of the income tax deduction.

In either case, whether the recapture amount is calculated against trust income taxable to the grantor or payments made to charity, the maximum amount includible in gross income is the original deduction amount even if the recapture event occurs many years after the original contribution. In other words, even if the entire recapture amount is recognized, the grantor had the time benefit of the income tax deduction (assuming the donor is able to use the deduction given the lower threshold limits applicable to charitable contribution deductions generated through CLATs).

### 3. *The Remaining § 642(c) Deduction*

The Treasury Regulations point out that upon termination of grantor trust status, after recapture has been calculated and recognized, the trust becomes a non-grantor trust, entitled to any then allowable § 642(c) deduction.<sup>117</sup> As such, recapture of the deduction under § 170(f)(2)(B) is not a loss of the deduction. Rather, the deduction is converted to a charitable deduction under § 642(c). In the case of a CLAT it may often produce a larger aggregate deduction than the origi-

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<sup>115</sup> Treas. Reg. § 1.170A-6(c)(4); *See* Treas. Reg. § 1.170A-6(c)(5), Ex. 3.

<sup>116</sup> I.R.C. § 170(f)(2)(B).

<sup>117</sup> Treas. Reg. § 1.170A-6(c)(5), Ex. 3(d), provides that after the grantor ceases to be the owner for grantor trust purposes, for the amounts paid to charity “see section 642(c)(1) and the regulations thereunder.”

nal deduction. To illustrate, in the extreme Shark-Fin example above, if the trust becomes a non-grantor trust in year 19, even if the entire \$10 million original deduction is recaptured (assuming no taxable income and nominal distributions to charity), the trust would still be entitled to over \$14.3 million in deduction in the last year of the trust when it is a non-grantor trust.<sup>118</sup> Interestingly, it is theoretically possible to get both deductions. If, as the Code provides, recapture is calculated by determining the discounted value of the income taxable to the grantor, then, from a planning standpoint, grantor trust status can be relinquished at the point that just enough taxable income is realized by the grantor so that there would be no recapture. From that point forward, the trust would be entitled to offset taxable income with the § 642(c) deduction, with all of the limitations noted above (particularly with the Shark-Fin CLAT) but, just as importantly, without any AGI threshold limitations. This can be particularly useful where the trust holds appreciated assets that otherwise would be used to pay charity in-kind and trigger capital gain tax liability to the grantor, as discussed above. Under these circumstances, grantor trust status can be relinquished and the capital gain realized can be offset fully by the § 642(c) deduction, which is equal in value to the payment to charity.

#### 4. *Income Tax Planning: Grantor to Non-Grantor Trust Status*

One of the significant benefits of contributing to a grantor CLAT is the resulting income tax deduction under § 170(a). This can provide significant tax savings to the grantor if the deduction can be used against ordinary income at the outset, in exchange for deferred grantor trust liability over the term of the CLAT, especially if the CLAT generates income at beneficial tax rates. For example, the grantor could use the deduction to shelter ordinary income tax in exchange for deferred grantor trust liability at long-term capital gain and qualified dividend rates (for example, the CLAT reinvests in U.S. equities) over the next 20 years. Recapture under § 170(f)(2)(B) does not distinguish between ordinary income and long term capital gain. It speaks in terms of “income earned by the trust and taxable to the” grantor.

Grantors can further maximize their income tax savings by monitoring the cumulative grantor trust tax liability over time. When enough income has been earned by the trust under § 170(f)(2)(B), the grantor can relinquish grantor trust status. As mentioned above, the trust then becomes a non-grantor CLAT entitled to offset trust taxable income with the § 642(c) deduction. Because this deduction is limited to the

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<sup>118</sup> But see *supra* Section II.A., regarding the possible inability of Shark-Fin CLATs to make effective use of this deduction.

charitable payment each year, the grantor should carefully consider what annuity pattern to choose for the CLAT. For example, if a grantor CLAT generates enough income by the 14th year of a 20 year CLAT and the trust becomes a non-grantor trust starting in year 15, a 150% back-loaded CLAT provides for a \$671,844 charitable payment/deduction (which will grow by 50% each year) but the Shark-Fin CLAT still provides for a \$1,000 charitable payment/deduction. It is likely under these circumstances that the 150% back-loaded CLAT will provide sufficient income tax savings vis-à-vis the Shark-Fin CLAT that both the charitable and non-charitable beneficiaries would prefer the 150% back-loaded CLAT over the Shark-Fin CLAT. That being said, losing grantor trust status is often not voluntary, as grantors sometimes die during the terms of CLATs.

## VII. PRIVATE FOUNDATION RULES

CLATs are split interest-trusts for which § 508(e) sets forth various governing instrument requirements. In pertinent part the Code provides:

In the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, section 507 (relating to termination of private foundation status), section 508(e) (relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) shall apply as if such trust were a private foundation.<sup>119</sup>

If, however, the present value (as determined under § 7520) of the charitable interest does not exceed 60% of the trust assets, the governing instrument of a charitable lead annuity trust is not required to prohibit acquisition and retention of § 4943 excess business holdings and § 4944 jeopardy investments.<sup>120</sup> Most CLATs are designed to generate

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<sup>119</sup> I.R.C. § 4947(a)(2).

<sup>120</sup> See I.R.C. § 4947(b)(3)(A); See also Treas. Reg. § 1.170A-6(c)(2)(i)(D); Treas. Reg. § 20.2055-2(e)(2)(vi)(e); Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(e); Rev. Rul. 88-82, 1988-2 C.B. 336.

a charitable deduction, at least for gift tax purposes, well in excess of 60%. If the private foundation rules are violated, income, estate or gift tax charitable deductions may be disallowed<sup>121</sup> and excise taxes may be imposed.<sup>122</sup>

Section 508(e) provides that the governing instrument of a private foundation must require the foundation to distribute income in such a way to avoid the excise tax imposed on undistributed income under § 4942. In addition, the governing instrument must prohibit the trust from: (i) engaging in self-dealing under § 4941(d); (ii) retaining excess business holdings under § 4943(c); (iii) making jeopardy investments under § 4944; and (iv) making taxable expenditures under § 4945(d).<sup>123</sup>

The most common private foundation rules issues arise with CLATs in conjunction with the sale, exchange or leasing of property between the CLAT and a disqualified person and the retention of excess business holdings. A “disqualified person,” in the context of CLATs, includes:

- A “substantial contributor,”<sup>124</sup> which includes the grantor and any persons “who contributed or bequeathed an aggregate amount of more than \$5,000 to a private foundation, if such amount is more than 2% of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person;”<sup>125</sup>
- A “foundation manager,”<sup>126</sup> which includes a trustee or any individual having similar powers or responsibilities;<sup>127</sup>
- A “family member”<sup>128</sup> of any of the foregoing, which includes an individual’s “spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren;”<sup>129</sup> and
- Trusts in which persons described above own more than 35% of the total beneficial interests.<sup>130</sup>

Fortunately, an exception to the self-dealing prohibitions allows reasonable and necessary compensation to be paid to a disqualified per-

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<sup>121</sup> I.R.C. § 508(d)(2).

<sup>122</sup> See I.R.C. §§ 4941-4945.

<sup>123</sup> It would be a rare circumstance that a termination tax would apply to a CLAT, so this provision of the private foundation rules is not further discussed in this article.

<sup>124</sup> I.R.C. § 4946(a)(1)(A).

<sup>125</sup> I.R.C. § 507(d)(2)(A).

<sup>126</sup> I.R.C. § 4946(a)(1)(B).

<sup>127</sup> I.R.C. § 4946(b)(1).

<sup>128</sup> I.R.C. § 4946(a)(1)(D).

<sup>129</sup> I.R.C. § 4946(d).

<sup>130</sup> I.R.C. § 4946(a)(1)(G). Beneficial interest is determined in accordance with the attribution rules under § 267(d). See I.R.C. § 4946(a)(4).



son, thereby permitting a trustee—including the grantor acting as such—to be compensated. In addition, the IRS has ruled that the payment of fees to an investment management company owned by the grantor's descendants is not an act of self-dealing.<sup>131</sup>

The Treasury Regulations do provide an exception for transactions with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death).<sup>132</sup> This exception has been relied upon to allow an estate's sale of real property to a disqualified person so that the CLATs could be funded with a promissory note instead of the real property.<sup>133</sup>

Section 4943 imposes an excise tax on the value of the "excessive business holdings" of a private foundation. A private foundation is deemed to have excess business holdings to the extent that it, together with all disqualified persons, own in the aggregate more than 20% of the voting stock of an incorporated business enterprise.<sup>134</sup> For unincorporated entities like partnerships and limited liability companies, the percentage ownership requirement is replaced with profits, capital and beneficial interest concepts.<sup>135</sup>

A "business enterprise" includes the active conduct of a trade or business and any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under § 513.<sup>136</sup> A business that derives more than 95% of its gross income from "passive sources" will not constitute a "business enterprise" within the meaning of § 4943, and a foundation's investment in such an entity will not constitute a "business holding."<sup>137</sup> Gross income from passive sources includes dividends, interest, payments with respect to securities loans and annuities, royalties (whether measured by production or by gross or taxable income from the property in question) rents, and gain from the sale or exchange of property (other than inventory or stock in trade).<sup>138</sup> Generally, where a private foundation acquires excess business holdings, it has five years from the date of acquisition to dispose of them in order to avoid the imposition of the excise tax.

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<sup>131</sup> PLR 200018062 (May 5, 2000).

<sup>132</sup> Treas. Reg. § 53.4941(d)-1(b)(3).

<sup>133</sup> See PLR 200124029 (June 15, 2001), PLR 200024052 (June 16, 2000).

<sup>134</sup> I.R.C. § 4943(c)(2)(A).

<sup>135</sup> Treas. Reg. § 59.4943(c)(2).

<sup>136</sup> Treas. Reg. § 53.4943-10(a)(1).

<sup>137</sup> I.R.C. § 4943(d)(1), (3)(B).

<sup>138</sup> I.R.C. §§ 512(b)(1)-(3), (5), 4943(d)(3).

### VIII. NON-CHARITABLE BENEFICIARIES AND THE GST TAX EXEMPTION

#### A. GST Tax Exemption with CLATs

Most practitioners limit the identity of the non-charitable beneficiaries of a CLAT to persons who are considered “non-skip persons”<sup>139</sup> for generation-skipping transfer (hereinafter, “GST”) tax purposes. Commonly, CLATs are viewed as wealth transfer vehicles only for the benefit of the grantor’s children, rather than grandchildren or more remote descendants. Unlike other trusts that allow allocation of the GST exemption in an amount equal to the gift taxable portion of the original contribution, § 2642(e) provides that the denominator of the applicable fraction for a trust is not determined until after the termination of the charitable lead term. In calculating the applicable fraction (and thus determining the inclusion ratio for GST tax purposes), the numerator is equal to the “adjusted GST exemption,”<sup>140</sup> which is calculated by starting with the original GST exemption allocated to the trust but increased at a rate of return (over the term of the trust) equal to the § 7520 rate used to calculate the original charitable deductions. The denominator is the value of the trust property at the expiration of the charitable lead term. Thus, if assets out-perform the § 7520 rate, as one typically would expect when rates are low as they are today, then some portion of the remainder will be subject to GST tax if it passes to a skip person. Further, if assets under-perform the § 7520 rate, it effectively results in an over allocation (and loss) of GST exemption.

Although different strategies have been discussed and attempted to circumvent this limitation, the IRS continues to take the position that leveraging of the GST tax beyond the § 7520 rate is impossible. For example, in Private Letter Ruling 200107015, the trustees of a “zeroed-out” 25-year CLAT proposed to amend the trust (pursuant to a power granted to them in the trust document) to allow a portion of the remainder interest to immediately vest in the son of the grantor. It was proposed that the son of the grantor would then make a taxable gift of his vested remainder interest to his own children at a time when the interest was a small portion of the trust assets (approximately 2%, after taking into account the value of the remaining charitable annuity payments). The trustees requested a ruling that the distribution of the gifted remainder interest to the son’s children would not be subject to GST tax because the son is the transferor for such purpose. The IRS ruled that there would be two transferors of the CLAT for GST tax purposes.<sup>141</sup>

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<sup>139</sup> I.R.C. § 2613.

<sup>140</sup> I.R.C. § 2642(e)(2).

<sup>141</sup> I.R.C §§ 2642(e), 7520; *See e.g.*, PLR 200107015 (Feb. 16, 2001).

The son would be the transferor of that fraction of the CLAT assets that was subject to gift tax (2%), and the original grantor would continue to be the transferor of the balance of the CLAT assets.<sup>142</sup>

For charitable lead unitrusts (“CLUTs”),<sup>143</sup> on the other hand, the gift or estate tax charitable deduction is available to reduce the denominator of the applicable fraction for GST tax purposes, and the denominator is determined based on values at the time of the contribution. Thus, if GST exemption is applied in an amount equal to the original taxable gift,<sup>144</sup> then an inclusion ratio of zero will result, thereby allowing any remainder to pass to skip persons free of GST tax. Thus, many practitioners view CLUTs as a vehicle to use in order to pass wealth to grandchildren, and CLATs as a vehicle that is limited to children.

## B. CLATs vs. CLUTs for the Benefit of Grandchildren Today

Given how attractive CLATs are today because of the low § 7520 rate, the authors wondered how a CLAT would fare against a CLUT, even if the non-charitable beneficiaries were skip persons for GST tax purposes. Surprisingly, even if one assumes a 45% GST tax rate (currently the rate is 35% under the Tax Relief Act of 2010 but it is unclear what the GST tax rate will be in the future), the CLAT results in significantly more wealth transfer than a comparable CLUT. For purposes of the comparison, we assumed a 20 year grantor CLUT, with an 11.136% unitrust percentage payable to charity, funded with \$10 million. With a § 7520 rate of 2.4%,<sup>145</sup> this results in a taxable gift of \$1 million, and we assumed that the gift was fully covered by a portion of the grantor’s applicable gift tax exemption, and that the grantor applied \$1 million of GST exemption to the taxable gift. We compared that CLUT to an “apples-to-apples” comparison, constructed as: (i) a 20 year “zeroed-out” grantor CLAT (150% back-loaded annuities) funded with \$9 million, and (ii) GST exempt grantor trust funded with \$1 million (fully covered by the applicable gift tax exemption). The resulting inflation-adjusted remainder values at the end of the term, after the payment of a 45% GST transfer tax on the CLAT remainder, are displayed below:

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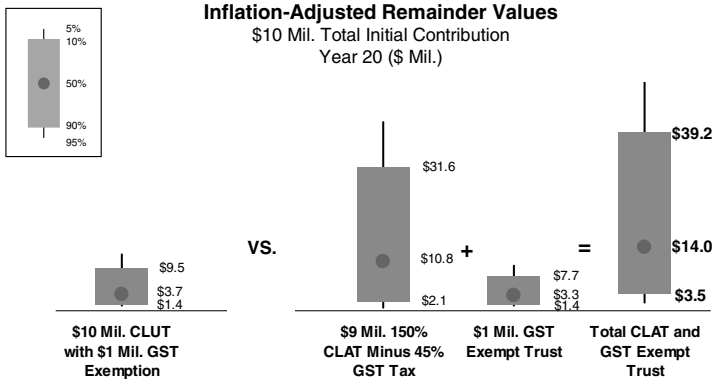
<sup>142</sup> See, e.g., PLR 200107015 (Feb. 16, 2001).

<sup>143</sup> See I.R.C. §§ 170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B) (collaboratively defining a CLUT as a “split-interest” trust that generally provides for an interest in favor of a charitable organization that is a “fixed percentage distributed yearly of the fair market value of the trust property” for income, gift and estate tax purposes). See also PLR 200043029 (Oct. 27, 2000).

<sup>144</sup> One cannot “zero-out” a contribution to a CLUT.

<sup>145</sup> With annual payments and the first payment made at the end of a 12 month period.

**CLAT May Still Be Better Today Even for Grandchildren**



Data do not represent past performance and are not a promise of actual future results.  
 For the 20-Year CLUT, assumes \$10 Mil. funded at the July 2011 Section 7520 rate with a 11.136% unitrust.  
 For the GST Exempt Trust, assumes \$1 Mil. Funded into a grantor trust.  
 For the CLAT, assumes \$9 million zeroed-out 20-year grantor CLAT funded at July 2011 Section 7520 rate.  
 All assets assumed to be invested in 100% global equity. Global equity has been modeled as 35% US value and 35% US growth, 25% developed international, and 5% emerging markets. Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. See Notes on Wealth Forecasting at the end of this presentation for further details.

As one can see, the median CLUT remainder of \$3.7 million is significantly lower than the CLAT remainder of \$10.8 million (even after GST tax). However, this is just the median outcome of the forecasted results. One of the benefits of a CLUT is that the non-charitable remainder beneficiaries are not disproportionately penalized by negative returns because the charitable payment is a percentage of the value of the assets each year. Thus, even if returns are very bad, the CLUT is guaranteed to pass assets at the end of the term to the remainder beneficiaries. With a CLAT, on the other hand, there may be no assets left. In fact, on this CLAT, there is a 3% chance that there will be no assets left at the end of 20 years. However, because the § 7520 rate is so low today, it's a very small probability, and when one takes into account the assets in the GST exempt trust (which had no required payments to charity), then the CLAT and GST exempt trust combination is a superior strategy to a CLUT today, even with the remainder passing to grandchildren or other skip persons.

**IX. INVESTMENT IMPLICATIONS**

Section 4944 imposes an excise tax on a private foundation for investing any amount in such a manner as to jeopardize the carrying out of its exempt purposes. The Treasury Regulations provide:

an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is de-

terminated that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return).<sup>146</sup>

In evaluating whether an investment is jeopardizing, the IRS has generally followed this “prudent trustee” standard, looking to where and how such investment fits in the overall portfolio.<sup>147</sup> The Treasury Regulations provide that no investment is per se considered a jeopardy investment, however “trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of ‘puts’ and ‘calls,’ and ‘straddles,’ the purchase of warrants and selling short” all require close scrutiny.<sup>148</sup>

Importantly, the Treasury Regulations provide,

[s]ection 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1)) in the amount of such consideration.<sup>149</sup>

In other words, it is permissible to contribute a speculative investment to a CLAT, but it would be a jeopardizing investment if the cash to purchase that same investment was first contributed and then the trustee of the CLAT made the investment.

CLATs do not have the same restrictions on investments as CRTs. Under the Treasury Regulations, “[a] trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from

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<sup>146</sup> Treas. Reg. § 53.4944-1(a)(2)(i).

<sup>147</sup> See, e.g., TAM 9205001 (Jan. 31, 1992); TAM 9627001 (July 5, 1996); see also PLR 9451067 (Dec. 23, 1994).

<sup>148</sup> Treas. Reg. § 53.4944-1(a)(2)(i).

<sup>149</sup> Treas. Reg. § 53.4944-1(a)(2)(ii).

the sale or disposition of trust assets.”<sup>150</sup> This restriction is not applicable to CLATs. That being said, the Treasury Regulations do provide that if the facts and circumstances suggest that charity will not receive some or all of the annuity payments, then any resulting tax deduction will be limited to the minimum amount charity will receive. The Treasury Regulations provide,

[i]f by reason of all the conditions and circumstances surrounding a transfer of an income interest in property in trust it appears that the charity may not receive the beneficial enjoyment of the interest, a deduction will be allowed . . . only for the minimum amount it is evident the charity will receive.<sup>151</sup>

The examples in the Treasury Regulations focus on circumstances where either by the terms of the trust document or by virtue of state law, the tax deduction should be limited to a lesser amount than would be calculated under § 7520.<sup>152</sup> The examples do not focus on situations involving the investments of the trust. Notwithstanding that fact, because this test is based upon “all the conditions and circumstances” it could conceivably be used to limit or disallow a charitable income or transfer tax deduction. For example, if the trust required the trustee to only invest in deferred annuities that had a return less than the § 7520, then it is quite possible the tax deduction would be reduced using the lower discount rate of return of the deferred annuities.

From an investment standpoint, the ability to back-load the annuity payments in a CLAT allows the trustee to invest in higher volatility (and, theoretically, higher returning) asset classes and strategies. Because failure with a CLAT is unforgiving, in a traditionally structured CLAT the trustee has to balance the competing interests of lower volatility portfolios with higher probabilities of success but lower return potential against higher volatility portfolios with lower probabilities of success but higher return potential. As the following diagram shows, as a CLAT’s asset allocation moves from 100% globally diversified equities toward a more diversified, less volatile portfolio, probabilities of success rise but often at the cost of potential wealth transfer.

The foregoing examples assume a 10 year, zeroed-out non-grantor CLAT with level annuity payments. The differences between probabilities of success and the projected wealth transfer can be muted by extending the term and making the CLAT a grantor trust. However, as

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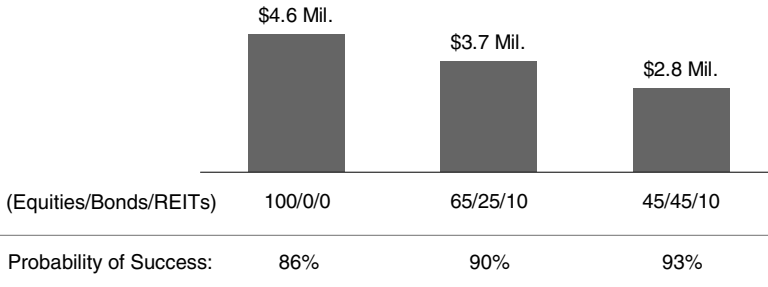
<sup>150</sup> Treas. Reg. § 1.664-1(a)(3); See PLR 7802037 (Oct. 14, 1977), where a charitable income tax deduction was denied because the trust document required the trustee to invest in tax exempt securities.

<sup>151</sup> Treas. Reg. §§ 1.170A-6(c)(3)(iii), 20.2055-2(f)(2)(iv), 25.2522(c)-3(d)(2)(iv).

<sup>152</sup> *Id.*

### Higher Probabilities of Success at the Cost of Potential Wealth Transfer

**Median Wealth Transferred\***  
\$10 Million, 10-Year Term Non-Grantor CLAT  
(Real, \$ Millions)

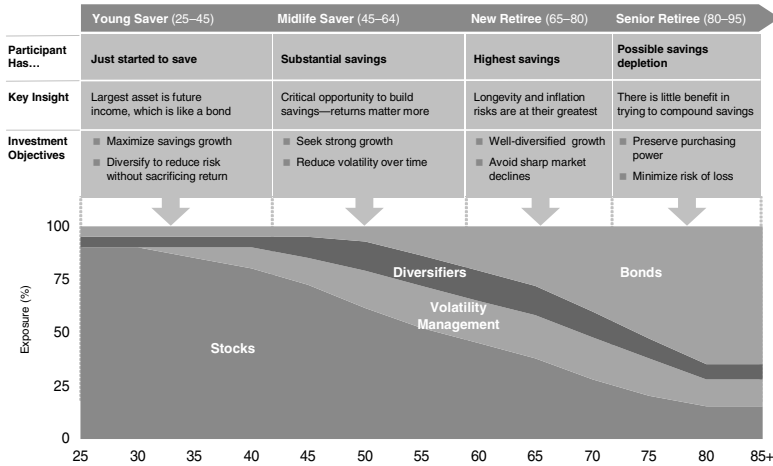


\*Median inflation-adjusted non-grantor CLAT remainder assuming \$10 million zeroed-out 10-year CLAT funded at the July 2011 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$1,000. Equities defined as 35% US Value, 35% US Growth, 25% Developed International and 5% emerging markets. Bonds are intermediate term taxable bonds.

pointed out above, higher probabilities of success and higher potential wealth transfer can best be achieved by back-loading the annuity payments in some manner. A trustee need not be as concerned with volatility during the initial years in a CLAT with a sufficiently long term if the bulk of the charitable payments are deferred to the end of the term.

One logical investment implication with back-loaded payments is a concept called “glide path” investing that is common in retirement and educational funding planning (for example, § 529 Plans). “Glide path” investing involves a gradual adjustment of an investor’s asset allocation as the investor gets closer to the point (retirement, matriculation, etc.) at which the portfolio will have significant outlays (living expenses, tuition, etc.). As the theory goes, the more time a portfolio has to be invested without any drawdown, the more volatile the portfolio can be. Thus, over time, as one gets closer to the point at which drawdowns begin, the portfolio should reflect a lower risk profile, as the following diagram on retirement glide path investing shows:

**Glide Path Design: Determined by Life Stage Circumstances and Objectives**



In addition to the foregoing, the flexibility to back-load the annuity payments in a CLAT provides a potential opportunity for planners to contribute certain types of assets and do certain types of planning that historically were not practical. This opportunity arises because very low annuity payments in early years reduce the concern that large mandatory payments each year may either require that the asset be sold to generate funds to make the annuity distribution, or be transferred in-kind to charity at a time when the asset either has no liquidity or very little value.

The planning in this arena is complicated by the application of the private foundation rules, discussed above. However, for careful planners who are willing to take on this additional set of considerations, the benefits to donors and charities can be substantial.

**X. PLANNING EXAMPLES**

**A. Interests of FLPs Holding Commercial Real Property**

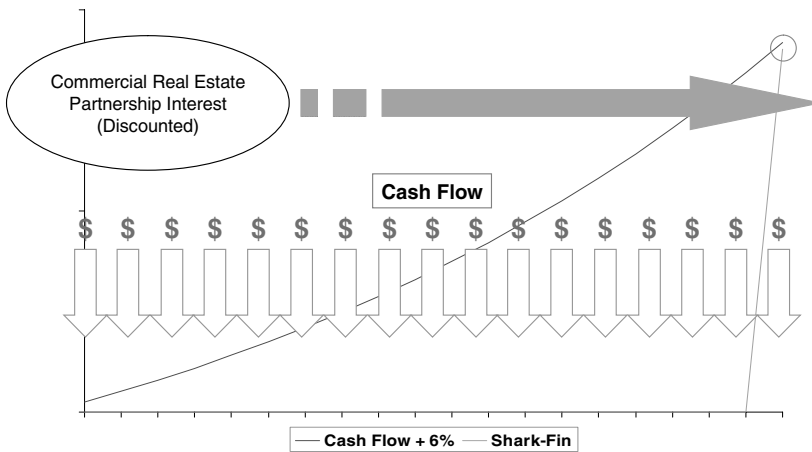
Interests in family limited partnerships and LLCs (collectively, “FLPs”) owning commercial real property have been thought poor candidates to contribute to CLATs because of the danger that cash flows from the property might fall, leaving insufficient cash to make the annuity payment. The choices at that point were dire: sell or mortgage the underlying property to generate the cash required for the distribution,



distribute FLP interests in-kind and have charity become a partner of the FLP, or have the trustee borrow from a third party in order to make all or a portion of the annual payment.

In a back-loaded CLAT, however, early cash flows from the real property may accumulate and be invested in the CLAT, providing a significant cushion for the larger payments to charity toward the end of the term, as illustrated in the diagram below. The term of the CLAT may be adjusted to ensure a high likelihood that there will be sufficient cash or liquid securities to satisfy the large charitable payments toward the end of the term.

### Interesting Application #1: Commercial Real Estate LP Interest



One feature common to commercial real property is the existence of debt. In general, a grantor can transfer mortgaged property to a CLT. If, however, the mortgage was acquired immediately prior to the transfer, UBTI problems may arise.<sup>153</sup>

Private letter ruling 7808067 is instructive. In the ruling, real property subject to a mortgage was transferred to a CLAT. The IRS ruled that there was no acquisition indebtedness for purposes of determining whether the trust had debt-financed income under the UBTI rules because the mortgage had been placed on the property more than 10 years

<sup>153</sup> See I.R.C. § 514(c)(2)(A).

prior to the transfer.<sup>154</sup> Interest on the mortgage, depreciation, amortization of leasehold, commissions, management expenses, and legal and accounting fees, as well as the annuity paid to the charity were all deductible by the trust and not deemed paid for a private purpose.<sup>155</sup> The ruling held that the excess business holdings provision was inapplicable because conducting the real estate business was found not to constitute a business enterprise on the grounds that over 95% of the gross income was derived from passive sources (i.e., rents).<sup>156</sup> The IRS also ruled that the jeopardy investment provisions were not violated by holding the real estate.<sup>157</sup>

As discussed previously,<sup>158</sup> the existence of UBTI in a grantor CLAT is of no consequence. If the grantor dies during the term of the CLAT, however, the trust will become a non-grantor trust and at that point UBTI will impose an impediment to the trust's investment performance because of limitations on the deductibility of the charitable distributions. To facilitate the disposal of the investment under these circumstances, planners should consider contributing the interests in the FLP subject to a purchase option at fair market value. The Treasury Regulations provide that, under the right terms, such a purchase from the CLAT by a disqualified person (for instance, the estate of the grantor) will not be considered an act of self-dealing.<sup>159</sup> Also, it is worth reiterating that if property is encumbered by debt which exceeds the

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<sup>154</sup> See I.R.C. § 514(c)(2)(B).

<sup>155</sup> PLR 7808067 (Nov. 28, 1977).

<sup>156</sup> *Id.*

<sup>157</sup> Treas. Reg. § 53.4944-1(a)(2)(i) provides “[n]o category of investment shall be treated as a per se violation of” the jeopardy investment rule. See also PLR 9451067 (Dec. 23, 1994) (ruling that a relatively small investment in distressed real estate would not constitute a jeopardizing investment).

<sup>158</sup> See *supra* Section II.A.

<sup>159</sup> Treas. Reg. § 53.4941(d)-1(b)(1) provides:

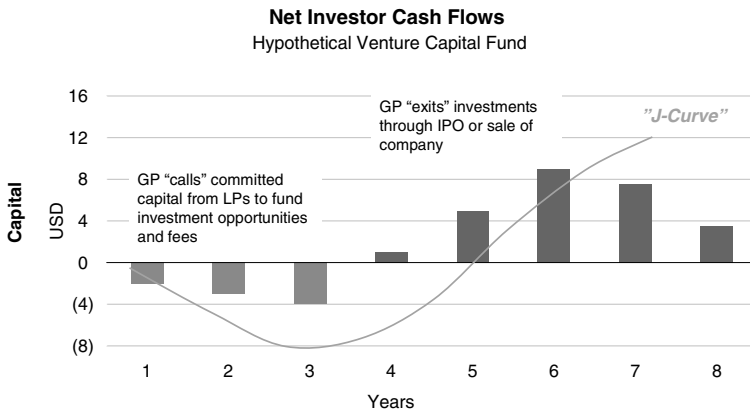
The term “indirect self-dealing” shall not include any transaction described in § 53.4941(d)-2 between a disqualified person and an organization controlled by a private foundation (within the meaning of paragraph (6)(5) of this section) if: [t]he transaction results from a business relationship which was established before such transaction constituted an act of self-dealing (without regard to this paragraph); [t]he transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and [e]ither: [t]he organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization, or [b]ecause of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship.

grantor's basis in the property, there will be recognition of gain when the trust's income tax status changes.<sup>160</sup>

## B. Private Equity Investments

Private equity investments, in particular venture capital investments, commonly have no liquidity or readily ascertainable value at the outset of the investment. Where the investment is made through a fund, these features are compounded because the fund likely will carry with it significant capital call obligations and restrictions on the ability to transfer, assign or liquidate the investments (generally the lock-up is 10 years). As such, private equity investments are said to follow the "J Curve" of investment return where the value of the investment falls in value before, one hopes, appreciating far above the original investment (through sale of the company, IPO or other liquidity event), as suggested in the diagram below.

### Interesting Application #2: Private Equity Investments



Private equity investments, which in years past were not strong candidates for a CLAT, may be candidates for contribution to a Shark-Fin or other back-loaded annuity CLAT so the charitable payments can be matched to when the private equity investment is expected to have liquidity and value.

<sup>160</sup> Treas. Reg. § 1.1001-2.

Theoretically, one could create 20 different Shark-Fin CLATs with 20 separate private equity investments (similar to asset-splitting zeroed-out “rolling” GRATs) with the understanding that many of the investments will fail, which is common to this particular type of investment.<sup>161</sup> Assuming the CLAT is not being used to satisfy enforceable charitable pledges of the grantor, the failure of the CLAT should not have adverse consequences to the grantor. By separating these investments, the spectacular returns of a few of them will not be watered down by the failure of most of them, thereby generating more wealth transfer than if they had been combined into one CLAT. Quite obviously, the transaction costs of this type of planning make it impractical in many settings.

Under any circumstance where private equity investments are the sole asset of the CLAT, one must be concerned with the jeopardy investment rules, as discussed in more detail earlier.<sup>162</sup> As mentioned, the gratuitous transfer of a speculative investment to a CLAT is not considered a jeopardizing investment.<sup>163</sup> While it is true that the Treasury Regulations provide that not only is the purchase of a speculative investment a jeopardy investment but the retention of the investment is also considered jeopardizing,<sup>164</sup> it is usually not possible for the CLAT to simply purge itself of private equity investments without further jeopardizing the charitable beneficiaries. Private equity investments typically have little or no liquidity and often have severe restrictions or penalties for liquidating or selling the investment prior to the end of the lock-up period, which often last up to 10 years. In any case, whether a single private equity investment or a diversified private equity fund is contributed, planners should provide for sufficient cash to be contributed to the CLAT along with the investment, so the CLAT can satisfy the capital call obligations on a timely basis.

### C. Preferred Investment FLP Interests

The contribution of preferred interests in an FLP holding investment securities is a prime candidate for contribution to a back-loaded CLAT. Anytime a preferred interest in an FLP is created or transferred, however, § 2701 must be considered. There are a myriad of ways that § 2701 can be implicated and a full discussion is beyond the scope of this article but assume that a FLP is funded with \$20 million in cash and marketable securities and receives, among other interests, a class

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<sup>161</sup> See Julie K. Kwon and Daniel J. Loewy, *GRATs: On a Roll*, 144 TR. & EST. No. 6 (June 2005).

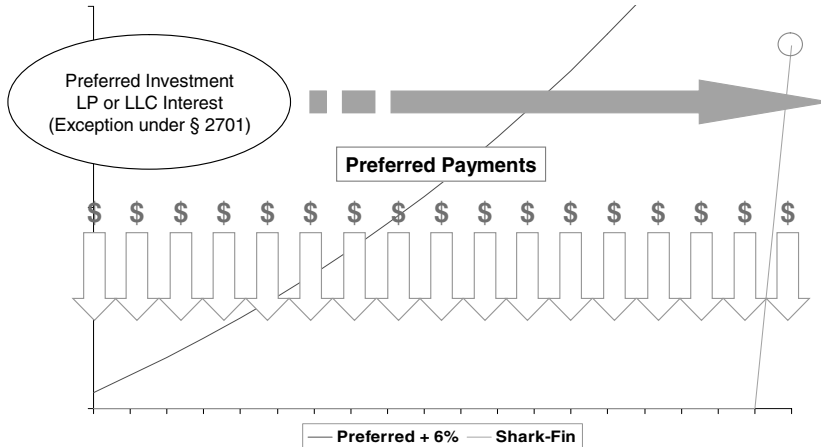
<sup>162</sup> See *supra* Parts VII. and IX.

<sup>163</sup> Treas. Reg. § 53.4944-1(a)(2)(ii)(a).

<sup>164</sup> Treas. Reg. §§ 20.2055-2(e)(2)(vi)(e), 25.2522(c)-3(c)(2)(vi)(e).

that has a liquidation preference of \$10 million,<sup>165</sup> and an appraiser determines that the fair annual yield on the interest is 8% per year (against the liquidation preference) until maturity.<sup>166</sup>

### Interesting Application #3: Preferred Investment FLP or LLC Interests



When the grantor gifts the entire 8% \$10 million preferred interest to a Shark-Fin or other back-loaded CLAT, the transfer will likely be entitled to a valuation discount which we will assume is 20%.<sup>167</sup> Now, the gift of the 8% \$10 million preferred interest, which was worth \$10 million before the discount, has a gift tax value of \$8 million. This increases the effective yield on the preferred interest from 8% to 10%.

The grantor has made an \$8 million gift that has an effective guaranteed return of 10%, which is being contributed to a CLAT that is being valued based upon an internal rate of return equal to the § 7520 rate of 2.4%.<sup>168</sup> These rates guarantee an arbitrage of 7.6% each year for the term of the CLAT. In addition, because the annuity payments are back-loaded, the preferred payment (which can be distributed in

<sup>165</sup> This interest should qualify for the so-called “vertical slice exception” to I.R.C. § 2701. See also Treas. Reg. § 25.2701-1(c)(4).

<sup>166</sup> This is according to the factors set out in Revenue Ruling 83-120, 1983-2 C.B. 170. See, e.g., Milford B. Hatcher & Edward M. Manigault, *Warming Up to the Freeze Partnership*, EST. & PERS. FIN. PLAN. (June 2000).

<sup>167</sup> The gifted interest should qualify for the so-called “junior equity interest exception” under I.R.C. § 2701(c)(2)(B)(i) and Treas. Reg. § 25.2701-2(b)(3)(i).

<sup>168</sup> The § 7520 rate for July 2011 is used throughout this discussion.

cash or in-kind) will continue to stay in the CLAT, further compounding for the remainder of the term, as illustrated in the diagram below.

Based on Bernstein's Wealth Forecasting Model, a grantor Shark-Fin CLAT providing for \$1,000 payment for 19 years and a \$12.8 million payment (based upon a discounted \$8 million contribution)<sup>169</sup> in the 20th year, the median value<sup>170</sup> of cash and securities (in nominal terms) that the remainder beneficiaries will receive at the end of the term (after charity is fully paid) is \$24.4 million, plus the remainder beneficiaries will receive a preferred interest in the FLP with \$10 million of liquidation preference and an 8% yield.

#### D. Single-Stock or Concentrated Stock Positions

Many wealthy individuals have highly appreciated but concentrated positions in one or a few companies. For those individuals, emotional ties to the company that created their wealth, the cost of diversifying (capital gain taxes) and the belief that a diversified portfolio will never out-perform their stock have prevented them from selling the position. Highly appreciated publicly-traded stocks are great candidates to contribute to charity because they result in an income tax deduction at fair market value, rather than adjusted tax basis.<sup>171</sup> However, the only economic benefit to the grantor (and the grantor's family) is the tax savings resulting from the charitable income tax deduction.

From an investment standpoint, concentrated or single stock positions have higher volatilities than diversified stock portfolios, and as a result, they exhibit what is commonly referred to as "risk drag." Stated another way, the more volatile the investment, the lower the compound annual return that investment is likely to have over time. However, notwithstanding "risk drag" and notwithstanding the risk of concentrating one's wealth in one company (consider, Bear Stearns, Lehman Brothers, Enron, WorldCom, TWA, etc.), for a certain cohort of individuals, diversifying is out of the question. Indeed, concentrated stock positions can create enormous wealth. The issue is how to effectively transfer the concentrated stock position to the next generation (and perhaps, also to charity).

A back-loaded or Shark-Fin CLAT, as illustrated in the diagram below, may be one solution for transferring a concentrated stock position to charity and to children. Concentrated stock positions will not suffer as badly in a back-loaded or Shark-Fin CLAT structure because

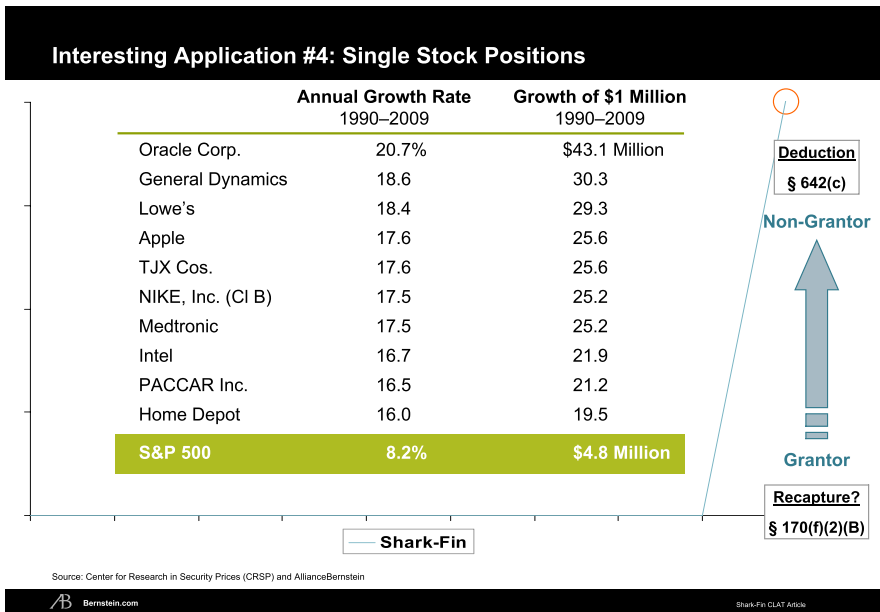
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<sup>169</sup> This is based upon the applicable annuity and remainder factors from Table S at a § 7520 rate of 2.4%.

<sup>170</sup> As with all of the figures in this article, a portfolio of globally diversified equities is assumed.

<sup>171</sup> I.R.C. § 170(e)(1)(A).

the fixed payments to charity will not lock-in the losses of the stock when it has negative volatility. Also, with a low § 7520 rate a grantor may be able to contribute a stock whose dividend alone already exceeds the § 7520 rate. By way of example, the S&P 500 is currently yielding 2.1%, and the companies in the S&P 500 Dividend Aristocrats Index (large-cap, blue-chip companies within the S&P 500 that have followed a policy of increasing dividends every year for at least 25 consecutive years) are yielding significantly more. As a result, all or significantly all of the § 7520 rate of return theoretically may be covered by the dividend yield alone.



An important question is whether a non-grantor CLAT or a grantor CLAT will create better results. A grantor CLAT has the obvious benefit of giving the grantor an individual income tax deduction upon contribution. That benefit is offset by the ongoing grantor trust liability. With a concentrated stock position that is not going to be sold, the income tax liability will come from the dividends paid over the term of the CLAT and any capital gains realized by the CLAT to make the charitable payments to charity. As mentioned above, the IRS’s current position is that in-kind payments in satisfaction of the charitable annuity will trigger capital gain. Thus, assuming the grantor contributed \$10 million of appreciated stock to a 20 year Shark-Fin CLAT, long-term capital gain would be triggered in the 20th year equal to the \$16 million minus the total dividends paid on the stock and any compounded earnings on

those dividends (assuming one only used enough appreciated stock as is necessary to satisfy the final charitable payment). The \$10 million upfront income tax deduction versus the deferred tax liability (most of which is recognized in the 20th year) at qualified dividend or long-term capital gain rates may be a reasonable trade-off especially considering the amount of wealth that could potentially be transferred to the remainder beneficiaries at the end of the CLAT term. While it is theoretically possible to swap cash for the low basis appreciated stock prior to the payment in-kind to charity under the grantor trust rules and to therefore avoid recognizing capital gain, given the dire penalties for self-dealing (sale or exchange between a private foundation and a disqualified person),<sup>172</sup> that is an impractical planning idea.

A non-grantor CLAT will not create an income tax deduction for the grantor, but because the § 642(c) charitable deduction is not limited by a percentage of contribution base (adjusted gross income), it provides a highly tax-efficient way of offsetting any resulting capital gain tax. With a concentrated stock position, annual payments to charity could be set to approximate the annual dividends with the anticipation that the larger, deferred payments to charity would be satisfied with appreciated shares of stock. The dividends and the resulting capital gain would be fully sheltered by the § 642(c) deduction.

One interesting planning option is to start as a grantor CLAT and then relinquish grantor trust status just prior to the last payment to charity. As mentioned above, the conversion from grantor to non-grantor trust status is not a taxable event unless there is debt in excess of basis. As such, the grantor could retain grantor trust status (as long as the grantor is alive, of course) until the bulk of the payments are payable to charity (in the 20th year, for example). Upon conversion to non-grantor trust status, there would be recapture of the income tax deduction under § 170(f)(2)(B) equal to the original deduction amount minus the discounted value of the dividends declared on the stock and the tax on the reinvestment of the dividends, but as discussed above, recapture is not as detrimental as it might appear at first glance. More importantly, once the CLAT is a non-grantor trust, any resulting gain from the payment in-kind to charity in the last year or years will be fully sheltered by the charitable deduction (\$16 million in the 20th year in the Shark-Fin example).

#### E. Life Insurance

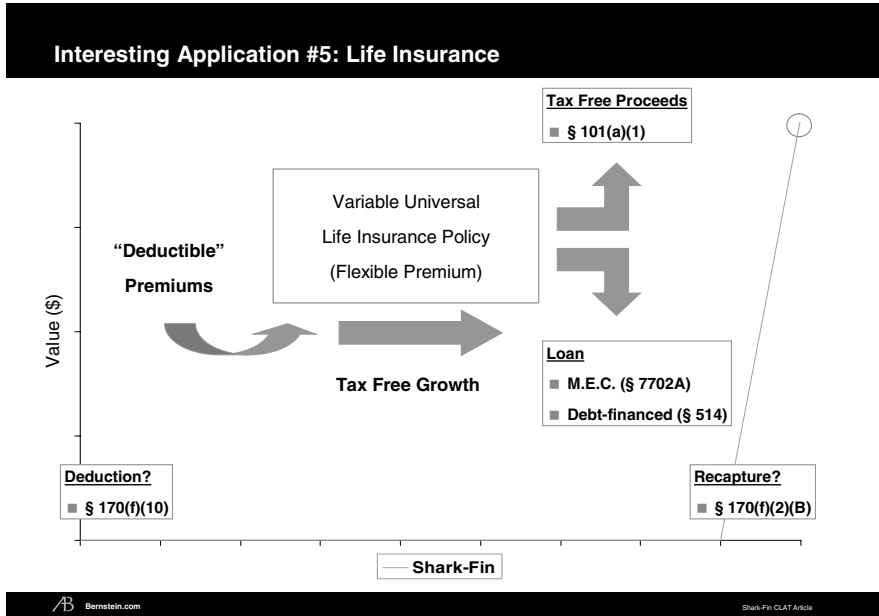
Because a grantor CLAT provides an income tax deduction to the grantor at the cost of having the grantor taxed on the CLAT's income,

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<sup>172</sup> I.R.C. § 4941(d)(1).



an investment inside the grantor CLAT that would not create any income tax liability may be desirable. Life insurance is such an investment, as illustrated in the diagram below. Proponents of the use of life insurance inside a grantor CLAT hope it will provide income tax deduction under § 170(a) to the grantor upon funding of the CLAT, but because all or a portion of the contributed assets will grow tax-free inside the policy there will be little or no income tax liability to the grantor over the term of the CLAT.



However, planners must be wary of a number of technical issues including the modified endowment contract rules under § 7702A, the charitable split-dollar rules under § 170(f)(10), the recapture rules, and the private foundation rules (as discussed in more detail above).

### 1. *Basics of the Plan*

In the most extreme, but simplified, version of the plan, the grantor makes a \$10 million cash contribution to a 20 year grantor Shark-Fin CLAT, which generates a \$10 million income tax deduction under § 170(a).

The trustee of the CLAT uses the cash to purchase a variable, universal or whole life insurance policy, paying premiums over 3-7 years (however long it takes to create a paid up policy without causing the policy to be a modified endowment contract under § 7702A). While the

cash is waiting to be paid into the policy in premiums, the trustee invests the assets in something that generates very little or no taxable income to the grantor like municipal bonds.<sup>173</sup> For purposes of this example, let's assume the premiums purchase \$60 million in death benefit.

The trustee then lets the assets grow inside the policy for the remainder of the 20 year term. Effectively the grantor has created \$10 million of personal income tax deduction, which is equal to the premiums paid, and no grantor trust liability. At the end of the 20 year period, only one of two things has occurred. The grantor, as the insured, is either alive or dead. In the less-likely event the grantor dies during the 20 year period, let's say in year 15, the following occurs:

1. \$60 million of death benefit is paid to the CLAT, tax free under § 101(a)(1), which is more than enough to pay charity the \$16 million it is owed in year 20 and leaving a sizeable amount of wealth transfer to the remainder beneficiaries at the end of the term.
2. There will be recapture of the original income tax deduction under § 170(f)(2)(B) in an amount equal to the deduction on the decedent's last income tax return. However, as noted above, the maximum amount included in income is the original deduction and the grantor has had the time value benefit of that deduction. Furthermore, the tax liability will be deductible for estate tax purposes under § 2053.

In most circumstances, from an economic standpoint, the family is better off if the grantor dies during the term.

In the more likely event that the grantor is still alive at the end of the 20 year term, the following is likely to occur:

1. So that charity can receive its \$16 million, the trustee takes \$16 million out of the life insurance policy, stripping \$10 million of basis out of the policy and then borrowing against the cash value for an additional \$6 million. Both of these are non-taxable from an income tax standpoint because the policy is not a modified endowment contract.<sup>174</sup> Trustee pays charity \$16 million.
2. It is highly likely that even after withdrawing \$16 million of funds from the policy, there will still be significant net cash

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<sup>173</sup> Contributing or exclusively investing in tax exempt bonds does not seem to be a problem with charitable lead trusts. *See, e.g.*, PLR 8427022 (Mar. 30, 1984); PLR 7803041 (Oct. 20, 1977). This is not necessarily the case with charitable remainder trusts. *See, e.g.*, Treas. Reg. §1.664-1(a)(3); PLR 7802037 (Oct. 14, 1977). *But see* PLR 8439091 (June 28, 1984).

<sup>174</sup> *See* I.R.C. § 7702(2)(A).

value in the policy. The assets have been growing tax free, and if those assets are invested in globally diversified equities (through the medium of a variable life insurance policy), the median amount after all payments to charity and after inflation will be \$43.5 million, less the costs of insurance and other policy costs (based upon the forecasted investment results for grantor CLATs described earlier in this article). Of course, one must take into account the reduction in value due to mortality charges, administrative charges, commissions on the policy and other expenses. For purposes of this illustration, let's assume that after all payments to charity, expenses and charges against the funds, this policy still has \$20 million nominally in net cash value (after debt).

This policy now passes to the remainder beneficiaries who can:

1. Cancel the policy and take the \$20 million of net cash value, but this will be a taxable event. However, the tax may be borne by the grantor if the remainder is held in a grantor trust;
2. Continue to maintain the \$60 million death benefit policy for the remainder of the grantor's lifetime, although this would likely require additional premiums to be paid into the policy; or
3. Reduce the death benefit to, say, \$40 million and have a fully paid-up policy on which no additional premiums will be paid.

It is likely that upon termination there is no recapture of the income tax deduction under § 170(f)(2)(B). First, there is the argument that recapture under these circumstances only occurs when the "donor ceases to be treated as the owner of such an interest for purposes of applying section 671."<sup>175</sup> If the term of the grantor CLAT expires and then the trust assets pass to another grantor trust, grantor trust status never ceases. More to the point, however, as mentioned above, the Treasury Regulations provide that as long as charity is paid, recapture has been satisfied.

In all, at least in theory, this plan has created \$10 million of deduction, no grantor trust liability, no recapture of the deduction and a life insurance policy that is out of the estate of the grantor and for which no taxable gifts and annual exclusions were needed.

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<sup>175</sup> I.R.C. § 170(f)(2)(B).

Different variations of this basic plan might include changing the term to a lifetime term to match up the termination of the CLAT to the economic event under the policy (death of the insured). Under this construction, the CLAT might purchase (or the insured grantor who is also the measuring life might purchase and then transfer to the CLAT) a single premium guaranteed universal life insurance policy. Any death benefit payable at death (presumably guaranteed) above the final charitable payment would pass to the remainder beneficiaries free of estate taxes. If, taking the lifetime term example from earlier in this article, a \$10 million single premium can purchase \$30 million of death benefit for a 62 year old insured, anything above \$14,061,618 that is payable to charity at death will pass to the remainder beneficiary (ignoring the \$1,000 payment each year).

It is important to note that the IRS is clearly aware of the use of life insurance in the grantor trust context, although perhaps not specifically with “intentionally defective” grantor CLATs. It bears remembering that pursuant to Revenue Procedure 2011-3,<sup>176</sup> the IRS has stated it will not rule on whether:

the grantor will be considered the owner of any portion of a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor’s spouse, (ii) the trustee or any other person has a power to apply the trust’s income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor’s spouse, (iii) the trustee or any other person has a power to use the trust’s assets to make loans to the grantor’s estate or to purchase assets from the grantor’s estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.<sup>177</sup>

The IRS has also ruled that under certain circumstances an investment in life insurance will be considered a jeopardy investment under the private foundation rules.<sup>178</sup>

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<sup>176</sup> Rev. Proc. 2011-3, 2011-1 I.R.B. 111.

<sup>177</sup> *Id.* at § 3.01(54).

<sup>178</sup> Rev. Rul. 80-133, 1980-1 C.B. 258. *But see* PLR 8134114 (May 28, 1981) where the IRS held that insurance policies are not jeopardy investments where there is no outstanding loan on the policy, the donor surrenders all incidents of ownership, and the donor pays the premiums. Presumably this would not be applicable to this technique because the grantor would not be paying any of the premiums, the CLAT would be paying them.

## 2. Charitable Split-Dollar Rules

One of the primary concerns associated with CLAT-owned life insurance is to what extent the “charitable split-dollar rules” of § 170(f)(10) are deemed to apply under these circumstances. The “charitable split-dollar” rules provide, “no deduction shall be allowed, for any transfer to or for the use of an organization described in subsection (c) if in connection with such transfer,”<sup>179</sup>

- “The organization directly or indirectly pays, or has previously paid, any premium on any personal benefit contract with respect to the transferor, or”<sup>180</sup>
- “There is an understanding or expectation that any person will directly or indirectly pay any premium on any personal benefit contract with respect to the transferor.”<sup>181</sup>

A “personal benefit contract” is

with respect to the transferor, any life insurance, annuity, or endowment contract if any direct or indirect beneficiary under such contract is the transferor, any member of the transferor’s family, or any other person (other than an organization described in subsection (c)) designated by the transferor.<sup>182</sup>

An individual’s family is deemed to include “the individual’s grandparents, the grandparents of such individual’s spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.”<sup>183</sup>

There is an exception for certain life insurance contracts held by charitable remainder trusts but not for CLTs.<sup>184</sup> A CLAT is not an organization described in § 170(c), so § 170(f)(10)(A)(i) is not applicable. Section 170(f)(10)(A)(ii), regarding the existence of an “understanding or expectation,” is more problematic.

The IRS could argue that in the example outlined above, there is an “understanding or expectation” that some “person” (the CLAT) “will directly or indirectly pay” premiums on a personal benefit contract. There are credible arguments to say that this provision does not apply to the example outlined above. For example, it can be argued that the life insurance here is not a “personal benefit contract” as defined above because the beneficiary is the CLAT and the person designating the bene-

<sup>179</sup> I.R.C. § 170(f)(10)(A).

<sup>180</sup> I.R.C. § 170(f)(10)(A)(i).

<sup>181</sup> I.R.C. § 170(f)(10)(A)(ii).

<sup>182</sup> I.R.C. § 170(f)(10)(B).

<sup>183</sup> I.R.C. § 170(f)(10)(H).

<sup>184</sup> I.R.C. §170(f)(10)(C), (E).

fiary of the contract is the CLAT trustee. Furthermore, it can be argued that, assuming the contract has an internal rate of return equal to the § 7520 rate (an assumption inherent within the calculation of the income tax deduction), no personal benefit is expected to pass to the grantor's family because the contract would only benefit charity (so long as the CLAT is zeroed out). Finally, it seems clear that the charitable split-dollar rules were not intended to apply to this situation. Indeed, the legislative history to § 170(f)(10) indicates that such section was designed to stop charitable split-dollar arrangements that provide little benefit to charity.<sup>185</sup>

What is unusual about this provision is that if a grantor had an existing policy that is paid-up (at least by the terms of the current in-force ledger and illustration), the grantor could contribute that existing policy, get an income tax deduction for the value of that contribution, and § 170(f)(10)(A)(ii) would apparently not apply, because there would be no "understanding or expectation" that the CLAT "will" (prospectively) pay any premiums. If an existing life insurance policy is transferred, however, the proceeds of the life insurance will continue to be includable in the estate of the transferor for 3 years following the transfer.<sup>186</sup>

Importantly, planners should keep in mind that if the charitable split-dollar rules do apply, not only will the original income tax deduction be disallowed, but the CLAT itself will be subject to an excise tax equal to the premiums paid.<sup>187</sup> The excise tax is imposed upon a § 170(c) organization, but the Code also provides, for purposes of the excise tax, "payments made by any other person pursuant to an understanding or expectation referred to in subparagraph (A) shall be treated as made by the organization."<sup>188</sup> In any case, before planners jump into the deep end on this type of plan, they should carefully consider the charitable split-dollar rules and whether they might or might not apply to their facts and circumstances.

## XI. CONCLUSION

The Internal Revenue Code assumes that any asset contributed to a CLAT will have a total return equal to the § 7520 rate. A zeroed-out CLAT is designed to distribute to charity what the government assumes the CLAT will earn and accumulate the excess—which the government assumes will be zero—for eventual distribution to the grantor's non-charitable beneficiaries, usually the grantor's children. Because the gov-

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<sup>185</sup> S. REP. NO. 106-120, at 206-07 (1999).

<sup>186</sup> I.R.C. § 2035(a)(2).

<sup>187</sup> I.R.C. § 170(f)(10)(F).

<sup>188</sup> I.R.C. § 170(f)(10)(F)(ii).

ernment assumes the excess accumulation is zero the grantor makes no gift to the children.

The central insight of the Shark-Fin or back-loaded CLAT is that the longer an asset remains in the CLAT the longer it may produce excess earnings for eventual distribution to the children (or other non-charitable beneficiaries). The Internal Revenue Code, Treasury Regulations, and IRS pronouncements have prohibited back-loaded annuities for charitable remainder annuity trusts, limited them for grantor retained annuity trusts, and allowed them for charitable lead annuity trusts; presumably this is because of policy differences that apply to the different types of trusts.

One of the most significant developments that has arisen from the Shark-Fin or back-loaded CLAT is that it opens the door to contributions of certain types of assets that traditionally have not been considered to be good candidates for CLATs. These types of assets are characterized by a lack of liquidity and often very low value at the time of contribution (for example, private equity investments or interests in FLPs holding commercial real property). Shark-Fin CLATs (or other back-loaded annuity CLATs) can ameliorate cash flow concerns so that the charitable payments are matched to when liquidity (and higher value) is expected to occur. Equally as important, from an investment standpoint, the deferred charitable payments allow trustees of CLATs to manage volatility in the portfolio more easily, which could result in higher overall returns over the term of the CLAT.

Concerns about back-loaded CLATs on policy grounds are misplaced. If the § 7520 rate accurately predicted the total return on investments, then a CLAT—regardless of the term—with a zero remainder would in fact produce zero for the non-charitable beneficiaries. To the extent that § 7520 underestimates the actual total return on the CLAT investments, a remainder is created for those beneficiaries. The government could have imposed a floor on the § 7520 rate or otherwise prohibited the use of extremely low rates such as those in effect now, and for the last several years. The government has chosen not to do so and, indeed, mandates use of the low rate. Why some “remainders” should be thought “permissible” and others “abusive” is unclear. Further, even a rate return of 2.4% may not be achieved in certain investment environments even over a long period of time.

Many grantors are troubled by a gift to charity that does not produce an income tax deduction as well as wealth transfer tax benefits. A non-grantor CLAT removes its earnings from the grantor's income tax return—in effect a 100% deduction for the grantor—and to the extent those earnings are paid to charity the trust will receive an income tax deduction. A non-grantor Shark-Fin CLAT will not allow a full income

tax deduction in the trust because the trust will likely not have sufficient income in the year in which the large charitable payment is made. In order to achieve a full income tax deduction a grantor CLAT may be used but at the risk of a mismatch between the income tax rates in effect when the trust is created and those in effect when the annuity payments to charity are made, whether by selling assets or by using appreciated assets directly.

Because the value of the grantor's gift is determined using the § 7520 rate in effect when the CLAT is created, doing so when the rate is low is more efficient than when it is high. Current rates, below 3%, are historically very low. Thus, creating CLATs now rather than waiting until the grantor dies is desirable.

From the point of view of a charity, a stream of payments from a CLAT, or a single payment in the future, has a present value that may be determined by reference to the expected earnings of the charity's endowment. Conceptually, to the charity, a dollar in a CLAT is worth only the dollar increased by the § 7520 rate until the date the charity receives the payment but a dollar in the charity's endowment is worth the actual earnings of the endowment. If those actual earnings are likely to exceed the § 7520 rate the charity may be amenable to selling its future payment or stream of payments for a lump sum. Such a transaction may be beneficial for the purchasers as well.



## APPENDIX

## NOTES ON THE WEALTH FORECASTING SYSTEM

The Bernstein Wealth Forecasting System uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation; it produces a probability distribution of outcomes, based on Bernstein's estimates of the range of returns for the applicable capital markets over the appropriate time period. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

### Capital Market Projections

	Median 30-Year Growth Rate	Mean Annual Return	Mean Annual Income	One- Year Volatility	30-Year Annual Equivalent Volatility
Short Term Taxables	4.8	5.1	5.3	1.0	10.0
Int.-Term Diversified Municipals	3.8	4.0	3.8	4.0	7.6
Int.-Term Taxables	4.8	5.1	5.9	4.6	9.2
U.S. Value	9.2	10.7	3.5	16.6	18.1
U.S. Growth	8.8	10.8	2.1	19.1	19.6
Developed International	9.6	11.6	3.5	18.8	19.0
Emerging Markets	7.8	11.7	3.2	27.9	27.6
Inflation	2.9	3.2	n/a	1.1	9.5

Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns. Based on 10,000 simulated trials each consisting of 50-year periods. Reflects Bernstein's estimates, and the capital market conditions as of March 31, 2011.