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## The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift

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A common plan among wealthy individuals is to leave the balance of his or her estate to charity, usually a private family foundation the individual established. While these transfers mitigate estate taxes, they may not eliminate all concerns or tax issues for the family, the family company, or the family foundation.

Rather than leaving the estate directly to the family foundation, this article explains, through a detailed example, the benefits of using an intermediary charitable lead annuity trust, which will pay the bequest to the family foundation over a number of years yet have the same federal estate tax benefit as a direct bequest.<sup>1</sup> Rather than flooding the foundation with a large bequest that may overwhelm its existing operation, distributing the large charitable bequest over a period of years allows the family foundation time to grow its operation to match its larger endowment.

*As illustrated through Monte Carlo simulations prepared by Bernstein, this approach also enables the family foundation's endowment to be larger at the end of the CLAT term than the endowment would be with a direct bequest.*

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\* Grateful acknowledgement goes to Matthew S. Pritzkur, Senior Investment Planning Analyst, and Brad M. Hawkins, Vice President, of Bernstein Global Wealth Management, Washington, DC, for their assistance and skill in preparing the modeling included in this article.

<sup>1</sup> This same approach could be used as an alternative to any large testamentary charitable bequest.

For the individual's family, this approach allows for the possibility of a reinfusion of wealth to counteract the succeeding generation's wealth depletion by estate taxes or its own large charitable bequests. The possibility of this reinfusion may soften the blow for the wealthy individual's children who are being skipped as direct beneficiaries of this charitable gift from the parent's estate, and do so at no estate tax costs. The transfer to a charitable lead annuity trust also will provide a framework in which the children could purchase private company interests or other illiquid assets from the parent's estate without running afoul of the self-dealing rules and perhaps provide a little more privacy.

#### FACTUAL SCENARIO

Peter's existing Will leaves his remaining assets (the "remaining family fortune") upon his death to his private family foundation (the "Foundation"). Peter believes that through lifetime gifts and associated planning he has sufficiently provided for his daughters and their families and now wishes to leave a more significant legacy to charity. This article reviews the alternative of Peter leaving his remaining family fortune indirectly to the Foundation by having it first pass to a charitable lead annuity trust ("CLAT"), a trust that would make annual payments to the Foundation with an aggregate present value equal to the remaining family fortune on Peter's death.<sup>2</sup>

Peter founded WXY Enterprises, Inc. ("WXY"). It is structured as an S corporation and it has a value of \$400 million. Peter currently owns 49% of WXY's stock. Peter's three daughters own the remaining 51% of the stock. Peter's stock is estimated to be worth \$130 million, after discounts for lack of marketability and lack of control. Peter also has a portfolio of publically traded securities, several houses, and an art collection, which assets have an aggregate estimated value of \$70 million. Each of Peter's three daughters has an estimated net worth of over \$100 million.

The Foundation currently has assets of approximately \$20 million. Peter is the sole contributor to the Foundation. Peter and his three daughters serve on the Foundation's Board of Directors. Currently, the Foundation makes grants to public charities of approximately \$1 million, in the aggregate, per year. The Foundation does not provide any direct charitable services. Upon Peter's death, his estate will be entitled to deduct the value of the assets passing from Peter's estate to the Foundation pursuant to the unlimited Federal charitable estate tax deduction.

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<sup>2</sup> For a review of the issues that arise under the private foundation rules (Sections 4941 through 4945) with respect to the intermediary CLAT plan, see PLRs 200024052 and 201323007.

This appeals to Peter because, even though he will leave behind a large estate, he does not want his estate burdened by estate taxes.

Peter's daughters are supportive of their father's desires, but are concerned with how this plan will unfold. Peter's oldest daughter, Natalie, is the current President of WXY, and she is concerned that Peter's transfer of his WXY stock to the Foundation will cause problems for WXY and perhaps for the Foundation. Peter's middle daughter, Nancy, is an art historian and curator of the local museum, and she has long been enamored with Peter's two prized modern master's paintings and is concerned about them passing to the Foundation. Natasha, Peter's youngest daughter, is the Foundation's Secretary and generally handles the Foundation's affairs on behalf of the family (e.g., oversees grant applications, meets with the Foundation's attorneys, accountants, and financial advisers, and coordinates meetings of the Board and the distribution of grants), and she worries that a large influx of funding to the Foundation will overwhelm its existing modest operation.

#### A. Natalie's Concerns

1. *Excess Business Holdings Rules* ("EBH Rules"). Natalie understands that Peter's WXY stock will constitute "excess business holdings"<sup>3</sup> that the Foundation must dispose of within five years.<sup>4</sup> While the normal period in which to dispose of excess business holdings is 90 days, the Foundation will have 5 years to dispose of the stock since it was not purchased but rather received as a gift from Peter's estate.<sup>5</sup>

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<sup>3</sup> "Excess business holdings" means the amount of stock or other interest in a business enterprise that the foundation would have to dispose of to a non-disqualified person in order for the foundation's remaining holdings in the enterprise to be "permitted holdings," as defined by I.R.C. § 4943(c)(2)-(3). The general rule is that a private foundation's permitted holdings in a corporation's voting stock are 20% of the voting stock, less the percentage of the voting stock owned by all disqualified persons. If all disqualified persons together do not own more than 20% of a corporation's voting stock, the nonvoting stock held by the foundation is treated as permitted holdings. In the case of a partnership or joint venture, "profits interest" is substituted for "voting stock," and "capital interest" is substituted for "nonvoting stock." In the case of a proprietorship, there are no permitted holdings, and in any other case, "beneficial interest" is substituted for "voting stock." Note that there is a special rule, which allows a foundation and disqualified persons to own up to 35%, if they do not have effective control over the company. There is also a de minimis safe harbor rule which allows a private foundation to own 2% or less of the outstanding shares, regardless of the percentage held by disqualified persons.

<sup>4</sup> Pursuant to Treas. Reg. § 53.4943-6(b)(1), the 5 year period begins upon receipt of the holdings from the estate.

<sup>5</sup> Treas. Reg. § 53.4943-6(a)(2). The Foundation should be able to properly dispose of the interest in the prescribed timeframe. If not, the IRS has discretion to extend the five-year divestiture period by an additional five years, if certain factors are present. I.R.C. § 4943(c)(7).

Natalie has been informed that a prohibited “self-dealing” issue arises if WXY’s shareholder agreement restricts the sale of Peter’s stock to family members, who are considered “related parties.”<sup>6</sup> To satisfy the excess business holdings requirement, the Foundation must dispose of the stock to one or more non-disqualified persons without imposing any material restrictions or conditions that would prevent such transferee(s) from freely or effectively using or disposing of the stock. While WXY’s shareholder agreement has been amended to allow for the Foundation to sell stock to a non-family member, Natalie is uncomfortable with this change and is hesitant to grant non-family members the ability to further transfer stock outside of the family. Natalie would prefer that WXY’s ownership remain in the family.

2. *Self-Dealing Rules.* Self-dealing includes any *direct or indirect* furnishing of goods, services, or facilities between a private foundation and a disqualified person.<sup>7</sup> Almost all transactions between a private foundation and a “disqualified person” are prohibited, irrespective of any positive benefit to the private foundation. For example, prohibited transactions include: (i) the purchasing or selling of assets between a disqualified person and the foundation, (ii) leasing property from a disqualified person, or any entity, such as a corporation or partnership, controlled by a disqualified person, unless such lease is without charge, and (iii) compensating a disqualified person, unless such compensation is for services rendered that are reasonable and necessary to the organization’s exempt purpose and the compensation is not excessive.

Peter is a disqualified person as to the Foundation because he is a substantial contributor to it – in fact, he is the only contributor. Peter’s daughters and WXY are also disqualified persons as to the Foundation. Disqualified persons include: (i) substantial contributors, (ii) foundation managers (trustees and officers), (iii) an owner of more than 20% of the total voting power of a corporation, profits interest in a partnership, or beneficial interest in a trust that is a substantial contributor, (iv) any spouse, ancestor, lineal descendant, or spouse of a lineal descendant of any person in (i) – (iii) above (a “family member”)<sup>8</sup>, and (v) any partnership, corporation, or trust in which a substantial contributor and/or his or her family members hold a greater than 35% interest.<sup>9</sup>

The self-dealing rules would generally prohibit the repurchase by family members of any interest in an entity, such as WXY, given to a private foundation. Likewise, most trusts created by a disqualified per-

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<sup>6</sup> I.R.C. § 4941(d)(1).

<sup>7</sup> I.R.C. § 4941(d)(1)(C).

<sup>8</sup> Note that a “family member” excludes such individual’s siblings.

<sup>9</sup> Treas. Reg. § 53.4946-1(a)(1).

son or for the benefit of a disqualified person would be prohibited from purchasing such interests.

Additionally, even if the repurchase were permitted, the private foundation could not finance the purchase. Generally, a loan between a disqualified person and a private foundation is considered self-dealing, regardless of whether the foundation is the lender or borrower. I.R.C. § 4941(d)(1)(B) provides that the lending of money or any other extension of credit between a private foundation and a disqualified person qualifies as self-dealing.

Natalie understands that there are two ways to navigate around the EBH and self-dealing rules and keep the ownership of Peter's equity interest within the family.<sup>10</sup>

(a) *Corporate Redemption Exception.* The general rule is that WXY cannot redeem its shares from the Foundation without violating the self-dealing rules. WXY is deemed a disqualified person with respect to the Foundation due to Peter's past contributions and his daughters' majority ownership of WXY's stock. However, provided that WXY offers to redeem all of WXY's outstanding stock, subject to the same terms and for no less than fair market value, no act of self-dealing will occur.<sup>11</sup> One drawback to using the corporate redemption exception to the self-dealing rules is that the redemption must be done for cash. Natalie is concerned that WXY will find it difficult to raise \$130 million in cash.

(b) *Estate Administration Exception to Self-Dealing Rules.* The estate administration exception to the self-dealing rules allows for transactions between a disqualified person and an estate in which a private foundation has expectancy (i.e., a case of indirect self-dealing), if the transaction is approved by the probate court having jurisdiction over the estate and the transaction is fair to the private

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<sup>10</sup> A great deal of caution is warranted as an excise tax is imposed on each act of self-dealing between a disqualified person and a private foundation. I.R.C. § 4941(a). The penalties for self-dealing are severe and include, but are not limited to, a 10% penalty tax on the "self-dealer" (10% of the amount involved) for each tax year and a 200% penalty tax on the self-dealer if the self-dealing activity is not corrected within the taxable period (e.g., reversing the deal so the funds are returned to the charity or the charity is placed in at least as good a position as if it had never engaged in the activity). I.R.C. § 4941(a)(1), (b)(1). A 5% penalty tax is imposed on any participating foundation manager (5% of the amount involved) for each tax year, unless such participation is not willful and is due to reasonable cause. I.R.C. § 4941(a)(2).

<sup>11</sup> Treas. Reg. § 53.4941(d)-3(d). The "cash-only" corporate redemption exception to self-dealing is not applicable if the IRS finds that the price is not adequate. A potential drawback is that I.R.C. § 512(e) deems any gain to be UBTI. In our example, the basis of Peter's stock would be subject to an adjustment pursuant to I.R.C. § 1014(a) and gain should be minimal if the redemption occurs quickly after Peter's death.

foundation.<sup>12</sup> This exception protects sales by the estate (not sales directly by the foundation).

Under the estate administration exception, Peter's three daughters (or WXY or a trust for the benefit of the daughters or their descendants) could purchase Peter's WXY stock from Peter's estate during its period of administration before the stock passes to the Foundation.<sup>13</sup> The purchase would be for the stock's fair market value and could be financed with a promissory note that would then pass to the Foundation as part of the residuary estate distribu-

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<sup>12</sup> Treas. Reg. § 53.4941(d)-1(b)(3) states the following:

"The term "indirect self-dealing" shall not include a transaction 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), regardless of when title to the property vests under local law, if —

(i) The administrator or executor of an estate or trustee of a revocable trust either —

- (a) Possesses a power of sale with respect to the property,
- (b) Has the power to reallocate the property to another beneficiary, or
- (c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation;

(iii) Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of 1.641(b)-3 of this chapter (or in the case of a revocable trust, before it is considered subject to section 4947);

(iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

(v) With respect to transactions occurring after April 16, 1973, the transaction either —

- (a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,
- (b) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or
- (c) Is required under the terms of any option which is binding on the estate (or trust)."

<sup>13</sup> If one of Peter's daughters purchases Peter's WXY stock from him during his lifetime for a promissory note, the self-dealing rules appear to prohibit the same promissory note from passing to the Foundation as part of the residuary estate distribution. Perhaps, under the estate administration exception to the self-dealing rules, the original note could be purchased from Peter's estate in exchange for a newly issued promissory note (with an interest rate and payment period that would allow the note to be valued at face value) that could pass as part of the residuary estate distribution to the Foundation.

tion.<sup>14</sup> Essentially, the estate and, subsequently, the Foundation would finance the purchase. The value of the promissory note must equal the fair market value of the stock<sup>15</sup>, and the probate court

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<sup>14</sup> Treas. Reg. § 53.4941(d)-2(c)(1) (“[E]xcept in the case of the receipt and holding of a note pursuant to a transaction described in § 53.4941(d)-1(b)(3) [the estate administration exception], an act of self-dealing occurs where a note, the obligor of which is a disqualified person, is transferred by a third party to a private foundation which becomes the creditor under the note.”). If the purchase is made pursuant to an option arrangement that is controlling on Peter’s estate, the liquidity of the property the purchaser exchanges does not have to be as liquid as the property sold by the estate. Therefore, in some cases specifically designing an option arrangement into Peter’s estate planning documents or into the shareholder’s agreement may be beneficial.

<sup>15</sup> In 2012, the IRS announced: “EO Technical will not issue letter rulings pertaining to the exception to § 4941 for transactions during the administration of an estate or trust set forth in Treas. Reg. § 53.4941(d)-1(b)(3) in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust.” Rev. Proc. 2012-4, § 6.18 (Jan. 3, 2012). This no ruling position has been carried forward each subsequent year. See Rev. Proc. 2014-4, § 6.18 (Jan. 2, 2014). The motivation for this position is unclear, but one thought is that the government views such a disqualified person as gaining an “abusive” advantage, in some cases, through the issuance of the promissory note. Some planners believe that a promissory note issued under the estate administration exception to the self-dealing rules could simply carry an interest rate at the applicable Federal rate (“AFR”), and that would make the fair market value of the promissory note equal its face amount. In support for this position, I.R.C. § 7872 cites the AFR as the floor for a market rate loan. Moreover, in several existing PLRs, the IRS has blessed purchase transactions under the estate administration exception where the purchase price was provided through a promissory note bearing interest at the AFR. PLR 201206019 (Nov. 15, 2011); PLR 201129049 (Apr. 26, 2011); PLR 200124029 (Mar. 22, 2001). Attention should be paid, however, to the fact that in each PLR the taxpayer made a blanket representation that the promissory note in question had a fair market value equal to that of the property purchased without providing any further explanation. Additionally, the IRS made specific reference to such representation in reaching its conclusion despite having already established the note’s rate of interest. Third-party loans, however, often carry much higher rates of interest. Given the near historically low AFRs, the government may view an AFR loan for purposes of the estate administration exception as being abusive. Pursuant to Treas. Reg. § 53.4941(d)-1(b)(3)(iv), the estate or trust must receive from the disqualified person property that “equals or exceeds the fair market value of the foundation’s interest or expectancy. . .” Therefore, consider whether the value of an AFR note is equal to its face value for purposes of the estate administration exception. Treas. Reg. § 53.4941(e)-1(f) provides that “fair market value” under the estate administration exception should be determined pursuant to Treas. Reg. § 53.4942(a)-2(c)(4). This provision in turn makes reference to the principles stated in I.R.C. § 2031. Clearly, on the seller’s side, the principles of § 2031 control how the property sold by the estate or trust would need to be valued. On the purchaser’s side, it would seem odd if the promissory note being exchanged by the purchaser could be valued pursuant to different rules, such as § 7872, which might allow an AFR note to have a value equal to its face value. I.R.C. § 2031 provides for an all-inclusive view of a promissory note’s value (i.e., the note’s value is not merely a factor of its principal amount and interest rate but also its terms of payment and enforceability, etc.). Treas. Reg. § 20.2031-4. The basic idea of the self-dealing rules is to prohibit a disqualified person from gaining an advantage at the founda-



having jurisdiction over Peter's estate must approve of the sale. To use this exception, the purchase must occur while Peter's estate is being administered – i.e., there is a time limit on this arrangement. Compared to the “cash only” corporate redemption, the estate administration exception is frequently more useful since the family does not have to raise all the cash at once.

#### B. Nancy's Concerns

With Nancy's museum background, she knows that charitable *income tax* deductions are limited if art is given to (i) a charity if the charity's does not use the art as part of its charitable mission or (ii) a charity that is a private non-operating foundation.<sup>16</sup> But that will not be a concern for Peter's gift of his art to the Foundation upon his death, as there is no such limitation on the *estate tax* charitable deduction.<sup>17</sup> Still the Foundation may have trouble justifying its continued ownership of such valuable paintings. Owning such a large portion of the Foundation's assets in two modern master's paintings may be considered an imprudent investment.<sup>18</sup> If this determination were made, the Foundation would need to sell the paintings for diversification purposes. One alternative would be that the Foundation could make grants of the paintings to a museum, but this would have the effect of depleting the Foundation's endowment.

Besides that, Nancy wants Peter's Modigliani and Manet for herself! Upon hearing Natalie describe the estate administration exception

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tion's expense. To construe the estate administration exception as allowing a disqualified person to garner a bargain rate of interest using the current low AFRs would seemingly violate the spirit of the self-dealing rules. For purposes of this paper, the assumption is that any promissory note issued under the estate administration exception must carry a market rate of interest, as well as other reasonable terms relating to enforceability, to enable the promissory note's value (i.e., by appraisal) to equal its face value.

<sup>16</sup> I.R.C. § 170(e)(1)(B).

<sup>17</sup> I.R.C. § 2055(a).

<sup>18</sup> The Board's management of the Foundation's assets will be subject to the Uniform Prudent Management of Institutional Funds Act, an act currently adopted (in some form) by 49 states and the District of Columbia (the “UPMIFA”). Under Section 3 of this act, “an institution shall diversify the investments of the institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification”. However, this duty to diversify may be modified by a donor's gift instrument, provided that the Foundation must retain its charitable mission. Thus, after reviewing the needs of the Foundation, the general economic conditions, the expected total return from the Foundation's investments, etc., the Board's duty to diversify may require the disposal of Peter's paintings. If Peter wishes to prevent this, he may include a restriction in his Will that such paintings are to be retained by the Foundation. This restriction will need to coincide with the Foundation's charitable purposes (e.g., the Foundation is to retain the paintings and grow the collection for later distribution to a museum).

to the self-dealing rules, Nancy felt much better knowing there was a way for her to buy the paintings from Peter's estate. She has requested that Peter simply provide her with that option. This arrangement suits Nancy, as she has already picked a spot for them to be displayed in her home. Nancy knows that if the paintings pass to the Foundation she could not display them in her home as that would be a prohibited act of self-dealing – she couldn't even pay the fair rental value to the Foundation for the paintings as that too would be a prohibited act of self-dealing. Moreover, being in the art world, Nancy knows there is no market for the rental of fine art and therefore determining a fair rental value is not possible even if a rental arrangement were permitted.

### C. Natasha's Concerns

1. *5 Percent Distribution Requirement.* Natasha understands that a private non-operating foundation, such as the Foundation, must annually spend a minimum amount to accomplish its charitable purposes or it will be subject to an excise tax. The minimum amount to be distributed is computed as (i) 5 percent of the excess of the aggregate fair market value of the foundation's assets (other than those used or held for use directly in carrying out its exempt purpose), over (ii) any acquisition indebtedness with respect to those assets, plus (iii) any amounts previously taken as qualifying distributions that have been reacquired, reduced by (iv) taxes imposed on the foundation on net investment income and unrelated business income.<sup>19</sup> For any year in which the foundation makes qualifying distributions that exceed the minimum amount, the foundation can carry over the excess to the next five succeeding tax years.<sup>20</sup> If the foundation's distributions in a year do not meet the minimum amount, the foundation has until the end of the next succeeding tax year to make distributions to cover the shortfall.<sup>21</sup> The requirements may be met through direct expenditures or through grants to certain public charities or private operating foundations.<sup>22</sup>

Natasha recognizes that adding \$200 million from Peter's estate will instantly increase the Foundation's prominence, making it one of the largest in the community, but worries that the concomitant required changes, such as the increase in the distribution required under the minimum distribution rule, will create a difficult period of adjustment. The

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<sup>19</sup> I.R.C. § 4942.

<sup>20</sup> I.R.C. § 4942(i).

<sup>21</sup> I.R.C. § 4942(g)(2)(C).

<sup>22</sup> If a foundation does not make its required minimum distributions, a two-tiered excise tax is imposed. For the first year after the distribution shortfall, the tax is 30% of the undistributed income. If not corrected by the next year, or by ninety days after a notice, the second-tier tax is 100% of the undistributed amount. I.R.C. § 4942(a)-(b).

annual distribution requirement will jump from approximately \$1 million to \$11 million. While on the surface it sounds easy to give away money, Natasha has learned through experience that thoughtfully using the funds requires research and significant efforts, including marshaling the agreement of the other members of the Board – i.e., her family!

2. *Unrelated business taxable income (“UBTI”).* Natasha is also concerned about certain tax issues the Foundation’s accountant has explained related to unrelated business income. Unrelated business income is, in general, gross income from an unrelated trade or business regularly carried on, less a deduction for expenses that are directly connected to the carrying on of such trade or business.<sup>23</sup> A trade or business is, in general, considered unrelated if its conduct is not substantially related to the exercise or performance of the organization’s tax exempt purpose, “aside from the need of such organization for income or funds or the use it makes of the profits.”<sup>24</sup> Income from property acquired with debt (acquisition indebtedness) is included in a tax exempt organization’s calculation of UBTI.<sup>25</sup> For example, marketable securities purchased on margin are considered debt-financed property. Debt-financed property can also be indirectly owned through the ownership of an interest in a flow-through entity, meaning that some or all of the income from that entity is included in UBTI.<sup>26</sup>

Since WXY is an S corporation, I.R.C. § 512(e) deems the stock as an interest in an unrelated trade or business. All items and income, loss or deduction, and any gain on disposition of the stock are taken into account in computing UBTI.

A private foundation is taxed on its UBTI. Income tax is imposed at either the corporate rates or the rates generally applicable to trusts and estates, depending on how the foundation was formed.<sup>27</sup>

Of further concern is that an organization’s exempt status may be jeopardized if it engages in *too much* unrelated business activity or earns *too much* UBTI. There is no quantifiable answer as to how much is too much.<sup>28</sup> In general, an organization may keep its tax-exempt status, even though it operates a trade or business as a substantial part of its activities, provided that the business furthers the organization’s exempt purpose. The tax-exempt entity cannot be operated for the primary pur-

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<sup>23</sup> I.R.C. § 512(a)(1).

<sup>24</sup> I.R.C. § 513.

<sup>25</sup> I.R.C. § 512(b)(4).

<sup>26</sup> Rev. Rul. 74-197, 1974-1 C.B. 143.

<sup>27</sup> I.R.C. § 511.

<sup>28</sup> TAM 201005061 (Feb. 5, 2010); PLR 9550001 (Dec. 15, 1995); and PLR 9128003 (Dec. 10, 1990) are examples of where the Service did not revoke the tax-exempt status for organizations with UBTI.

pose of carrying on an unrelated trade or business. The facts and circumstances, including the size and extent of the trade or business and the size and extent of the charitable activities, are considered in determining whether a tax-exempt entity has too much UBTI.<sup>29</sup> Generally, the rule is that an organization that is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt from tax.

If a private foundation owns an interest in an operating business that is a flow-through entity, the income from the trade or business is considered UBTI, assuming the conduct of the operating business is not substantially related to the exercise or performance of the organization's tax exempt purpose. A special rule exists in I.R.C. § 512(e) for S corporations, which deems all flow-through income or gain on disposition as UBTI. Accordingly, the foundation is subject to tax at ordinary rates (corporate or trust) on the income. If the operating business is a C corporation, the foundation does not realize UBTI on dividends.<sup>30</sup> In addition to the filing of Form 990-PF, any foundation with UBTI of \$1,000 or more must file Form 990-T, Exempt Organization Business Income Tax Return, that computes a tax based on UBTI.

3. *S Corporation Election.* Finally, Natasha fears that the transfer of WXY stock to the Foundation would terminate WXY's S corporation election. However, WXY's accountants have assured her that, due to changes in the law, a 501(c)(3) charity may now be an S corporation shareholder.<sup>31</sup> Regardless, Natasha realizes that the Foundation is a poor candidate to serve as a WXY shareholder given the problems posed by the EBH Rules and the UBTI WXY will generate.

#### D. Intermediary Charitable Lead Annuity Trust

During her last meeting with the Foundation's attorney, Natasha learns of an intermediary device called a charitable lead annuity trust or CLAT that may solve many of the daughter's concerns and still achieve Peter's goals. The attorney explains that a CLAT is a trust that could receive the remaining family fortune and pay an annuity to the Foundation over a period of time, say 20 years (the "Intermediary CLAT"). The annuity payment is determined as a fixed percentage of the fair market value of the property transferred into the CLAT on Peter's death. The idea is that the CLAT's annuity payments are designed to have an aggregate present value (based on the I.R.C. § 7520 rate) equal to the fair market value of the remaining family fortune. Peter's estate

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<sup>29</sup> Treas. Reg. § 1.501(c)(3)-1.

<sup>30</sup> I.R.C. § 512(b)(1).

<sup>31</sup> I.R.C. § 1361(c)(6).

also receives a charitable estate tax deduction for the aggregate present value of the annuity payments.

For example, a 20-year term CLAT paying an annuity equal to 6.355% of the initial value of the CLAT assets would reach a zero remainder value (assuming a 2.4% 7520 rate)(see Chart 1). This means that a 100% charitable estate tax deduction will be applicable to the funding of the CLAT, just as in the case of a direct transfer of the remaining family fortune to the Foundation. Additionally, the Foundation, as recipient of the annuity payments from the CLAT, will receive 100% of the value of the contributed assets on a present value basis. In effect, on a present value basis, the Foundation is whole under this approach.<sup>32</sup>

CHART 1

CLAT remainder calculation		
	Year	Annual Payments:
1	2014	12,710,000
2	2015	12,710,000
3	2016	12,710,000
4	2017	12,710,000
5	2018	12,710,000
6	2019	12,710,000
7	2020	12,710,000
8	2021	12,710,000
9	2022	12,710,000
10	2023	12,710,000
11	2024	12,710,000
12	2025	12,710,000
13	2026	12,710,000
14	2027	12,710,000
15	2028	12,710,000
16	2029	12,710,000
17	2030	12,710,000
18	2031	12,710,000
19	2032	12,710,000
20	2033	12,710,000
		254,200,000
Present Value @		2.40%
		\$200,022,815.91
		Assumed 7520 Rate
Trust Funding		200,000,000.00
Annuity Percentage		6.35500%

<sup>32</sup> There is a great deal of flexibility in structuring the CLAT arrangement. The annuity payments could start out at lower amounts and grow over time or even balloon at the end of the term. Additionally, several CLATs could be established with differing terms. Another favorable benefit to the CLAT arrangement is that it offers valuation protection for hard to value assets. If the fair market value of the asset transferred is challenged and determined to be higher than originally appraised, the annuity payments will automatically adjust (since they can be based on a percentage of the initial fair market value of the CLAT's assets) based on the increased value.

1. *Reinfusion of Wealth to Family.* After the annuity payments end upon conclusion of the 20-year term, any remaining assets in the CLAT could pass to Peter's daughters. The remainder interest held by Peter's daughters has a zero value upon Peter's death and therefore causes no transfer tax (i.e., no gift, estate or GST tax).

2. *5 Percent Distribution Requirement.* Utilizing the CLAT structure allows the Foundation's endowment to grow at a slower rate, which will reduce the annual required 5% distributions (and eliminate some of Natasha's concerns). If the remaining family fortune is contributed to the Foundation in a lump sum, the value of this contribution must be considered when complying with the Foundation's minimum distribution requirement, thereby causing a spike in the amount distributed. Conversely, if the remaining family fortune is contributed to a CLAT, only the annual annuity payment will be added to the Foundation's endowment each year for purposes of the minimum distribution requirement.<sup>33</sup> Chart 2, below, illustrates (very simplistically) the 5 percent distribution requirements with use of the intermediary CLAT (Part 1) as compared to the direct transfer of the remaining family fortune to the Foundation (Part 2). The important point is that, under the CLAT plan, the 5 percent distributions grow steadily over the 20-year period. This allows the Foundation's operations time to adjust to meet the increased demand.

3. *Private Foundation Restrictions and Estate Administration Exception.* CLATs are considered to be private foundations for purposes of the restrictions placed on such organizations. Therefore, like the Foundation, a CLAT created and funded by Peter's estate could not engage in self-dealing, violate the excess business holdings rule, hold jeopardizing investments, own assets that produce UBTI, or make taxable expenditures.<sup>34</sup>

The estate administration exception to the self-dealing rules, however, would also apply to a CLAT's expectancy interest in Peter's estate. Peter's daughters could buy assets from Peter's estate before the assets pass to the CLAT.<sup>35</sup> For example, assume that at the time of Peter's

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<sup>33</sup> The Foundation's net worth does not include the capitalized value of the potential future annuity distributions from the CLAT to the Foundation. See *The Ann Jackson Family Found. v. Comm'r*, 15 F.3d 917 (9th Cir. 1994).

<sup>34</sup> Per I.R.C. § 4945(d), a "taxable expenditure" is any amount paid to carry on propaganda or influence legislation, to influence the outcome of a public election or carry on any voter registration, or, under certain circumstances, as a grant to an individual or taxable organization.

<sup>35</sup> The sale of the Peter's WXY stock to his daughters would not only satisfy the EBH Rules but would also permit the CLAT to claim a larger charitable deduction for charitable distributions made. While a CLAT may be an S corporation shareholder if it elects to be treated as an electing small business trust (an "ESBT"), the portion of the

CHART 2

Year	Part 1—Foundation with CLAT Plan					Part 2—Foundation Directly Receiving Estate				
	Beginning Year Value of Foundation	CLAT Payment	Net Investment Return @ 6%	Distribution based on 12/31 value of prior year	End of Year Value of Foundation	Beginning Year Value of Foundation	Distribution form Estate	Net Investment Return @ 6%	Distribution based on 12/31 value of prior year	End of Year Value of Foundation
12/31/2013					20,000,000					20,000,000
1 12/31/2014	20,000,000	12,710,000	1,200,000	(1,000,000)	32,910,000	20,000,000	1,200,000	(1,000,000)	220,200,000	220,200,000
2 12/31/2015	32,910,000	12,710,000	1,974,600	(1,645,500)	45,949,100	220,200,000	- 13,212,000	(11,010,000)	222,402,000	222,402,000
3 12/31/2016	45,949,100	12,710,000	2,756,946	(2,297,455)	59,118,591	222,402,000	- 13,344,120	(11,120,100)	224,626,020	224,626,020
4 12/31/2017	59,118,591	12,710,000	3,547,115	(2,955,930)	72,419,777	224,626,020	- 13,477,561	(11,231,301)	226,872,280	226,872,280
5 12/31/2018	72,419,777	12,710,000	4,345,187	(3,620,989)	85,853,975	226,872,280	- 13,612,337	(11,343,614)	229,141,003	229,141,003
6 12/31/2019	85,853,975	12,710,000	5,151,238	(4,292,699)	99,422,514	229,141,003	- 13,748,460	(11,457,050)	231,432,413	231,432,413
7 12/31/2020	99,422,514	12,710,000	5,965,351	(4,971,126)	113,126,740	231,432,413	- 13,885,945	(11,571,621)	233,746,737	233,746,737
8 12/31/2021	113,126,740	12,710,000	6,787,604	(5,656,337)	126,968,007	233,746,737	- 14,024,804	(11,687,337)	236,084,205	236,084,205
9 12/31/2022	126,968,007	12,710,000	7,618,080	(6,348,400)	140,947,687	236,084,205	- 14,165,052	(11,804,210)	238,445,047	238,445,047
10 12/31/2023	140,947,687	12,710,000	8,456,861	(7,047,384)	155,067,164	238,445,047	- 14,306,703	(11,922,252)	240,829,497	240,829,497
11 12/31/2024	155,067,164	12,710,000	9,304,030	(7,753,358)	169,327,836	240,829,497	- 14,449,770	(12,041,475)	243,237,792	243,237,792
12 12/31/2025	169,327,836	12,710,000	10,159,670	(8,466,392)	183,731,114	243,237,792	- 14,594,268	(12,161,890)	245,670,170	245,670,170
13 12/31/2026	183,731,114	12,710,000	11,023,867	(9,186,556)	198,278,425	245,670,170	- 14,740,210	(12,283,508)	248,126,872	248,126,872
14 12/31/2027	198,278,425	12,710,000	11,896,706	(9,913,921)	212,971,209	248,126,872	- 14,887,612	(12,406,344)	250,608,140	250,608,140
15 12/31/2028	212,971,209	12,710,000	12,778,273	(10,648,560)	227,810,921	250,608,140	- 15,036,488	(12,530,407)	253,114,222	253,114,222
16 12/31/2029	227,810,921	12,710,000	13,668,655	(11,390,546)	242,799,031	253,114,222	- 15,186,853	(12,655,711)	255,645,364	255,645,364
17 12/31/2030	242,799,031	12,710,000	14,567,942	(12,139,952)	257,937,021	255,645,364	- 15,338,722	(12,782,268)	258,201,818	258,201,818
18 12/31/2031	257,937,021	12,710,000	15,476,221	(12,896,851)	273,226,391	258,201,818	- 15,492,109	(12,910,091)	260,783,836	260,783,836
19 12/31/2032	273,226,391	12,710,000	16,393,583	(13,661,320)	288,668,655	260,783,836	- 15,647,030	(13,039,192)	263,391,674	263,391,674
20 12/31/2033	288,668,655	12,710,000	17,320,119	(14,433,433)	<b>304,265,342</b>	263,391,674	- 15,803,500	(13,169,584)	<b>266,025,591</b>	<b>266,025,591</b>
				(150,326,708)				(230,127,954)		

death, his estate is still worth \$200 million (\$130 million of WXY stock, and \$70 million of publicly traded securities, houses, and art). Assume further that each of Peter's three daughters buys one-third of his WXY stock from his estate in exchange for a \$43,333,333 million, 21-year promissory note, paying annual interest at a market rate of interest that is 6.5% (e.g., assume that an interest rate equal to the January 2014 long-term AFR of 3.49% plus three percent, rounded to 6.5%, is a market rate of interest). Finally, assume that Nancy purchases Peter's Modigliani and Manet for the aggregate appraised value of \$15.5 million in exchange for a 21-year promissory note, paying annual interest at a market rate of interest that is 6.5%.<sup>36</sup> Peter's fiduciaries sell the estate's remaining assets and distribute to the CLAT \$145,500,000 of promissory notes and \$54,500,000 of cash.<sup>37</sup>

The CLAT will be a separate taxable trust for Federal income tax purposes. A CLAT, however, is entitled to a charitable income tax deduction of 100% of its distributions to the Foundation (i.e., it is not subject to any percentage of AGI limitation). Therefore, if the CLAT's annuity payment is equal to or greater than its income, the CLAT pays no income taxes! This means that the CLAT can operate very efficiently for income tax purposes and with careful planning it may pay little or no income taxes.<sup>38</sup>

Each daughter would be required to pay annual interest of \$2,816,667 on her promissory note used to purchase her share of Peter's WXY stock. Generally, this interest payment should be deductible on the daughter's income tax return as an interest expense against the corresponding income. Nancy would also pay interest of \$1,007,500 on the promissory note used to purchase the paintings. This would typically be personal interest and, therefore, not deductible.

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CLAT that holds S corporation stock will be denied a charitable deduction for any charitable distribution made by the CLAT. If the CLAT holds a promissory note in place of the WXY stock, no such diminishment of the charitable deduction will occur. Treas. Reg. §§ 1.1361-1(m), 1.641(c)-1(g)(4), and 1.641(c)-1(l), Example 4.

<sup>36</sup> PLR 200024052 involved revocable trusts for a couple that would establish a charitable lead unitrust and CLAT ("CLTs") upon the surviving spouse's death. The terms of the revocable trusts required that any purchase note issued in a transaction qualified under the estate administration exception to carry interest at the percentage payment rate of the CLT receiving assets upon the surviving spouse's death.

<sup>37</sup> For simplicity purposes, the example ignores estate administration expenses of Peter's estate.

<sup>38</sup> Pursuant to Treas. Reg. § 1.642(c)-3(b)(2), the I.R.C. § 642(c) deduction is deemed to consist of the same proportion of each class of the items of the trust's (or estate's) income as the total of each class bears to the total of all classes. Any provision otherwise in a will or trust must have an economic effect independent of the income tax consequences to be respected for federal tax purposes.



The CLAT would distribute one-third of the remainder of the trust after the 20-year term ends to each daughter. Natalie and Natasha each could be assigned her promissory note, respectively, and one-third of the remaining portfolio assets (including, for this purpose, a one-third interest in Nancy's \$15.5 million promissory note).<sup>39</sup> Nancy could be assigned her stock-related promissory note and the remaining portfolio assets (including her share of the art-related promissory note). Each daughter would, at this point, be both lender and borrower under each stock-related promissory note and the underlying obligation for such note would merge and should disappear without any adverse income tax issues. The same would be true for the Nancy's one-third interest in the art-related promissory note. Nancy could utilize her portion of the distributed portfolio assets to satisfy any remaining obligations under the art-related promissory note. Alternatively, the art-related promissory note could be assigned just to Nancy with compensating adjustments in other portfolio assets to her two sisters.

4. *Moving the Remainder Down a Generation.* Perhaps a better plan is to provide each daughter with a vested remainder interest in the CLAT. The interest would be fully assignable. Each daughter would sell her remainder interest to a trust (an "Irrevocable Descendants Trust") for the primary benefit of her children (i.e., Peter's grandchildren) shortly after Peter's death when the value of the remainder is quite low (i.e., early in the term of the CLAT). For purposes of the generation-skipping transfer tax, the daughters would be the transferors of their remainder interests in the CLAT.<sup>40</sup> This has the effect of mov-

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<sup>39</sup> Use of the CLAT structure would eliminate any need to justify the retention of the promissory notes in the context of the Foundation's charitable purposes. Unlike the UPMIFA that governs the Foundation's investment strategy, the CLAT will most likely be subject to the Uniform Prudent Investor Act, an act adopted (in some form) by 41 states and the District of Columbia (the "UPIA"). The UPIA requires that a trustee "diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." However, all or any portion of the UPIA may be waived by the trust's terms. Thus, careful drafting of the CLAT would permit the Trustee to retain the promissory notes throughout the trust term, an outcome that may be more difficult to achieve if such notes were held by the Foundation.

<sup>40</sup> In PLR 200107015, the IRS determined that the grantor of a CLAT would be considered a transferor for generation-skipping transfer tax purposes of a portion of the remainder interest assigned by the remainder beneficiary. Some practitioners believe that the reasoning of the PLR is flawed. Consider whether the issue can be avoided by a child assigning the remainder to a trust when its value is low and then repurchasing the interest from the trust shortly before the CLAT term expires when its value is higher. As additional protection against incurring generation-skipping transfer tax, the trust could be a non-skip person. For example, Natalie could assign her interest to a trust for the benefit of both her husband and her children shortly after the CLAT is funded and repurchase the interest shortly before the CLAT expires. In this manner, nothing passes di-

ing the remainder value of the CLAT down a generation without the imposition of the GST tax.

Furthermore, the obligation of the daughters to repay the promissory notes would continue. When the 20-year term of the CLAT ends, the promissory notes would be assigned (along with the other CLAT assets) to the Irrevocable Descendants Trusts created by the daughters, respectively. This is helpful because the liability would in effect reduce the value of each daughter's estate for estate tax purposes. Each daughter could negotiate with her Irrevocable Descendants Trust to either satisfy the note by paying it off, or in some cases swapping other assets into the Irrevocable Descendants Trust in payment of the note, or perhaps extending the term of the note.

5. *Privacy and Tax Reporting.* The CLAT structure also would provide Peter's daughters with more privacy than an outright bequest to the Foundation. This may be a concern to the daughters if they wish to avoid public scrutiny of their purchases from Peter's estate. With the direct bequest of \$200 million to the family Foundation, the Foundation's endowment would be \$220 million, but \$145.5 million would be promissory notes from the daughters. The daughters may wish to keep the loans more private, if possible.

The Foundation is required to file a Form 990-PF Private Foundation Return with the Internal Revenue Service each year, on which it must report the identity of each contributor to the Foundation for that tax year.<sup>41</sup> This return is open to public inspection and may be requested from the IRS.<sup>42</sup> Additionally, the Foundation is required to make the return available for public inspection at the Foundation's principal office during regular business hours for three years after the return's required filing date and must provide a copy of such return to any individual who requests one.<sup>43</sup> The Foundation may forgo providing copies to inquiring parties if the return is made "widely available" (e.g., posted to the Foundation's website or to a database of returns from other tax-exempt organizations).<sup>44</sup> The Form 990-PF requires that loans receivable be disclosed, including the name of the borrower and the balance due. Therefore, the purchase of Peter's assets by his daughters with promissory notes will be subject to public disclosure.

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rectly from the CLAT to a generation-skipping trust. Moreover, if the IRS takes the position that the CLAT did fund the trust, because Natalie's husband is a discretionary beneficiary, there has not yet been a generation-skipping transfer.

<sup>41</sup> I.R.C. § 6033.

<sup>42</sup> Treas. Reg. § 301.6104(b)-1.

<sup>43</sup> Treas. Reg. § 301.6104(d)-1.

<sup>44</sup> Treas. Reg. § 301.6104(d)-2.

A CLAT, on the other hand, must file a Form 5227 Split-Interest Trust Information Return with the IRS each year.<sup>45</sup> Only certain portions of this form are open to public inspection so that the identity of contributors and non-charitable beneficiaries may remain anonymous.<sup>46</sup> Additionally, the public disclosure requirements for the Form 5227 are less strenuous. The trust is not required to provide reasonable access to the return or copies to requesting parties, thereby eliminating any reason to make such returns widely available. Thus, the only recourse of an individual seeking further information about the assets of a CLAT is to file a written request for the 5227 with the IRS. If someone does gain access to the 5227, however, it does require that loans receivable be disclosed, including the name of the borrower and the balance due. While the promissory notes will be subject to public disclosure even when using the CLAT alternative, there are hurdles for the curious and it seems less likely to attract attention. For example, most 990s are readily available at [www.guidestar.org](http://www.guidestar.org), whereas 5227s are not available at this site.

*6. Impact to Foundation's Endowment.* The use of the Intermediary CLAT generates a larger endowment for the Foundation at the end of the 20-year CLAT term than the endowment generated by a direct bequest. Chart 2 illustrates this result: when the CLAT is used, at the end of the 20th year, the Foundation's endowment is approximately \$304 million versus \$266 million with the direct bequest.

Chart 2, however, is admittedly an overly simplistic illustration. Does this conclusion hold up under more rigorous analysis and stress testing? Matthew S. Pritzkur, Senior Investment Planning Analyst, and Brad M. Hawkins, Vice President, of Bernstein Global Wealth Management, in Washington, DC, assisted by preparing a Monte Carlo analysis of this fact pattern that is summarized on Exhibit A (the "Bernstein Analysis"). The Bernstein Analysis illustrates that across the spectrum of investment performance, the Foundation's endowment should be more with the Intermediary CLAT than without it. These are fascinating results, especially given the other benefits of the CLAT plan as outlined above.

Page 3 of the Bernstein Analysis (on page 380) provides a numeric comparison of five scenarios. Scenario A is the baseline example of the Foundation receiving the \$200 million lump sum contribution. Scenarios B – E are CLAT alternatives, in each case funded with the \$200 million estate. Scenario B is a CLAT with level annuity payments of \$12,710,000 for 20 years to reach a zero gift amount (matching the annuity amounts in Chart 1). Scenario C is a spread of 3 CLATs, of 10, 15

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<sup>45</sup> Treas. Reg. § 1.6034-1.

<sup>46</sup> It should be noted, however, that a copy of the trust must be filed with the initial return and will be open to public inspection.

and 20 terms, each with 1/3rd of the \$200 million estate, designed to reach a zero gift amount. Scenario D is the same as Scenario C, except that the CLATs have increasing 20% annuity amounts, and therefore are more backloaded. Scenarios A – D assume the investments of the Foundation and CLATs are according to an asset allocation of 70% globally diversified equities and 30% intermediate-term taxable bonds. Scenario E tracks the article's example, with \$145.5 million of the estate's assets being purchased under the estate administration exception to the self-dealing rules and promissory notes of an equivalent amount passing to the CLAT paying annual interest of 6.5%, and the remaining portfolio invested as indicated above. Additional assumptions are detailed in the Bernstein Analysis. The results of the Bernstein Analysis are shown on page 380.

a. *50th Percentile – Typical Markets.* At the 50th percentile for investment performance, or typical markets, the Foundation's endowment at the end of 20 years (i.e., when the CLATs would have all ended) is approximately *10% larger* if the CLAT alternative is used.

b. *90th Percentile – Poor Markets.* At the 90th percentile for investment performance, or poor markets, the Foundation's endowment at the end of 20 years is approximately *38% larger* if the CLAT alternative is used. Therefore, in bad markets, the CLAT acts a buffer to insulate the Foundation's endowment from being harder hit.

c. *10th Percentile – Very Good Markets.* At the 10th percentile for investment performance, or very good markets, the Foundation's endowment at the end of 20 years is approximately *\$70 million smaller* if the CLAT alternative is used. However, and this is a big however, the remainder to the family is astronomically larger – e.g., in Scenario B the remainder to the family is \$496.9 million. The CLAT could be written to ensure the Foundation's endowment is larger in this permutation too. For example, the CLAT could be written to direct the distribution of the remainder as follows: the first \$200 million (i.e., the original funding amount) is distributed to Peter's daughters, and the balance is split 50% to the Foundation and 50% to Peter's daughters. With this split, the Foundation's endowment under Scenario B would be \$657 million or about \$80 million more than under Scenario A and the family would still be receiving \$348 million.

Peter might look at the Bernstein Analysis (page 380, fourth row) and see that the cumulative distributions made from the Foundation (i.e., under the 5% distribution requirement) during the 20-year period of the CLAT is less by using the CLAT plan. At the 50th percentile for

investment performance, under Scenario A with the direct bequest to the Foundation, it will pay \$228.1 million in 5% distributions over the 20-year period. Under Scenario B, the Foundation will distribute only \$131.8 million over the same 20-year period. Thus, the Intermediary CLAT reduces the Foundation's 5% required distributions by 42%. Peter may see this as a detriment of the Intermediary CLAT, but the countervailing attributes of the alternative plan might console him:

a. First, the CLAT plan allows the Foundation to grow its operations more slowly and perhaps that means the funds distributed under the 5% distribution requirement during these early years, while less in total dollars, could be used more thoughtfully.

b. Second, the CLAT plan enables the Foundation's endowment to be larger at the 20th year and from that point on the Foundation's 5% distributions will be larger than without using the CLAT plan. Therefore, in terms of total dollars spent some catch-up will start to occur.

c. Third, the CLAT plan allows for the possibility of some reinfusion of wealth to the family. One could argue that the Foundation is advantaged in the long-term if the family remains advantaged.

The Bernstein Analysis also illustrates the remainders to Peter's daughters (page 380, last 3 rows). These numbers illustrate the reinfusion of wealth back to the family in 20-years by using the Intermediary CLAT. This reinfusion is done without causing estate tax in Peter's estate and without reducing the Foundation's endowment – it will actually be larger. In the last row, when the CLAT investment performance is stress tested, at the 90th percentile – poor markets, the CLAT remainder may be meager, but remember, if Peter gave his estate directly to the Foundation, nothing would pass to his daughters (and, as noted above, in this situation the Foundation's endowment is on the average 38% better off from having used the CLAT plan). While there is no guarantee of a large remainder passing to the family, it is a zero cost option.

Importantly, note that under Scenario E, the scenario in which Peter's daughters buy \$145.5 million of assets from Peter's estate in exchange for the promissory notes, the illustrated remainder numbers do not include the promissory note values — i.e., the \$138.7 million in the 3rd row from the bottom are the assets of the CLAT in addition to the notes passing back to the Peter's daughters! When the fixed rate promissory notes are part of the CLAT plan as illustrated under Scenario E, they act to cushion the remainder during a period of poor performance and limit the remainder during a period of stellar performance.

## CONCLUSION

The use of the Intermediary CLAT will likely lead to a larger endowment built up in a more controlled and manageable pace. The use of the Intermediary CLAT also enables a reinfusion of wealth to occur into Peter's family at the end of the 20-year term. And what if the total rate of return on the CLAT's assets plummets to the point that the annuity payments exhaust the trust and leave nothing to Peter's family? In that event, all of the assets comprising Peter's remaining family fortune would be paid to the Foundation, which was Peter's initial plan. Thus, the Intermediary CLAT is a heads "win" for the Foundation and family or a tails "even" scenario – i.e., the same result as the original plan of leaving the remaining family fortune to the Foundation.<sup>47</sup> The Interme-

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<sup>47</sup> If Peter's residuary estate passes to the Foundation, the income tax returns for the estate should be able to claim a charitable income tax deduction for any gross income during the period of administration, but this benefit is not available for the CLAT alternative plan. I.R.C. § 642(c) provides that an estate is allowed a charitable income tax deduction, without limitation, for any amounts which pursuant to the terms of the governing instrument are paid or permanently set aside for organizations described in I.R.C. § 170(c), determined without regard to I.R.C. § 170(c)(2)(A). A testamentary CLAT would not qualify under I.R.C. § 170(c). In the CLAT alternative, the planning would involve distributing all net income to the CLAT in each taxable year of the estate to enable a distribution deduction under I.R.C. § 661(a).

In the case of the Foundation alternative, the charitable set aside income tax deduction would be available with a residuary charitable gift, whether or not the income is actually distributed. For example, the regulations under I.R.C. § 642(c) provide that a remainder to charity and mandatory allocation of capital gains to corpus (which is not subject to invasion) is a permanent setting aside of the capital gain for charity. Treas. Reg. § 1.642(c)-3(c), Ex. (1). Even income to be added to corpus is deductible on the grounds that ultimately all the income from the built-up corpus will be used for charitable purposes. This includes post-mortem income of the deceased which falls into his residuary estate left to charity. An estate may take a charitable deduction for UBTI. The limitation on charitable deductions for UBTI that applies to trusts does not apply to estates. I.R.C. § 681(a) provides, "In computing the deduction allowable under I.R.C. § 642(c) to a *trust*, no amount otherwise allowable under I.R.C. § 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." There are no estate limitations on charitable deductions in the I.R.C. § 681 Regulations. Caution is needed however, because an estate is not entitled to take a charitable deduction unless income has been paid or permanently set aside for the charity. In *Richardson Foundation v. United States*, 430 F.2d 710 (5th Cir. 1970), a decedent had left all the stock of a subchapter S corporation to a foundation. The decedent's estate took a deduction for *undistributed S corporation earnings* accrued during the estate administration period (i.e., phantom income from a pass through entity). The Service denied the deduction. The court agreed with the Service and held that although the undistributed income was considered in computing the gross income of the decedent's estate, the income was never a part of the estate because the estate never had dominion and control over the income and the income never actually went to the foundation. The income was not permanently set aside although the income would ultimately belong to the foundation. The Service has also won other phan-

diary CLAT should be considered for any large testamentary charitable gift.

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tom income cases. In *Estate of Joseph R. Esposito*, 40 T.C. 459 (2nd Cir.1963), the court held that an estate could not take a charitable deduction for dividend income when no cash or property was distributed. In *Freund's Estate v. Commissioner*, 303 F.2d 30 (1962), the court held that an estate was not entitled to a charitable deduction for partnership income when the underlying cash had already been withdrawn by the partner prior to the partner's death.



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## Essential Facts\*

This Wealth Forecasting Analysis has been prepared for Richard Franklin in order to analyze the difference between the amount of assets held in a private foundation over 20 years after being funded entirely in year one, and the amount of assets held in a private foundation after being funded on an annual basis through the use of a Testamentary Charitable Lead Annuity Trust.

We have assumed that the private foundation and the CLAT are funded in year one with assets in the amount of \$200 million received from the decedent's estate. In each scenario, we assumed that the foundation and CLAT assets are invested according to an asset allocation of 70% globally diversified equities and 30% intermediate-term taxable bonds.

The private foundation will distribute 5% annually based on the value of the portfolio as of the end of the preceding year. In addition, any excise taxes owed by the foundation on net investment income have been accounted for.

With regard to the CLAT, we have modeled trusts of various term lengths and assumed that each CLAT will be "zeroed out" based on the prevailing IRS Section 7520 rate. We have varied the rate in order to quantify the range of outcomes driven by a change in the amount the CLAT must distribute annually based on the prevailing 7520 rate. In this initial analysis, we have assumed the prevailing 7520 rate at the time each CLAT is funded is 2.4% for the month of October 2013.

In an alternate iteration of this analysis, we have modeled the same scenarios as outlined below assuming a 7520 rate of 5.8%, which is the average rate from May 1989 to present.

### Scenarios

A: In this scenario, we assumed the private foundation is funded with \$200 million at the onset of the analysis.

B: In this scenario, we assumed that a CLAT with a term of 20 years will be established at the onset of the analysis and funded with \$200 million. We assumed the CLAT will be "zeroed out" and will make level annual annuity payments to a private foundation, which will in-turn distribute 5% of the portfolio annually. Annual annuity payments from the CLAT to the private foundation are assumed to be \$12,710,000. Any assets remaining in the CLAT at the end of the term will be transferred to the decedent's children free of tax.

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## Essential Facts\*

C: In this scenario, we assumed that three CLATs of varying terms will be established at the onset of the analysis, one each with a term of 10, 15 and 20 years. Each CLAT will be funded with 1/3<sup>rd</sup> of \$200 million, will be "zeroed out", and will make level annual annuity payments to a private foundation, which will in-turn distribute 5% annually. Annual annuity payments are assumed to be \$4,236,667, \$5,345,333 and \$7,578,000 for the 20, 15 and 10 year CLATs, respectively. Any assets remaining at the end of the term of each CLAT will be distributed to the decedent's children free of tax.

D: In this scenario, we have made all of the same assumptions as in scenario C, but we assumed that the annual annuity distributions from the three CLATs to the private foundation will increase by 20% each year. The initial annual annuity payments to the private foundation are assumed to be \$513,333, \$1,198,000 and \$3,020,667 for the 20, 15 and 10 year CLATs, respectively.

E: In this scenario, we have made all of the same assumptions as modeled in scenario B, but we assumed that of the \$200 million worth of assets used to fund the 20-year CLAT, \$145.5 million will be composed of a promissory note with a term of 21 years. The note will earn interest at a rate of 6.5%, which is the Long-Term AFR of 3.5% for October 2013 plus 3%. This will serve as a proxy for a "market" rate of interest and annual interest payments to the CLAT are assumed to be \$9,457,500. The remaining \$54.5 million will be composed of a liquid portfolio invested according to an asset allocation of 70% globally diversified equities and 30% intermediate-term taxable bonds.

In Scenarios C and D, we assumed the children will reinvest any CLAT remainder in a taxable portfolio invested according to an allocation identical to those of the CLAT and foundation. We assumed the children will be subject to top marginal federal and Maryland state and local income tax rates.

Please see the appendix for further details concerning the annual annuity payout amounts for the version of the analysis where a 7520 rate of 5.8% has been used.

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## Range of Foundation Values After Taxes and Cash Flows – 20<sup>th</sup> Year (nominal)<sup>\*</sup>

7520 Rate Assumption – 2.4%

Foundation Assets (\$ Millions)	Scenario A Private Foundation Only	Scenario B CLAT With Level Payments	Scenario C Three CLATs With Level Payments	Scenario D Three CLATs with Increasing Payments	Scenario E*** CLAT With Level Payments Funded W/Note
50 <sup>th</sup> Percentile – Typical Markets	\$280.3	\$308.5	\$301.9	\$310.1	\$311.0
10 <sup>th</sup> Percentile – Very Good Markets	\$576.4	\$508.1	\$533.5	\$500.2	\$509.2
90 <sup>th</sup> Percentile – Poor Markets	\$139.3	\$195.0	\$174.9	\$198.4	\$201.2
Cumulative Distrib. From Foundation 50 <sup>th</sup> Percentile – Typical Markets	\$228.1	\$131.8	\$156.3	\$119.8	\$131.9
CLAT Remainders**					
50 <sup>th</sup> Percentile – Typical Markets	NA	\$191.2	\$145.7	\$179.3	\$138.7
10 <sup>th</sup> Percentile – Very Good Markets	NA	\$496.9	\$414.9	\$510.8	\$256.0
90 <sup>th</sup> Percentile – Poor Markets	NA	\$5.6	\$5.1	\$15.0	\$75.0

<sup>\*</sup>Based on Bernstein's estimates of the range of returns for the applicable capital markets over the forecast period. Data does not represent any past performance and is not a promise of actual future results. All portfolios are assumed to be invested according to an asset allocation of 70% Globally Diversified Equities and 30% Intermediate-Term Bonds. "Typical Markets", "Very Good Markets" and "Poor Markets" are defined as 50<sup>th</sup>, 10<sup>th</sup>, and 90<sup>th</sup> percentile outcomes, respectively, of 10,000 trials in our Wealth Forecasting System. See Assumptions and Notes on Wealth Forecasting System in Appendix for further details.

<sup>\*\*</sup>With regard to Scenarios C and D, any assets remaining at the end of the 15-year term CLATs is assumed to be transferred to a taxable portfolio for the benefit of the client's children. The children are assumed to be subject to top marginal federal and Maryland state local income tax rates and the portfolio will be invested according to the same asset allocation as referenced above.

<sup>\*\*\*</sup>With regard to Scenario E, CLAT remainder values do not include the principal value of the promissory note in year 20.



APPENDIX



## CAPITAL MARKETS PROJECTIONS

	Median 20-Year Growth Rate	Mean Annual Return	Mean Annual Income	1-Year Volatility	20-Year Annual Equivalent Volatility
Cash Equivalents	2.1	2.4	2.4	0.0	6.2
Int.-Term Diversified Municipals	2.9	3.1	3.0	3.3	4.8
Int.-Term Taxables	3.3	3.5	4.8	3.9	5.3
US Diversified	7.2	8.8	2.6	16.3	16.4
US Value	7.5	9.0	3.1	15.8	16.3
US Growth	6.9	8.8	2.1	18.2	17.7
US SMID	7.5	9.5	2.2	18.6	18.9
Developed International	7.9	9.9	3.2	18.0	17.3
Emerging Markets	6.3	10.0	3.6	25.8	25.8
Diversified Hedge Fund Portfolio	5.5	6.0	2.5	10.8	14.9
Inflation	2.7	3.0	n/a	0.9	7.5

Based on 10,000 simulated trials each consisting of 20-year periods.

Reflects Bernstein's estimates and the capital market conditions of September 30, 2013.

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.

For hedge fund asset classes, "Mean Annual Income" represents income and short-term capital gains.

PROJECTED CORRELATIONS

	Cash Equivalents	Int.-Term Diversified	Int.-Term Taxables	US Diversified	US Value	US Growth	US SMID	Developed International
Cash Equivalents	1.00	(0.02)	(0.03)	0.00	0.01	(0.01)	0.00	0.00
Int.-Term Diversified Municipals	(0.02)	1.00	0.47	0.01	0.01	0.01	0.00	0.00
Int.-Term Taxables	(0.03)	0.47	1.00	0.30	0.28	0.29	0.27	0.27
US Diversified	0.00	0.01	0.30	1.00	0.95	0.96	0.87	0.76
US Value	0.01	0.01	0.28	0.95	1.00	0.84	0.86	0.72
US Growth	(0.01)	0.01	0.29	0.96	0.84	1.00	0.81	0.73
US SMID	0.00	0.00	0.27	0.87	0.86	0.81	1.00	0.66
Developed International	0.00	0.00	0.27	0.76	0.72	0.73	0.66	1.00
Emerging Markets	0.01	0.03	0.28	0.56	0.54	0.53	0.55	0.57
Diversified Hedge Fund Portfolio	0.01	0.00	0.16	0.48	0.46	0.47	0.42	0.44
Inflation	(0.02)	(0.17)	(0.13)	(0.08)	(0.08)	(0.08)	(0.06)	(0.06)

Based on the first year of each of 10,000 simulated trials.

Reflects Bernstein's estimates and the capital market conditions of September 30, 2013.

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.

[Continued...]

## PROJECTED CORRELATIONS

	Emerging Markets	Diversified Hedge Fund	Inflation
Cash Equivalents	0.01	0.01	(0.02)
Int.-Term Diversified Municipals	0.03	0.00	(0.17)
Int.-Term Taxables	0.28	0.16	(0.13)
US Diversified	0.56	0.48	(0.08)
US Value	0.54	0.46	(0.08)
US Growth	0.53	0.47	(0.08)
US SMID	0.55	0.42	(0.06)
Developed International	0.57	0.44	(0.06)
Emerging Markets	1.00	0.31	(0.04)
Diversified Hedge Fund Portfolio	0.31	1.00	(0.03)
Inflation	(0.04)	(0.03)	1.00

Based on the first year of each of 10,000 simulated trials.

Reflects Bernstein's estimates and the capital market conditions of September 30, 2013.

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.

## Notes on Wealth Forecasting System

### Purpose and Description of Wealth Forecasting Analysis

Bernstein's Wealth Forecasting Analysis is designed to assist investors in making their long-term investment decisions as to their allocation of investments among categories of financial assets. Our planning tool consists of a four-step process: (1) Client-Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what the cash-flow stream is likely to be, whether his portfolio can beat inflation long-term, and how different asset allocations might impact his long-term security; (3) The Capital-Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, which takes into account the linkages within and among the capital markets, as well as their unpredictability, and finally (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated ranges of returns and asset values the client could expect to experience are represented within the range established by the 5th and 95th percentiles on "box-and-whiskers" graphs. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Expected market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results or the actual probability that these results will be realized. The information provided here is not intended for public use or distribution beyond our private meeting.

### Rebalancing

Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, stocks, REITs, and hedge funds over the period of the analysis. Where this is not sufficient, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio will be maintained reasonably close to the target allocation. In addition, in later years, there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his personal portfolio and entirely of stocks in his retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value.

### Expenses and Spending Plans (Withdrawals)

All results are generally shown after applicable taxes and after anticipated withdrawals and/or additions, unless otherwise noted. Liquidations may result in realized gains or losses which will have capital gains tax implications. See details on withdrawals in Cash-Flow Summary, if any.



## Notes on Wealth Forecasting System

### Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed on the Assumptions page. In general two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.0%. But with intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment that volatility of fixed-income assets is different for different time periods.

### Technical Assumptions

Bernstein's Wealth Forecasting Analysis is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs which summarize the current condition of the capital markets as of September 30, 2013. Therefore, the first 12-month period of simulated returns represents the period from September 30, 2013 through September 30, 2014, and not necessarily the calendar year of 2013. A description of these technical assumptions is available on request.

### Tax Implications

Before making any asset allocation decisions, an investor should review with his/her tax advisor the tax liabilities incurred by the different investment alternatives presented herein including any capital gains that would be incurred as a result of liquidating all or part of his/her portfolio, retirement-plan distributions, investments in municipal or taxable bonds, etc. Bernstein does not provide tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

### Private Foundations

The Private Foundation is modeled as a charitable trust or not-for-profit corporation, which can be either a private operating foundation or a private non-operating foundation. The foundation may receive an initial donation and periodic funding from either the personal portfolio modeled in the system or an external source. Annual distributions from the foundation may be structured in a number of different ways, so long as the foundation distributes the minimum amount required under federal regulations, including: 1) only the minimum amount; 2) an annuity or fixed dollar amount, which may be increased annually by inflation or by a fixed percentage; 3) a unitrust or annual payout of a percentage of foundation assets, based on a single year or averaged over multiple years; 4) a linear distribution of foundation assets, determined each year by dividing the foundation assets by the remaining number of years; or 5) the greater of the previous year's distribution or any of the above methods. These distribution policies can be varied in any given year. For non-operating foundations, the system calculates the excise tax or net investment income.

### Charitable Lead Trusts

The Charitable Lead Trust (CLT) is modeled as a portfolio which receives its initial funding from the grantor and transfers payments to one or more charitable recipients each year for a specified number of years. The annual payments may be a fixed dollar amount (Charitable Lead Annuity Trust or CLAT) or a percentage of the trust's assets (Charitable Lead Unitrust or CLUT). In the case of a CLAT, annuities may be fixed (the same amount each year), or increasing. The annual payment is made first from available cash and then from other trust assets in kind. The trust will pay income taxes on retained income and will receive a charitable income tax deduction for income paid to the charitable recipients). Realized capital gains may be treated in one of two ways, as directed: 1) taxed entirely to the trust, or 2) included in the payment to charity and, therefore, deducted from the trust's income, to the extent the payment exceeds traditional income. When the CLT term ends, the remainder, if any, may be transferred in kind to 1) a non-modeled recipient, 2) a taxable trust, or 3) a beneficiary's portfolio. The transferred assets will have carryover basis.