

**INNOVATIVE CLAT STRUCTURES:
PROVIDING ECONOMIC EFFICIENCIES
TO A WEALTH TRANSFER WORKHORSE**

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**INNOVATIVE CLAT STRUCTURES:
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TO A WEALTH TRANSFER WORKHORSE¹**

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I. BACK-LOADED ANNUITY AND “SHARK-FIN” CLATS

A. Introduction

1. With section 7520² rates (and applicable federal rates³ or “AFRs”) at near all-time lows, as illustrated in the display below (Very Low AFR and Section 7520 Rates That Are Rising),⁴ estate planners should reconsider the benefits of the charitable lead annuity trust (hereinafter, “CLAT”).⁵ Despite the fact that CLATs have been a tool in the estate planner’s kit for four decades, it is perhaps the least used planning technique. Most estate planners have concluded that a CLAT is only appropriate for those clients who have considerable charitable intent, so it is attractive to a relatively small subset of clients. More significantly, from a wealth transfer standpoint, CLATs are generally not as effective as Grantor Retained Annuity Trusts (“GRATs”) and installment sales to Intentionally Defective Grantor Trusts (“IDGTs”).

2. Although a CLAT is generally appropriate only for a client with some charitable intent, there are significant wealth transfer benefits as well. A 2007 revenue procedure has inspired a CLAT structured with back-loaded annuities.

¹ Portions of this outline were previously published in Lee, Berry & Hall, “Reeling, Rolling and Reining in ‘Shark-Fin’ CLATs,” 51 Tax Mgmt. Memo No. 25, 435 (12/06/2010).

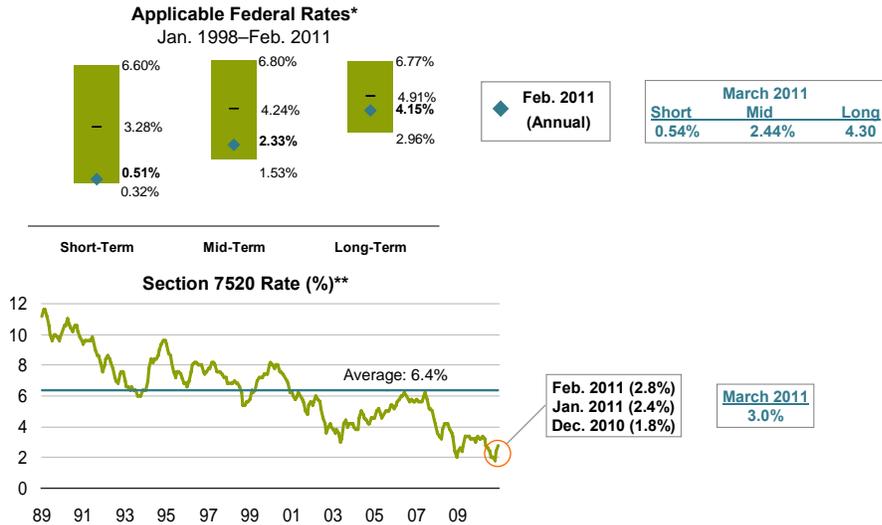
² For purposes of this outline, unless provided otherwise, all “section” references will refer to of the Internal Revenue Code of 1986, as amended (hereafter, the “Code”).

³ § 1274.

⁴ Rev. Rul. 2010-29, 2010-50 I.R.B. 818 (12/13/10). The section 7520 rate for December 2010 is 1.8%, and the short-, mid- and long-term AFRs are 0.32%, 1.53% and 3.53% respectively (compounded annually).

⁵ For purposes of this outline, a CLAT will refer to a “split-interest” trust that generally 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 §§ 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 §§ 1.170A-6(c)(2), 20.2055-2(e)(2), 25.2522(c)-3(c)(2) of the Treasury Regulations, with the remainder interest passing to or for the benefit of non-charitable beneficiaries (other than the grantor).

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 February 2011.
Source: Internal Revenue Service (IRS) and AllianceBernstein

Bernstein.com

Short-Term CLAT Article

3. With interest rates likely to continue to increase from this point forward,⁶ based on the projections of Bernstein’s Wealth Forecasting System as indicated in the display below (CLATs: The Time is Now), estate planners should seriously consider a CLAT for those clients who have a modicum of charitable intent and who would also like to transfer wealth to their children.⁷ The 1.8% section 7520 rate for December 2010 will be available through February 2011 (January’s 2.4% rate will be available through March 2011) because of the 3 month election for charitable trusts,⁸ so there is a limited window of time to take advantage of a historic wealth transfer opportunity.

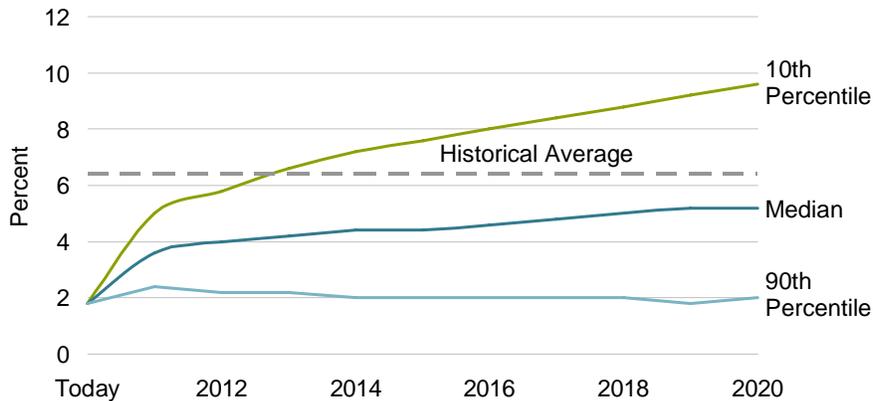
⁶ Bernstein’s Wealth Forecasting System forecasts that there is less than an 11% chance of the section 7520 rate remaining as low as 1.8% (December 2010) over then next 10 years. In fact, at the time of the writing of this article the section 7520 rate for February 2010 had already risen to 2.8% and the March 2010 rate had been announced at 3.0%.

⁷ We will not discuss in detail the issues relating to the identity of non-charitable beneficiaries. In particular, we do not discuss the limitations regarding the application of any generation-skipping transfer (GST) tax exemption under section 2642(e), which generally limits the ability to leverage the exemption by the section 7520 rate. 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 section 7520 rate is impossible. *See e.g.* Ltr. Rul. 200107015 (The trustees of a zeroed-out CLAT proposed to amend the trust to allow a portion of the remainder interest to vest in the child of the grantor. The child of the grantor would then gift his vested remainder interest to his own children at a time when the interest was 2% of the trust property. The IRS ruled that the child would not be considered the transferor for GST purposes).

⁸ If section 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 Code provides, “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).” § 7520(a). *See also* Treas. Reg. §§ 1.7520-2(b), 20.7520-2(b) and 25.7520-2(b).

CLATs: The Time Is Now

Projected 7520 Rate



*Only 10.2% of forecasted trials resulted in a 7520 rate of 1.8% 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

Short-Term CLAT Article

B. Traditionally Structured CLATs

1. In the traditionally structured CLAT, there are two primary reasons a CLAT may fail to transfer wealth. First, as with a GRAT, if the assets of a “zeroed-out” CLAT do not have a total return that exceeds the section 7520 rate, then no assets will remain in the CLAT at the end of the term. On the other hand, 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, however, 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 discharged in full depending on the degree of underperformance.

2. Second, even if the CLAT assets have a total return that exceeds the section 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 section 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. Unfortunately, returns in the publicly-traded capital markets are never straight-line. So, consider two different paths that a 9.3% growth rate could take:⁹

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

Year	Return Path 1	Return Path 2
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%
CAGR	9.3%	9.3%

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 equal annuity payouts beginning in year one—will quite often fail or perform poorly even when the compound annual returns exceed the section 7520 rate

3. 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 investments of the CLAT in preparation for the required CLAT payments.

4. May a CLAT be back-loaded or must the annuity payments be equal throughout the term of the CLAT? Estate and charitable planners looked to two other types of trusts--the charitable remainder annuity trust¹⁰ (hereinafter, “CRAT”) and the grantor retained annuity trust¹¹ (hereinafter, “GRAT”)--as precedents.

5. “Annuities” with CRATs

a. 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.

b. In case there were any doubt whether “a sum certain” means that the CRAT may vary the annuity paid each year, the Treasury Regulations provide clearly 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.”¹² Thus, there is no ambiguity with a CRAT: the annuity payment may not increase during the term.

6. “Annuities” with GRATs

¹⁰ § 664(d)(1).

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

¹² Treas. Reg. § 1.664-2(a)(1)(ii).

a. Because both GRATs and CLATs calculate the resulting taxable gift upon contribution according to section 7520, some estate planners believed that one could back-load CLAT annuity payments in a comparable manner as a “qualified interest”¹³ under section 2702.

b. In pertinent part, the Treasury Regulations provide:

(1) “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. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.”¹⁴

(2) “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.”¹⁵

c. If the GRAT rules applied to CLATs, then a CLAT could have back-loaded annuity payments but only to the extent that each payment increased by no more than 20% of the previous year’s payment. Even that minimal step results in more being paid to charity in aggregate over the term of the CLAT and more potential wealth transfer to the non-charitable beneficiary because it provides a cushion in case there are negative returns in the first few years. With a sufficiently low section 7520 rate, the fact that more is being paid to charity should be outweighed by the more forgiving annuity stream. Thus, the theory goes, even minimal back-loading should result in a higher probability of wealth transfer and a higher wealth transfer amount.

C. Revenue Procedure 2007-45

1. Happily for CLAT drafters, Treasury and the Internal Revenue Service are prepared to be more generous to CLATs than to CRATs or GRATs in defining what an annuity is. In 2007, the IRS issued sample trust forms for charitable lead trusts. Significantly, Revenue Procedure 2007-45¹⁶ (hereinafter, “Rev. Proc. 2007-45”), in the annotations section, provides, in pertinent part:

a. “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

¹³ § 2702(b)(1).

¹⁴ Treas. Reg. § 25.2702-3(b)(1).

¹⁵ Treas. Reg. § 25.2702-3(b)(1)(ii)(A) and (B).

¹⁶ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (7/16/2007), specifically for inter-vivos CLATs. Rev. Proc. 2007-46, 2007-29 I.R.B. 102 (7/16/2007) for testamentary CLATs.

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).¹⁷

b. “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 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.”¹⁸

2. The foregoing is applicable to non-grantor CLATs, but Rev. Proc. 2007-45 provides substantially identical provisions for grantor CLATs.¹⁹

3. The rules for a CLAT are quite clear and quite different from those for CRATs or GRATs. The amount being distributed to charity must be ascertainable but there is no maximum or minimum annual payment. As a result, any one of the following annuity streams would seem to be permissible to “zero-out” a \$10 Million CLAT, assuming a section 7520 rate of 1.8%:

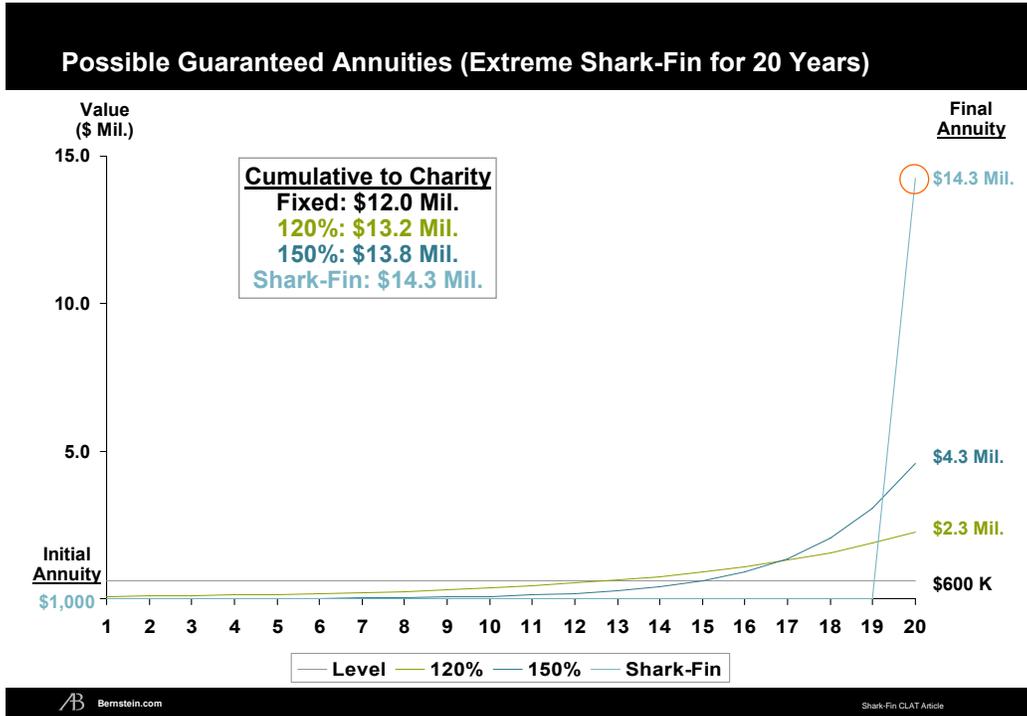
Year	Level	120%	150%	"Shark-Fin"
1	\$ 599,827	\$ 70,453	\$ 2,072	\$ 1,000
2	\$ 599,827	\$ 84,543	\$ 3,108	\$ 1,000
3	\$ 599,827	\$ 101,452	\$ 4,662	\$ 1,000
4	\$ 599,827	\$ 121,742	\$ 6,993	\$ 1,000
5	\$ 599,827	\$ 146,090	\$ 10,489	\$ 1,000
6	\$ 599,827	\$ 175,308	\$ 15,733	\$ 1,000
7	\$ 599,827	\$ 210,370	\$ 23,600	\$ 1,000
8	\$ 599,827	\$ 252,444	\$ 35,400	\$ 1,000
9	\$ 599,827	\$ 302,933	\$ 53,100	\$ 1,000
10	\$ 599,827	\$ 363,519	\$ 79,650	\$ 1,000
11	\$ 599,827	\$ 436,223	\$ 119,475	\$ 1,000
12	\$ 599,827	\$ 523,468	\$ 179,212	\$ 1,000
13	\$ 599,827	\$ 628,162	\$ 268,819	\$ 1,000
14	\$ 599,827	\$ 753,794	\$ 403,228	\$ 1,000
15	\$ 599,827	\$ 904,553	\$ 604,842	\$ 1,000
16	\$ 599,827	\$ 1,085,463	\$ 907,262	\$ 1,000
17	\$ 599,827	\$ 1,302,556	\$ 1,360,894	\$ 1,000
18	\$ 599,827	\$ 1,563,067	\$ 2,041,341	\$ 1,000
19	\$ 599,827	\$ 1,875,680	\$ 3,062,011	\$ 1,000
20	\$ 599,827	\$ 2,250,816	\$ 4,593,016	\$ 14,264,658
Total	\$ 11,996,545	\$ 13,152,636	\$ 13,774,905	\$ 14,283,658

¹⁷ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(1) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4).

¹⁸ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4).

¹⁹ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraphs .02(1) and .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 7).

4. The last annuity pattern has been nicknamed the “Shark-Fin” CLAT (for the shape the annuity pattern makes if arrayed horizontally), but it has also been called the “Balloon” CLAT (like a balloon payment at the end of the term of an installment note). As such, the reason for back-loading the annuity payments is just like reason for structuring an installment sale as interest-only with a balloon payment at the end of the term.



5. However, there are 2 critical differences between the “Shark-Fin” and an interest-only installment sale:

a. 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).

b. The internal rate of return or discount rate with the Shark-Fin CLAT is the section 7520 rate, which is currently significantly lower than the long-term AFR (1.8% vs. 3.53%).²⁰

6. As a result, the Shark-Fin CLAT should 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 over the same period of time, assuming that a donor’s objective is to also transfer assets to charity.

D. How Extreme of a Shark-Fin Is Allowable?

1. 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. In Private Letter Ruling 9112009, the IRS did approve a CLAT where “the ‘minimum’ annuity amount payable varies each year” but the “amount

²⁰ December 2010.

payable each year is specified in the instrument.”²¹ However, no other information about how the annuity varied is contained in the ruling.

2. At least one article has expressed concern about the Shark-Fin CLAT. In “Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance,”²² the authors take the position that a series of small payments (followed by a large payment at the end of the term) may be disregarded because they would be considered de minimis. The authors point to a number of rulings concerning charitable remainder trusts (“CRTs”) which 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).”²³ With respect to that requirement, the authors cite a number of private letter rulings that require the amount payable to non-charitable beneficiaries must be more than de minimis under the facts and circumstances.

3. This disregards the fact that Rev. Proc. 2007-45 explicitly provides that “CLATs are not subject to any minimum ... payout requirements.”²⁴ Furthermore, it ignores the policy reason for the foregoing de minimis requirement with respect to CRTs. CRTs are afforded tax-exempt status. The de minimis requirement is meant to ensure that 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 Section 7520 specifically takes into account time value concepts. In fact, as pointed out below, back-loading the annuity actually increases the probability that charity will receive the entire amount due to it.

4. In addition to the foregoing, the authors 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.”²⁵ The authors point to the preamble to the final Treasury Regulations for GRATs that state 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 Section 2702.²⁶ 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

²¹ Ltr. Rul. 9112009.

²² Fox & Teitelbaum, “Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance,” 37 Est. Plan. J. 3 (Oct. 2010).

²³ Treas. Regs. §§ 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i).

²⁴ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4).

²⁵ Fox & Teitelbaum, “Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance,” 37 Est. Plan. J. 3 (Oct. 2010).

²⁶ The authors quote the following: “The 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 payment 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, 2/4/1992.

GRAT.²⁷ The authors don't 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 1969,²⁸ whereas GRATs were enacted under the Revenue Reconciliation Act of 1990.²⁹ To say that the Treasury Regulations for GRATs have direct bearing on CLATs seems a stretch.

5. GRATs and CLATs are fundamentally different in one critical regard. As mentioned above, GRATs, at least currently, are a no lose proposition. Failing with a GRAT simply means all of the assets of the GRAT are returned to the grantor, and the grantor can redeploy those assets in another GRAT with little or no limitations. Failure with a CLAT means all of the assets have been passed to charity, charity does not receive the full amount due to it under the trust document, no assets are returned to the grantor, and no assets will pass to the remainder beneficiaries.

6. The policy issue that the authors seem to worry about is the potential amount of wealth transfer that could result from a severe back-loading of a CLAT's annuity payments. Keep in mind, however, the IRS has never limited the maximum amount that could be transferred in a GRAT or a CLAT. Furthermore, much of the potential wealth transfer that can be transferred today is a function of the current interest rate environment.

7. Finally, the authors contend that the Shark-Fin or Balloon 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. 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." That being said, if planners are concerned about not having annual increases, then theoretically one could increase the annuity by 100% (which have a starting annuity of \$20 and a final annuity of \$7.8 million in the 20th year to zero-out a \$10 million contribution) or an annuity that increased by \$1 each year with a final large payment. To say that the annuity must increase in some manner over the term seems overly picayune.

8. The technical issue at play is whether a "guaranteed annuity"³⁰ (applicable to CLATs) is different than a "qualified interest"³¹ in the form of a "qualified annuity interest"³² (applicable to GRATs). The Treasury Regulations for GRATs make clear that a "qualified annuity interest" may only be back-loaded by 120% of the previous year's payment.³³ The Treasury Regulations for CLATS only require that that the periodic payments are a "determinable amount."³⁴ These are two very different standards.

²⁷ See Walton v. Commissioner, 115 T.C. 589 (2000) and Tech. Adv. Mem. 200245053 (the National Office stated that the preamble to the final regulations under Section 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).

²⁸ P.L. 91-172 (1969).

²⁹ P.L. 101-508 (1990).

³⁰ §§ 170(f)(2), 2055(e)(2)(B) and 2522(c)(2)(B).

³¹ § 2702(b)(1).

³² Treas. Reg. § 25.2702-3(b)(1).

³³ Treas. Reg. § 25.2702-3(b)(1)(ii).

³⁴ Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

9. My belief is that 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. My speculation is that there are policy differences that the government has considered, among them that the CRAT 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. Regardless, I see no reason to question such a clear and definitive pronouncement.

II. FORECASTED RESULTS AND PLANNING IMPLICATIONS

A. Forecasted Investment Results for Non-Grantor CLATs

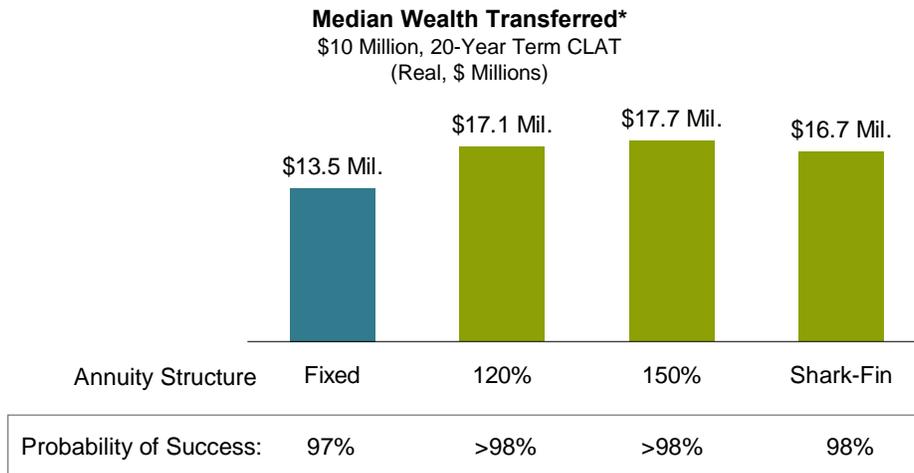
1. The latest generation of financial planning tools moves beyond historical averages and takes into account the paths of return and the often random and unpredictable nature of the markets. Generically it is called stochastic or probabilistic modeling. The colloquial term is "Monte Carlo" modeling. For this outline, we used a proprietary analytical tool that marries the benefits of stochastic modeling with our structural model of the capital markets (the "Wealth Forecasting Model").³⁵ In each instance we 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 Section 7520 Rates). In each case, we assumed 100% globally diversified equities and, for purposes of simplicity, a starting contribution of \$10 million of cash.³⁶ 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 would be there is a 50% chance of the remainder being at least \$10 million or more.

2. For 20 year "zeroed-out" CLATs with the aforementioned annuity patterns, the resulting median (50th percentile) inflation-adjusted remainder values, after all payments to charity and after the payment of income taxes, are illustrated in the below display (Back-Loading Increases Wealth Transfer...Only to a Point):

³⁵ Bernstein's proprietary capital markets engine and wealth forecasting model 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.

³⁶ 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, based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. The data does not represent any past performance and is not a promise of actual future results.

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



*Median inflation-adjusted non-grantor CLAT remainder assuming \$10 million zeroed-out 20-year CLAT funded at the December 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$0.

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Shark-Fin CLAT Article

3. As one can see, 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 level annuity CLAT. Despite a very low section 7520 rate and the most extreme benefit of back-loading, the Shark-Fin does not produce the types of results that one would expect.

4. This surprising result can be attributed to the income tax liabilities on the return experienced by the trust assets during the term. The traditional wealth-transfer CLAT (with the remainder passing to 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 a deduction under section 642(c) in connection with the payment each year of the charitable annuity.

5. Section 642(c) 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.”³⁷

6. Although section 642(c) does not limit a trust’s income tax deduction as section 170 does with an individual (based on adjusted gross income), it effectively provides that the deduction in any given taxable year is 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 paid in

³⁷ § 642(c).

the previous taxable year, there is no mechanism to carry-back or carry-forward unused charitable deductions (in the instance 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 these “terminating distribution” tax benefits to unused carryover losses and unused deductions other than the charitable deduction and the personal exemption deduction.³⁸

7. The practical result of the foregoing is that a Shark-Fin CLAT pays income taxes on almost all of its income every 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. As a consequence, the income tax benefits from the charitable payments during the term of the trust are minimal. As can be seen in the chart above, the model shows that the most efficient use of the section 642(c) charitable deduction is a CLAT with 50% annually increasing annuities.

8. 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 section 7520 rate. A different asset allocation or a longer/shorter term for the non-grantor CLAT would likely result in a different back-loaded annuity pattern being the most efficient in terms of wealth transfer.

9. The efficient use of the section 642(c) deduction is an important component of successfully administering a non-grantor CLAT. If a non-grantor CLAT realizes unrelated business taxable income (“UBTI”),³⁹ while it will not result in the imposition of an excise tax as it would for tax-exempt entities, a reduction of the otherwise allowable section 642(c) charitable deduction will result. The Code provides, “[i]n computing the deduction allowable under section 642(c) to a trust, no amount otherwise allowable under section 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.”⁴⁰ The Treasury Regulations provide a methodology for reducing and allocating any remaining deduction between UBTI and other income.⁴¹

10. The most common instance when a CLAT will realize UBTI is if the CLAT has “unrelated debt-financed income” under section 514. In particular, this arises when “acquisition indebtedness”⁴² 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.”⁴³ 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 section 642(c) deduction.

³⁸ § 642(h)(1) and (2).

³⁹ § 512.

⁴⁰ § 681(a).

⁴¹ Treas. Reg. § 1.681(a)-2(b).

⁴² § 514(c)(1).

⁴³ § 514(c)(2)(B).

11. The loss of the section 642(c) charitable deduction in the context of back-loaded annuities (especially the Shark-Fin) may be of little consequence because the disallowance is a reduction of the otherwise allowable deduction that year. In the Shark-Fin example above, the maximum allowable deduction for the first 19 years would only be \$1,000. As a result, any reduction that might result due to the existence of UBTI for those years would be negligible.

12. Furthermore, the existence of UBTI is of no consequence if the CLAT is a grantor trust.

B. Forecasted Investment Results for Grantor CLATs

1. If Shark-Fin CLAT benefits are limited by section 642(c), might intentionally making the CLAT a grantor trust⁴⁴ create better results?

2. 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 section 7520) in return for taking on grantor trust income tax liability for the trust's assets.⁴⁵ Of course, there are wealth transfer benefits to the grantor paying the income tax liability, similar to the installment sale to an IDGT. There have been a number of rulings regarding this construct and planning technique.⁴⁶

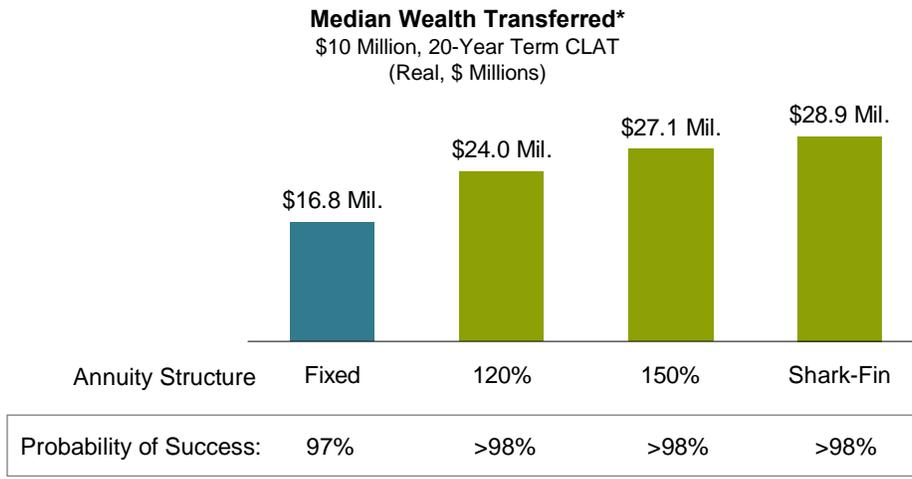
3. In the grantor CLAT form, the resulting median (50th percentile) inflation-adjusted remainder values, after all payments to charity (but ignoring income taxes) are illustrated in the below display (Grantor CLATs):

⁴⁴ §§ 671-679. Unless otherwise noted, a grantor CLAT for purposes of this outline will refer to a CLAT that is a grantor trust for income tax purposes but that is not includible in the estate of the grantor for estate tax purposes. As such, it does not refer to a CLAT where the grantor has retained a power under section 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 section 2038 for estate tax purposes.

⁴⁵ See § 170(f)(2)(B) and Treas. Reg. § 1.170A-6(c).

⁴⁶ Ltr. Ruls. 200011012, 200010036, 199936031, 199922007, 199908002, 9810019, and 9224029.

Grantor CLATs



*Median inflation-adjusted grantor CLAT remainder assuming \$10 million zeroed-out 20-year CLAT funded at December 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$0.

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4. The grantor Shark-Fin CLAT, unburdened by the limitations of section 642(c), now results in significantly more wealth transfer than all of the 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:⁴⁷

INFLATION-ADJUSTED REMAINDER VALUES (MEDIANS) \$10 MILLION INITIAL FUNDING YEAR 20		
Installment Sale to IDGT	GRAT	Grantor "Shark-Fin" CLAT
\$21.3 Mil.	\$24.0 Mil	\$28.9 Mil.

5. Significantly, even the more gentler 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.

6. 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:

a. First, the installment sale to an IDGT remainder value, while it has the same initial funding amount of \$10 million, requires a \$1 million "seed" gift to the IDGT to support the

⁴⁷ All strategies were assumed to have been funded with \$10 million. The 20 year GRAT is assumed to be funded at the December 2010 section 7520 rate with 20% increasing annuities. For the installment sale to the IDGT, the numbers assume a \$1 million "seed" gift with \$9 million installment sale to intentionally defective grantor trust with a promissory note paying interest only at the appropriate applicable federal rate for December 2010 with a balloon payment at the end of the term. All forecasted figures are based on Bernstein 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 outline 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).

payment of a \$9 million installment sale. In other words, the installment sale figure created a \$1 million taxable gift, either requiring the use of exemption equivalent or paying gift tax. The grantor Shark-Fin CLAT, on the other hand, is a zeroed-out gift, and yet still results in more wealth transfer.

b. Second, while the GRAT results are better than the installment sale, it assumes that the grantor survives the 20 year term. The grantor Shark-Fin CLAT, on the other hand, does not have the same mortality risk because if the grantor of a CLAT dies during the trust's term, the CLAT continues to its expiration (although grantor trust status is terminated) with its wealth transfer benefits intact.

c. Third, none of the figures above takes into account the benefit passed to the grantor upon funding of the grantor CLAT in the form of the resulting \$10 million charitable income tax deduction. Neither the installment sale nor the GRAT creates an income tax deduction but the resulting grantor trust tax liability is the same in all of the foregoing strategies.

7. 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.⁴⁸ As such the higher 50% limitation is unavailable to the grantor. 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.⁴⁹ However, subsequent rulings have ruled otherwise, and it seems that the 1988 ruling has been superseded.⁵⁰

III. TERM OF THE CHARITABLE LEAD INTEREST

A. Term of Years

1. All of the examples for illustrative purposes, to this point, have assumed CLATs with a 20 year term certain. Unlike charitable remainder trusts which are limited to term certain interests of no more than 20 years and annuity amounts of not less than 5% and more than 50% of the initial fair market value of the contributed property,⁵¹ CLATs do not have any statutory limitations on the length of a term certain or on the size of the annuity. The Treasury Regulations simply require that a CLAT have a "specified term" of years.⁵²

2. If the grantor intends to zero-out the gift to the non-charitable beneficiaries, the longer the term the smaller the charitable annuity payments need. Consequently, the CLAT will potentially transfer more wealth to the non-charitable beneficiaries. For example, in order to zero-out a \$10 million contribution with a fixed level annuity payment at a 1.8% section 7520 rate, a 10 year term would require an annual payment of approximately \$1.1 million, but a 20 year term would require approximately \$599,800. With smaller charitable annuity payments and a longer period during which to out perform the section 7520 rate, longer term CLATs should result in more wealth transfer. This turns out generally to be true, as one can see in the display below (Longer Terms Increase Wealth Transfer and Probabilities of Success), which are median inflation-adjusted remainder values for 10, 20 and 30 year non-grantor CLATs that are zeroed-out and that have fixed level annuities:

⁴⁸ § 170(b)(1)(B) and Treas. Regs. § 1.170A-8(a)(2).

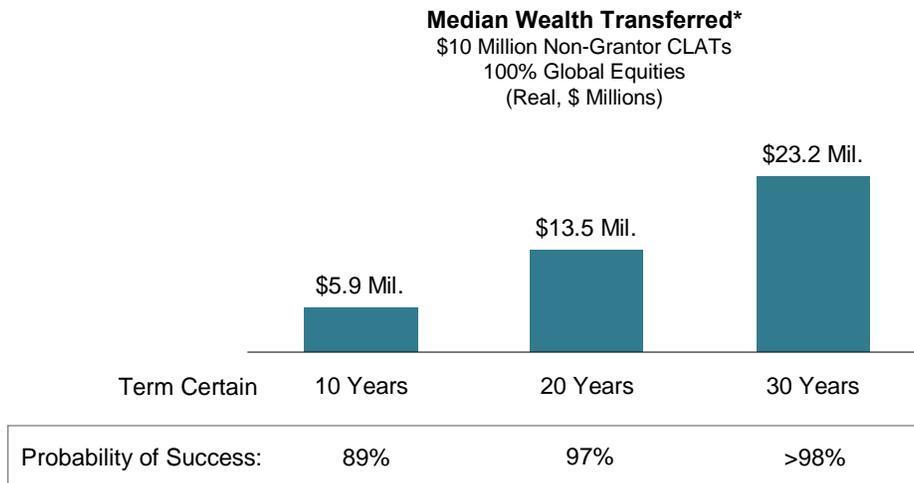
⁴⁹ Ltr. Rul. 8824039.

⁵⁰ See e.g. Ltr. Rul. 200010036.

⁵¹ § 677(d)(1)(A) (pertaining to charitable remainder annuity trusts with a similar rule for charitable unitrust interests in § 677(d)(2)(A)).

⁵² Treas. Regs. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), and 25.2522(c)-3(c)(2)(vi)(a).

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 December 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$0. Equities defined as 35% US value, 35% US growth, 25% developed international and 5% emerging markets.

3. From a wealth transfer standpoint, CLATs do not have the same “mortality risk” as GRATs⁵³ because if the grantor dies prior to the end of a term certain CLAT, generally no portion of the assets will 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, and the only difference moving forward would be the conversion from grantor to non-grantor trust status if the CLAT was a grantor trust at the time of grantor’s death (as discussed below in more detail). Despite the wealth transfer benefit of longer CLAT terms, because it defers 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 enjoyment with the potential wealth transfer benefits.

4. Many charitable gifts including those made through CLATS are testamentary. In a low interest rate environment like today, there is an opportunity for grantors to fund these gifts now. The benefits would seem clear: (i) lock-in a low section 7520 rate (1.8% currently) 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.

B. Lifetime Terms and Mortality Risk

1. In addition to a term certain, the Code provides that a CLAT may provide for annual charitable payments “for the life or lives of an individual or individuals, each of whom must be living at

⁵³ See Treas. Regs. § 20.2036-1(c)(1).

the date of transfer and can be ascertained at such date.”⁵⁴ In order to preclude certain abusive transactions where grantors were inflating the charitable deduction by using the measuring lives of unrelated individuals who were seriously ill,⁵⁵ 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.⁵⁶

2. 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 purpose, it must be assumed that it is possible for each measuring life to survive until age 110.” 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, or (ii) significantly “over funding” the trust with additional assets (above the determined charitable amount pursuant to the 110 year exhaustion test).

3. 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,” the ability to “over fund” a CLAT at little or no transfer tax cost has dramatically increased. For this reason, I 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 I 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, I use the standard annuity factors set out in section 7520 based upon an annuity stream that will be payable for the life of the measuring life.

4. Assuming, for purposes of this outline, 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) (hereinafter, “Publication 1457”),⁵⁷ supplemented by Notice 2009-18⁵⁸ with factors for section 7520 rates below 2.2%. The annuity factors in Table S of IRS Publication 1457, however, assume a fixed level payment. With any back-loaded annuity, the annuity factors cannot be used. That being said, the remainder factors (which are the factors used to determine the present value of the right to receive an amount in the future) from Table S can be utilized.

⁵⁴ Treas. Reg. § 1.170A-6(c)(2)(i)(A) with similar language in Treas. Regs. §§ 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

⁵⁵ Individuals who were seriously ill but who was 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) and 25.7520-3(b)(3).

⁵⁶ Treas. Regs. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), and 25.2522(c)-3(c)(2)(vi)(a). See T.D. 8923, 66 Fed. Reg. 1040 (1/5/01).

⁵⁷ If IRS Publication 1457 is not directly on point, an annuity factor may be calculated from Table S in Treas. Reg. § 20.2031-7T(d)(7) by subtracting the applicable Table S remainder factor from 1.0 and dividing the result by the applicable § 7520 rate.

⁵⁸ IRS Notice, 2009-18, 2009-10 I.R.B. 64.

5. For example, the term certain Shark-Fin CLAT described above provided for a \$1,000 annual payment and a \$14.3 million payment at the end of year 20 (zeroing-out the \$10 million gift). The calculation of a lifetime CLAT for a 62 year old donor (who has a 20 year life expectancy based on the 2000 mortality tables), that is patterned in the same manner can be calculated by using the appropriate annuity factor from Table S for the \$1,000 annuity for life, and using the appropriate remainder factor from Table S for the last payment, as follows:

PV of Annuity for Lifetime	
Annuity Factor from Table S	16.1105
x Annuity Amount	\$ 1,000
Present Value	\$ 16,111
PV of Final Payment at Death	
Remainder Factor from Table S	0.71001
x Final Payment	\$ 14,061,618
Present Value	\$ 9,983,890
TOTAL CHARITABLE VALUE	\$ 10,000,000

Keep in mind that both the \$1,000 annuity amount, as pro rated to the date of death, and the final payment of \$14,061,618 must be paid.

6. The final payment at death (ignoring any pro rated portion of the \$1,000 annuity) is \$203,040 *less* than the final payment that would be paid in the 20 year term certain (\$14,264,658) despite the fact that a 62 year old grantor has a 20 year life expectancy. This can be seen as the present value of the unusual “mortality risk” associated with lifetime CLATs. However, the mortality risk is different depending on whether the CLAT is a fixed level annuity or a Shark-Fin. 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 \$620,713,⁵⁹ which is \$20,886 per year *more* than the 20 year term annuity of \$599,545. Over 20 years, assuming the grantor survives, the lifetime CLAT would cumulatively pay \$417,719 more to charity.

7. 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 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 Shark-Fin CLAT dies significantly before life expectancy, charity receives its share earlier than it anticipated and the remainder beneficiaries do not realize as much wealth transfer. In fact, if the grantor of a Shark-Fin CLAT dies at the very beginning of a lifetime CLAT, there is a high probability that the CLAT will not have sufficient assets to pay the \$14.0 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.⁶⁰ 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

⁵⁹ Table S annuity factor for 62 year old (1.8% section 7520 rate) of 16.1105 multiplied by the annuity (\$620,713) equals \$10 million.

⁶⁰ See Treas. Reg. § 25.7520-3(b)(2)(i) which provides that the standard section 7520 annuity factor may not be used if the trust will exhaust itself. 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.

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 discussed later in this outline.

8. The mortality risk profile of other back-loaded annuity patterns (like 120% and 150% of the previous year's annual payment) is similar to the fixed level annuity: (i) early mortality benefits the remainder beneficiary to the detriment of charity, and (ii) late mortality benefits charity to the detriment of the remainder beneficiary. However, the magnitude of the swing in assets is skewed by the extent of the back-loading. In other words, with a lifetime CLAT for a 62 year old that provides for a small initial payment and for increasing payments in an amount 50% greater than the previous year's payment, if the grantor passes away after the first or second year, the benefit to remainder beneficiaries is significantly higher than the comparable fixed level payment CLAT. However, if the grantor passes away long after his or her actuarial life expectancy, the detriment to the remainder beneficiaries gets increasingly larger by 50% each year.

9. It is not readily evident based upon the examples provided in Publication 1457 how to calculate the charitable interest and, thus, zero-out 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). That being said there seems to be at least a few different methodologies for calculating the charitable interests by using a combination of mortality adjusted annuity factors (subtracting smaller annuity amounts from larger annuity amounts) and remainder factors under Table S with the commutation factors under Table H. For the less actuarially inclined, the IRS has a procedure for requesting special actuarial factors.⁶¹ The preamble to the section 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."⁶²

10. 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.⁶³ At the prevailing section 7520 rate, Table S (single life annuity factors) of Publication 1457 provides an annuity factor of 16.1105 for "ordinary" (fixed level) annuities. If, as I have assumed throughout this outline, the grantor is zeroing-out a \$10 million contribution, this equates to a \$620,713.29 fixed level annuity⁶⁴ for the life of a 62 year old grantor ($\$620,713 \times 16.1105 = \$10,000,000$). In arriving at this figure, the IRS actuaries may have utilized the equations and methodology set out in the display below (Lifetime CLAT Formula: Mortality-Adjusted Present Value):

⁶¹ See §§ 20.2031-7T(d)(4) and 25.2512-5T(d)(4).

⁶² Preamble to the Treasury Regulations applicable to § 7520.

⁶³ Table 2000CM from IRS Publication 1457 provide, based initially on 100,000 lives, the number of individuals alive at each age. For example, the l_x value at age 0 is 10000 and the l_x 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%

⁶⁴ $\$620,713.29 \times 16.1105 = \$10,000,000$.

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

$$PV = \sum \frac{FV}{(1+i)^n} = \frac{\$620,713}{1.018} + \frac{\$620,713}{(1.018)^2} + \frac{\$620,713}{(1.018)^3} + \dots + \frac{\$620,713}{(1.018)^{48}}$$

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

$$MAPV = PV \times P_n = \frac{\$620,713 \times 99.38\%}{1.018} + \frac{\$620,713 \times 98.08\%}{(1.018)^2} + \frac{\$620,713 \times 96.7\%}{(1.018)^3} + \dots + \frac{\$620,713 \times 0.01\%}{(1.018)^{48}}$$

P_n = Probability of surviving to time n
 (Table 2000CM)

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11. As the foregoing display shows, the value of the charitable deduction under section 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 “Mortality-Adjusted Present Value”). In arriving at the Mortality-Adjusted Present Value, the following should be noted:

a. 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.⁶⁵

b. 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.

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

12. Based on the foregoing formula, I calculated that in order to zero-out a \$10 million contribution to a lifetime CLAT for a 62 year old grantor at the prevailing 1.8% section 7520 rate with annual increases of 20% and 50%, the first annuity would be \$24,139.59 and \$20.23 respectively. As

⁶⁵ 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 lx (number of lives at age x) value at age 62 is 85691. The lx 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.

such, the annual and cumulative payments each year, assuming the grantor survives to age 100 years, would be as follows:⁶⁶

ANNUAL PAYMENTS				CUMULATIVE PAYMENTS			
Year	Level	120%	150%	Year	Level	120%	150%
1	\$620,713	\$ 24,140	\$ 20	1	\$ 620,713	\$ 24,140	\$ 20
2	\$620,713	\$ 28,968	\$ 30	2	\$ 1,241,427	\$ 53,107	\$ 51
3	\$620,713	\$ 34,761	\$ 46	3	\$ 1,862,140	\$ 87,868	\$ 96
4	\$620,713	\$ 41,713	\$ 68	4	\$ 2,482,853	\$ 129,581	\$ 164
5	\$620,713	\$ 50,056	\$ 102	5	\$ 3,103,566	\$ 179,637	\$ 267
6	\$620,713	\$ 60,067	\$ 154	6	\$ 3,724,280	\$ 239,704	\$ 420
7	\$620,713	\$ 72,080	\$ 230	7	\$ 4,344,993	\$ 311,785	\$ 651
8	\$620,713	\$ 86,496	\$ 346	8	\$ 4,965,706	\$ 398,281	\$ 997
9	\$620,713	\$ 103,796	\$ 518	9	\$ 5,586,420	\$ 502,077	\$ 1,515
10	\$620,713	\$ 124,555	\$ 778	10	\$ 6,207,133	\$ 626,632	\$ 2,293
11	\$620,713	\$ 149,466	\$ 1,167	11	\$ 6,827,846	\$ 776,098	\$ 3,459
12	\$620,713	\$ 179,359	\$ 1,750	12	\$ 7,448,560	\$ 955,457	\$ 5,209
13	\$620,713	\$ 215,231	\$ 2,625	13	\$ 8,069,273	\$ 1,170,688	\$ 7,834
14	\$620,713	\$ 258,277	\$ 3,937	14	\$ 8,689,986	\$ 1,428,965	\$ 11,771
15	\$620,713	\$ 309,933	\$ 5,906	15	\$ 9,310,699	\$ 1,738,898	\$ 17,677
16	\$620,713	\$ 371,919	\$ 8,859	16	\$ 9,931,413	\$ 2,110,817	\$ 26,536
17	\$620,713	\$ 446,303	\$ 13,288	17	\$10,552,126	\$ 2,557,120	\$ 39,824
18	\$620,713	\$ 535,564	\$ 19,932	18	\$11,172,839	\$ 3,092,683	\$ 59,756
19	\$620,713	\$ 642,676	\$ 29,898	19	\$11,793,553	\$ 3,735,359	\$ 89,655
20	\$620,713	\$ 771,211	\$ 44,848	20	\$12,414,266	\$ 4,506,571	\$ 134,502
21	\$620,713	\$ 925,454	\$ 67,271	21	\$13,034,979	\$ 5,432,025	\$ 201,773
22	\$620,713	\$ 1,110,545	\$ 100,907	22	\$13,655,692	\$ 6,542,569	\$ 302,680
23	\$620,713	\$ 1,332,653	\$ 151,360	23	\$14,276,406	\$ 7,875,223	\$ 454,041
24	\$620,713	\$ 1,599,184	\$ 227,041	24	\$14,897,119	\$ 9,474,407	\$ 681,081
25	\$620,713	\$ 1,919,021	\$ 340,561	25	\$15,517,832	\$ 11,393,428	\$ 1,021,642
26	\$620,713	\$ 2,302,825	\$ 510,841	26	\$16,138,546	\$ 13,696,253	\$ 1,532,483
27	\$620,713	\$ 2,763,390	\$ 766,262	27	\$16,759,259	\$ 16,459,643	\$ 2,298,745
28	\$620,713	\$ 3,316,068	\$ 1,149,393	28	\$17,379,972	\$ 19,775,711	\$ 3,448,137
29	\$620,713	\$ 3,979,282	\$ 1,724,089	29	\$18,000,686	\$ 23,754,993	\$ 5,172,226
30	\$620,713	\$ 4,775,138	\$ 2,586,133	30	\$18,621,399	\$ 28,530,131	\$ 7,758,360
31	\$620,713	\$ 5,730,166	\$ 3,879,200	31	\$19,242,112	\$ 34,260,297	\$ 11,637,560
32	\$620,713	\$ 6,876,199	\$ 5,818,800	32	\$19,862,825	\$ 41,136,496	\$ 17,456,360
33	\$620,713	\$ 8,251,439	\$ 8,728,200	33	\$20,483,539	\$ 49,387,934	\$ 26,184,560
34	\$620,713	\$ 9,901,726	\$13,092,300	34	\$21,104,252	\$ 59,289,661	\$ 39,276,861
35	\$620,713	\$11,882,072	\$19,638,451	35	\$21,724,965	\$ 71,171,733	\$ 58,915,311
36	\$620,713	\$14,258,486	\$29,457,676	36	\$22,345,679	\$ 85,430,219	\$ 88,372,987
37	\$620,713	\$17,110,183	\$44,186,514	37	\$22,966,392	\$102,540,402	\$132,559,501
38	\$620,713	\$20,532,220	\$66,279,771	38	\$23,587,105	\$123,072,622	\$198,839,272

13. I have shaded 3 significant time periods in the table that quantify the very different mortality risks associated with the different annuity patterns. By the end of year 20 (life expectancy according to the 2000 mortality tables), the level annuity would have cumulatively paid to charity \$12.4

⁶⁶ The figures in the table are rounded to the nearest \$1.

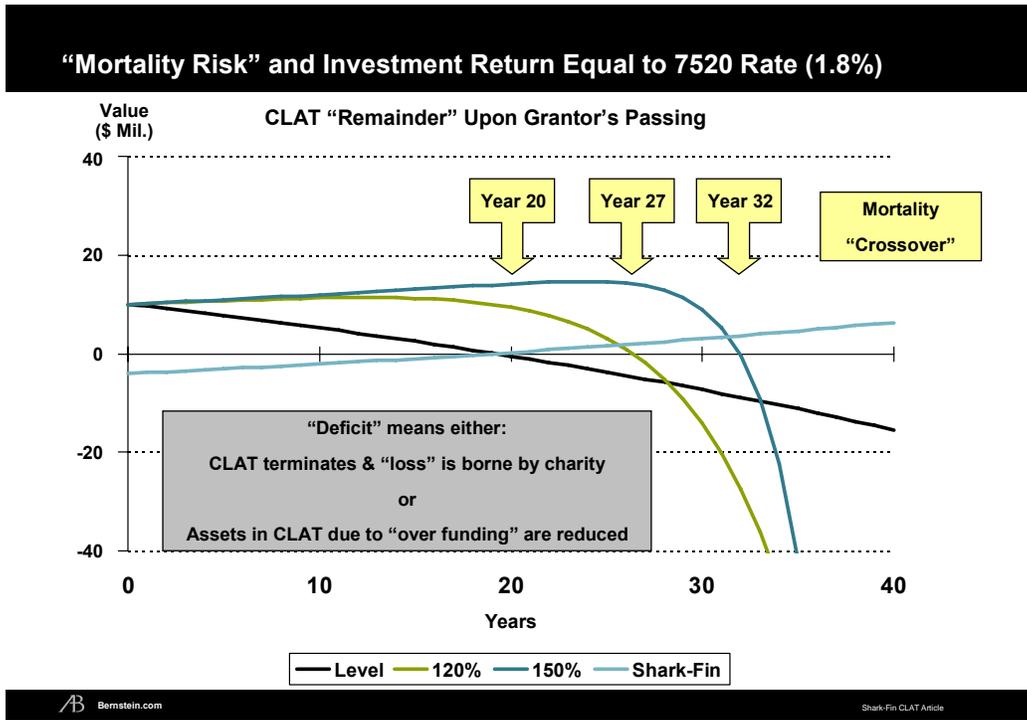
million, whereas the 120% and 150% back-loaded annuities would have paid \$4.1 million and \$134,502 respectively to charity. That's a startling difference in terms of amounts paid to charity and consequently amounts transferred to the remainder beneficiaries if death occurred at that time. It is not until the 28th year that more amounts would be paid in the 120% annuity pattern than the level annuity, and by the 36th year, the 150% annuity pattern would pay more than the 120% annuity. However, the probability of the grantor living 36 years, according to the mortality tables is approximately 4%,⁶⁷ as illustrated below:

Year	CUMULATIVE PAYMENTS			SURVIVAL PROBABILITY
	Level	120%	150%	
1	\$ 620,713	\$ 24,140	\$ 20	99.4%
2	\$ 1,241,427	\$ 53,107	\$ 51	98.1%
3	\$ 1,862,140	\$ 87,868	\$ 96	96.7%
4	\$ 2,482,853	\$ 129,581	\$ 164	95.2%
5	\$ 3,103,566	\$ 179,637	\$ 267	93.6%
6	\$ 3,724,280	\$ 239,704	\$ 420	91.9%
7	\$ 4,344,993	\$ 311,785	\$ 651	90.2%
8	\$ 4,965,706	\$ 398,281	\$ 997	88.3%
9	\$ 5,586,420	\$ 502,077	\$ 1,515	86.2%
10	\$ 6,207,133	\$ 626,632	\$ 2,293	84.1%
11	\$ 6,827,846	\$ 776,098	\$ 3,459	81.8%
12	\$ 7,448,560	\$ 955,457	\$ 5,209	79.3%
13	\$ 8,069,273	\$ 1,170,688	\$ 7,834	76.7%
14	\$ 8,689,986	\$ 1,428,965	\$ 11,771	73.9%
15	\$ 9,310,699	\$ 1,738,898	\$ 17,677	70.9%
16	\$ 9,931,413	\$ 2,110,817	\$ 26,536	67.8%
17	\$10,552,126	\$ 2,557,120	\$ 39,824	64.5%
18	\$11,172,839	\$ 3,092,683	\$ 59,756	61.1%
19	\$11,793,553	\$ 3,735,359	\$ 89,655	57.5%
20	\$12,414,266	\$ 4,506,571	\$ 134,502	53.8%
21	\$13,034,979	\$ 5,432,025	\$ 201,773	50.0%
22	\$13,655,692	\$ 6,542,569	\$ 302,680	46.1%
23	\$14,276,406	\$ 7,875,223	\$ 454,041	42.2%
24	\$14,897,119	\$ 9,474,407	\$ 681,081	38.3%
25	\$15,517,832	\$ 11,393,428	\$ 1,021,642	34.4%
26	\$16,138,546	\$ 13,696,253	\$ 1,532,483	30.6%
27	\$16,759,259	\$ 16,459,643	\$ 2,298,745	26.8%
28	\$17,379,972	\$ 19,775,711	\$ 3,448,137	23.3%
29	\$18,000,686	\$ 23,754,993	\$ 5,172,226	19.9%
30	\$18,621,399	\$ 28,530,131	\$ 7,758,360	16.8%
31	\$19,242,112	\$ 34,260,297	\$ 11,637,560	13.9%
32	\$19,862,825	\$ 41,136,496	\$ 17,456,360	11.4%
33	\$20,483,539	\$ 49,387,934	\$ 26,184,560	9.1%
34	\$21,104,252	\$ 59,289,661	\$ 39,276,861	7.1%
35	\$21,724,965	\$ 71,171,733	\$ 58,915,311	5.4%
36	\$22,345,679	\$ 85,430,219	\$ 88,372,987	4.1%
37	\$22,966,392	\$102,540,402	\$132,559,501	3.0%

⁶⁷ 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 percentages above reflect the probability of living half-way through the year in question.

38	\$23,587,105	\$123,072,622	\$198,839,272	2.1%
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14. What the foregoing table illustrates is the stark difference in “mortality” risk that is associated with different increasing annuities with respect to cumulative amounts required to be paid to charity. 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 display (“Mortality Risk” and Investment Return Equal to 7520 Rate (1.8%)) which shows the “remainder” values (again, ignoring any assets from the reinvestment of any “over funding”) that would be paid if the 62 year old grantor died during the next 40 years and the CLAT assets had an annual compound return exactly equal to the section 7520 rate (the IRS assumption on return):



15. As one can see, there are 3 significant years (mortality “crossover”) to consider:

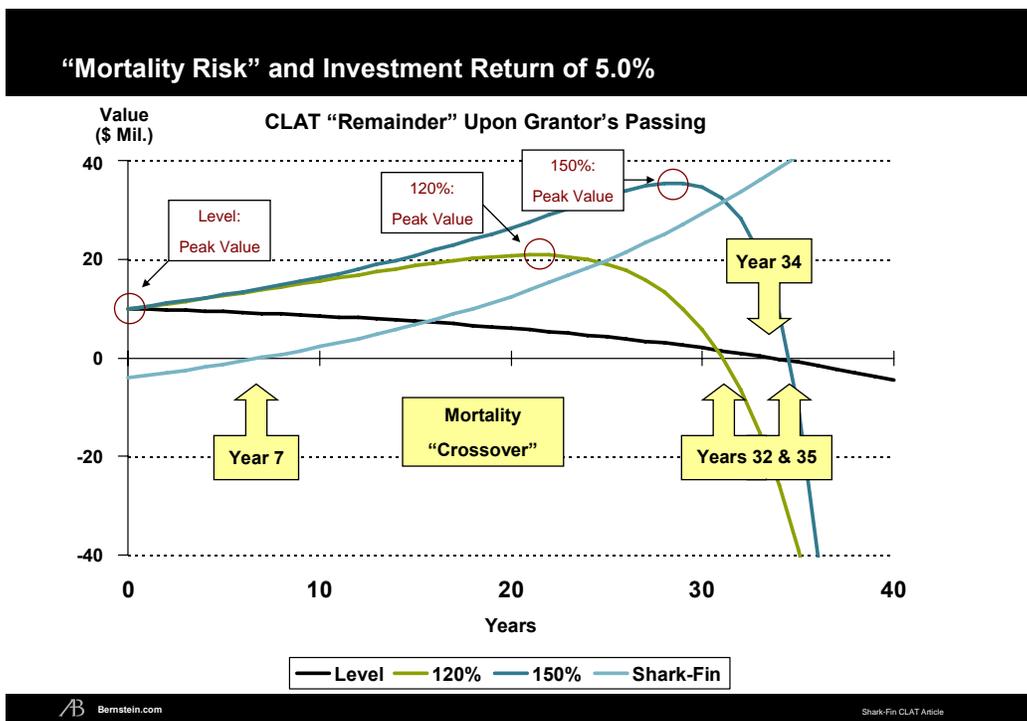
a. Year 20 (the life expectancy of the grantor according to the mortality tables): The level annuity CLAT has exhausted its assets, and the CLAT goes into a “deficit.” Of course, for the grantor this is not truly a “deficit” or a continuing liability. In this instance, either (i) the CLAT will terminate because it does not have any assets and this “loss” is theoretically borne by charity that otherwise would have continued to receive annual payments if the grantor had survived past year 20; 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 before year 20. Also, by year 20, the Shark-Fin CLAT assets start to exceed the \$14.0 million required payment to charity. The Shark-Fin CLAT, which initially had significant mortality risk, no longer has any such risk and the longer the grantor lives past this point, the larger the remainder becomes.

b. Year 27 (grantor would be 89 years of age): The 120% back-loaded annuity CLAT goes into deficit.

c. 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 section 7520 rate, “crossover” occurs by year 32. It’s also at this point that the Shark-Fin CLAT has more wealth transfer than all of the other CLATs.

16. What is also notable is 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 section 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. I have limited the annual increases to 20% and 50%. Imagine how far out the mortality “crossover” point would be with a 75% or 100% annual increases.

17. Of course, one hopes and expects that the investments of the CLAT will exceed the section 7520 rate. If the CLAT assets earned 5% per year, “mortality risk” and wealth transfer benefits change significantly, as shown by the following display (“Mortality Risk” and Investment Return of 5.0%):



18. As one can see, a very different picture starts to emerge when the assets exceed the section 7520 rate:

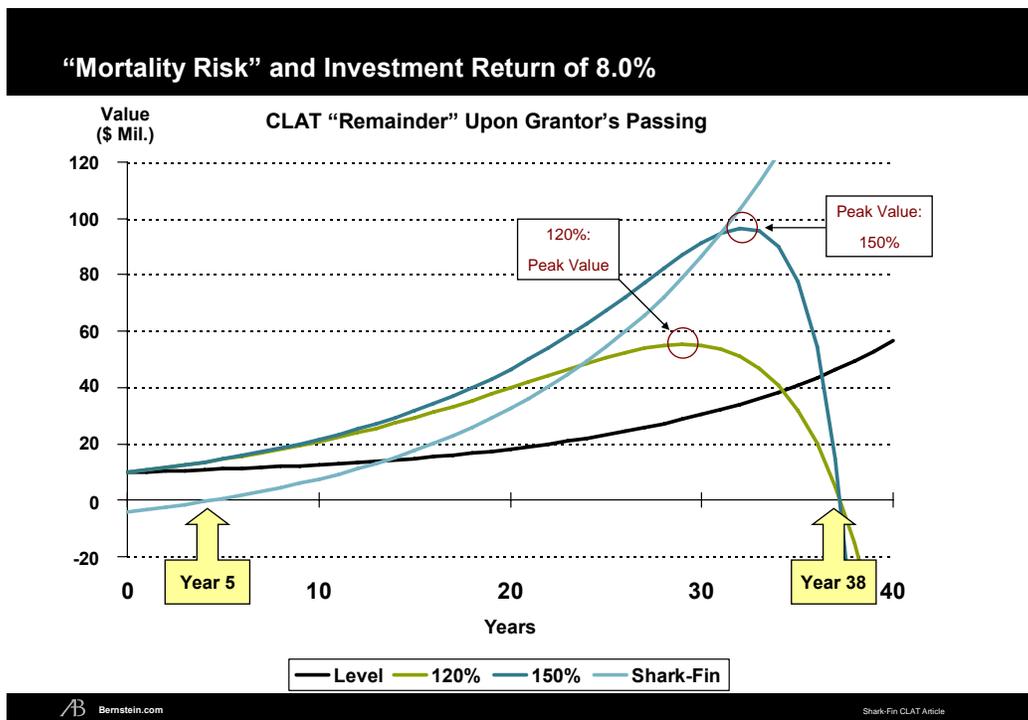
a. Year 7: The Shark-Fin CLAT has assets that exceed the \$14.0 charitable payment. From this point forward, if the grantor survives, the remainder value continues to increase and by the 32nd year will exceed all of the other CLATs.

b. Year 32 (grantor would be 94 years of age): The 120% back-loaded annuity CLAT goes into deficit, but the peak remainder value was in the 21st year. However, you will note that the remainder value is never above the 150% back-loaded annuity CLAT.

c. Year 34 (grantor would be 96 years of age): The level annuity CLAT goes into deficit. This is 14 years past the assumed section 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 at the section 7520 rate, for level annuity lifetime CLATs, the peak remainder value was at the outset of the term.

d. Year 35 (grantor would be 97 years of age): The 150% back-loaded annuity CLAT goes into deficit, but the peak remainder value was in the 30th 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.

19. 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 display (“Mortality Risk” and Investment Return of 8.0%):



20. 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:

a. Year 5: The Shark-Fin CLAT has assets that exceed the \$14.0 charitable payment. Perhaps more significantly, it not until the 32nd year when the grantor will be 94 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 11.4%, according to the methodology used by the IRS.

b. 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.

c. Year 38 (grantor would be 100 years of age): Both the 120% and 150% back-loaded annuity CLATs go into a “deficit.” Peak remainder values are in years 29 and 32 respectively. As with all other rates of return, if the grantor seeks to maximize wealth transfer to the non-charitable beneficiaries, and the grantor is choosing between an annually increasing annuity CLAT, the grantor should always choose the higher annual increase (in this case, 150%).

21. The “mortality risk” (whether defined in relation to maximum wealth transfer or the point that the CLAT will go into “deficit” and terminate) 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 the 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 only have the most wealth transfer 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 outline, 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.

22. With annually increasing lifetime CLATs, because a “deficit” is borne by charity (and under some circumstances, the non-charitable 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 displays show, higher annual annuity increases provide higher remainder values and more extended mortality “crossover.” I have limited the discussion in this outline 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.

23. 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 section 7520 rate. Even when the investment return is 5% (significantly greater than the section 7520 rate), the CLAT collapses in the 34th 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 35th 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 display above), there is no mortality risk (even in the first few years when the Shark-Fin CLAT is more vulnerable).

24. 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 limit the term to the earlier of the death of the measuring life, and 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. 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 into a “deficit” for both charity and the non-charitable beneficiaries.

25. Notwithstanding the “mortality risk” statistics and discussion above, it should be noted that the mortality tables used in section 7520 tend to over estimate the probability of death for most grantors for the following reasons:

a. The statistics are based on the 2000 census data.⁶⁸ As such, the data is already 10 years old, and life expectancies have lengthened since then.

b. The statistics are sex neutral, and female grantors have longer life expectancies than their male counterparts.

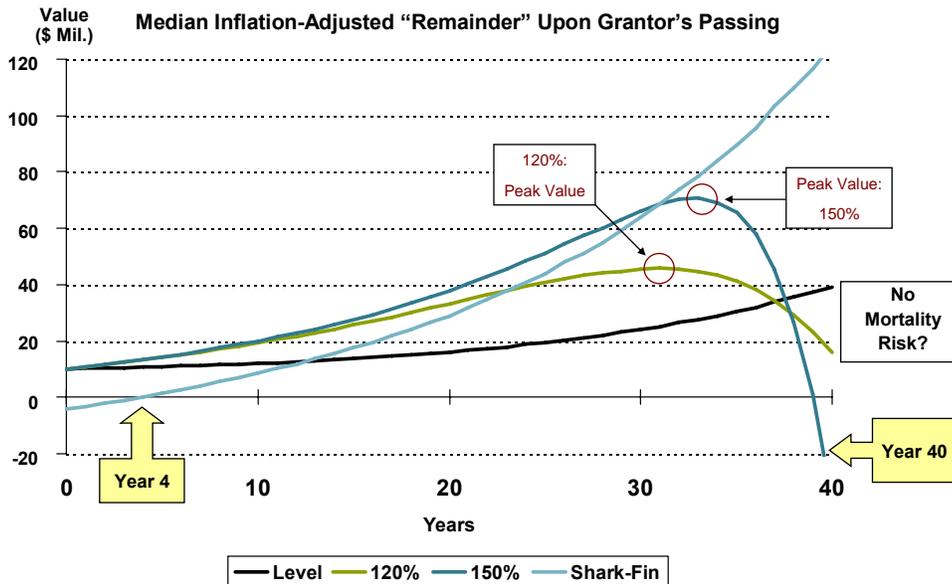
c. The statistics are based on the total population. Generally, grantors of CLATs tend to be wealthier than the general population, and studies have shown that wealthier individuals have longer life expectancies.

d. The statistics do not take into account self-selection. In other words, grantors who are healthy and who have a family history of longevity are less likely to create lifetime CLATs than those who do not have those characteristics.

26. Furthermore, the discussion above assumes a constant rate of return. As discussed above, the path of the investment returns are equally as important as the magnitude of the returns. Based upon our forecast of investment returns for global equities, the median inflation-adjusted remainder values over the next 40 years for these lifetime CLATs are in the display below (“Forecasted Returns for Lifetime CLATs):

⁶⁸ IRS Publication 1457 provides the factors and tables are take 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.”

Forecasted Returns for Lifetime CLATs



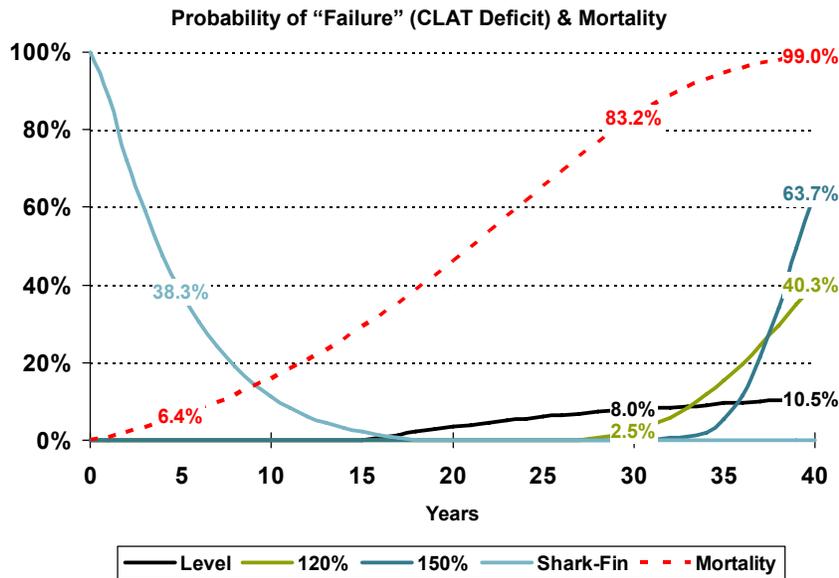
27. As one can see, based upon our current forecast of returns, the mortality risk profile is similar to the assumed 8% annual return above (although these are inflation-adjusted values so the compound annual return is greater than 8%).⁶⁹ However, “mortality risk” for all of the lifetime CLAT annuities is greatly minimized:

- a. For the Shark-Fin CLAT, mortality crossover is expected to occur by year 4, and by year 31, the remainder values will exceed those of the other CLATs.
- b. For the 150% back-loaded CLAT, peak value occurs in year 33, and the CLAT is not expected to go into a deficit until year 40 (at which point the grantor would be 102 years of age).
- c. In contrast to the 5% assumed rate of return, the 120% back-loaded CLAT has no mortality risk, but peak value is expected to occur in year 31.
- d. As with the previous display, the level annuity CLAT has no mortality risk.

28. These are, of course, 50th percentile results, and although it seems as though the 120% and level annuity CLATs have no mortality risk, the actual probabilities of “failure” (the CLAT going into a “deficit”) due to investment returns and the probability death occurring each year are illustrated in the following display (Probability of Failure & Mortality/Survival Cancel Each Other Out):

⁶⁹ Based on Bernstein’s forecast of returns, global equities will have a median compound annual growth rate of 9.8% over the next 40 years.

Probability Failure & Mortality/Survival Cancel Each Other Out



AB Bernstein.com

Shark-Fin CLAT Article

29. The solid lines 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 highest, the probability of mortality or survival is quite low. By way of example, consider the following time periods:

a. In year 5, there is a 38.3% chance that the Shark-Fin CLAT will go into a “deficit” but the probability of death occurring at this point is only 6.4% according to the mortality tables (as computed by the IRS). There is no chance, according to our forecasted returns that any of the other CLATs will be in a “deficit” at that point.

b. In year 30, the level annuity and the 120% back-loaded CLATS have an 8.0% and a 2.5% chance of being in a deficit at such time. However, there is an 83.2% that the grantor has already passed away at that point. Thus, there is only a 16.8% chance that the CLAT will still be in existence for those probabilities of failure to occur.

c. In year 40, all of the lifetime CLATs (other than the Shark-Fin) have probabilities of failure that range from 10.5% to 63.7%. However, there is only a 1% chance that the grantor has survived to that point (102 years of age).

30. 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 outline, 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 7.1%. As mentioned above, practitioners will likely limit the term to a term of years (set at 30 years) and the prior death of the measuring. Again, I have limited the 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 pure lifetime term is not utilized.

C. Purchasing the Charitable Lead Interest

1. 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 is based upon 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 it can invest those assets at higher rate of return than the prevailing section 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, the remainder beneficiaries could purchase the interest, which would collapse the trust and accelerate transfer of the assets.

2. To illustrate, consider the following, perhaps extreme, example. In a month when the section 7520 rate is 1.8%, 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 \$59,261,547 would be required at the end of the 100th year in order to zero-out the gift. Charity's right to receive the \$59.3 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 \$450,654. As a result, the remainder beneficiaries might negotiate the purchase of charity's lead interest for, say, \$500,000.⁷⁰ The remainder beneficiaries would thus net \$9.5 million (assuming exactly \$10 million of assets in the trust at the time of purchase).

3. 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 if: (i) the charity in question is a public charity and (ii) the CLAT trustee is an unrelated, independent trustee not involved in the negotiation of the transaction and is not a party to the transaction.

4. Commutation clauses are generally prohibited in CLATs. Rev. Proc. 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."⁷¹ 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 seem to be a commutation.

5. 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. HIGHER SECTION 7520 RATES

⁷⁰ The annuity factor for 100 years at an assumed rate of return of 5% is 19.848. Thus, a \$1,000 annuity for 100 years would be \$19,848, which when added to the \$450,654 the sum would be \$470,502.

⁷¹ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(1) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4), citing Rev. Rul. 88-27, 1988-1 C.B. 331. See Ltr. Rul. 9844027 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.

A. All of the figures in this outline are based on a section 7520 rate of 1.8%, which is the lowest rate to date. The interest rates for March 2011 have already been announced, and as anticipated, the section 7520 rate of 3.0% is higher. The obvious question that must be addressed is, as interest rates rise, whether a Shark-Fin or other back-loaded annuity CLATs are still compelling?

B. Quite simply, in higher interest rate environments, Shark-Fin or other back-loaded CLATs become even more important, although the amount of wealth transfer will likely be less than it is today. This is because the section 7520 rate is currently very low (even at 3.0% for March 2011) and forecasted investment returns of global equities (the assumed investment) are relatively high.⁷² It is not just the section 7520 rate that determines whether a CLAT will result in significant wealth transfer. While the section 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 section 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 section 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 section 7520 rates, a CLAT would still be compelling in that type of environment.

C. 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 section 7520 rate for CLATs was 4.2%.⁷³ For 20 year “zeroed-out” CLATs, the median inflation-adjusted remainder values were forecasted as follows:

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

D. 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 to 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, 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 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:

⁷² Based on Bernstein’s forecast of returns, global equities will have a median compound annual growth rate of 9.8% over the next 40 years.

⁷³ The § 7520 rate for July, August and September 2008.

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

V. IS A SHARK-FIN ADVISABLE?

A. 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 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 lives far beyond life expectancy).

B. Second, although term CLATs do not have the same type of mortality risk as lifetime terms, as discussed later in this outline, if the grantor dies during the term of a grantor CLAT, the trust becomes a non-grantor trust. 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 section 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 it ensures the best results if the grantor dies unexpectedly and it 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).

C. Although I 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. For these practitioners, annually increasing annuities of 20%, 50% or greater each year “feels” better than a Shark-Fin. As illustrated above, today annually increasing annuity CLATs provide results comparable to Shark-Fin CLATs.

D. There a few circumstances when a Shark-Fin annuity pattern might 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 bequests, a lifetime grantor Shark-Fin CLAT is a superior way of fulfilling that bequest. Not only would the 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 this, most planners will likely choose annually increasing annuities over the Shark-Fin.

VI. “INTENTIONALLY-DEFECTIVE” GRANTOR CLATS

A. Introduction

1. As one can see, 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. Under the grantor trust rules, the grantor is taxed only on that portion of the trust assets that he or she is considered an owner. Under the portion rules, this can include a fractional portion of the assets, only the ordinary or capital gain tax items, only the income or the remainder, or the entire trust. To get the maximum benefit from an income and wealth transfer tax standpoint, the grantor must be deemed owner of the entire trust for grantor trust purposes.

2. Because there are many grantor trust powers available, all with different grantor trust, estate tax, income tax, and private foundation rule implications, it is crucial that tax planners carefully consider which grantor trust power to use with a CLAT.

B. What Grantor Trust Power?

1. As mentioned above, the most common power retained to ensure grantor trust status is under Section 673, a reversionary interest equal in value to at least 5% of the value of the corpus as of the date of transfer. However, for estate tax purposes, this reversionary power will cause the corpus of the CLAT to be includible in the estate of the grantor under Section 2038. If the grantor relinquishes that power within 3 years of death, Section 2035 will nevertheless cause the assets to be includible for estate tax purposes. Furthermore, many of the other grantor trust powers would cause estate tax includibility under Section 2036.⁷⁴ As a result, some other grantor trust power must be relied upon in order to achieve the perceived benefits of the “super CLAT.”

2. Theoretically, the following retained powers may achieve grantor trust status without causing includibility for estate tax purposes:

a. 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.”⁷⁵

b. Giving a non-adverse person (other than the grantor) the “power of disposition” over “the beneficial enjoyment of the corpus or the income therefrom” without the approval or consent of any adverse party.⁷⁶

c. Giving the grantor, in a non-fiduciary capacity, the “power to reacquire the trust corpus by substituting other property of an equivalent value.”⁷⁷

⁷⁴ If the grantor of charitable lead trust is a member, director or officer of the charitable organization which is the income beneficiary of the trust, the entire corpus may be included in the grantor's estate pursuant to § 2036(a)(2), notwithstanding the fact that an income tax deduction was allowed for the contribution to the trust. Rifkind v. U.S., 5 Cl. Ct. 362 (1984). See also Rev. Rul. 72-552, 1972-2 C.B. 525, and Ltr. Rul. 7929002.

⁷⁵ § 677(a)(3).

⁷⁶ § 674(a).

⁷⁷ § 675(4).

d. Giving a person (other than the grantor) the “power to reacquire the trust corpus by substituting other property of an equivalent value” because this power can be exercised “by any person without the approval or consent of any person in a fiduciary capacity”⁷⁸

e. 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 Section 679.

3. The IRS promulgated CLAT forms use the power of substitution in favor of a person other than the grantor. The form provides, “[d]uring the Donor's life, [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.”⁷⁹

4. In Private Letter Ruling 9224029, a person who was not a trustee or a Section 672(a) adverse party had the substitution power over assets in a CLT. The power was exercisable in a non-fiduciary capacity, without the approval or consent of fiduciary. The IRS held that the CLT was a grantor trust under Section 675(4) without discussing any possible self-dealing issue. The IRS also ruled that the grantor was entitled to a Section 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. More recently, however, the IRS has declined to affirmatively rule on the grantor trust status of trusts under Section 675(4) saying that it is a determination that depends on all of the facts and circumstances.⁸⁰

5. 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.

6. Most practitioners will list a number of the foregoing powers in the CLAT document in order to ensure grantor trust status as to the entire trust. This is because even with certain legal or practical limitations on the ability to exercise that power, for most of the grantor trust rules, it is the existence not the actual exercise of the power that causes grantor trust treatment.

7. 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.⁸¹

8. The IRS has ruled favorably on a CLAT involving the application of Section 674.⁸² In the ruling, 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

⁷⁸ *Id.*

⁷⁹ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Section 7, Paragraph 11).

⁸⁰ See *e.g.* Ltr. Rul. 199908002

⁸¹ See *e.g.* Ltr. Rul. 9110016.

⁸² Ltr. Rul. 199936031.

under Section 672(b). The IRS ruled that the grantor was the owner of the trust under Section 674(a). The IRS did point out that the exception to Section 674(a) under Section 674(c) does not include a power held by non-adverse parties to add to the beneficiaries who are entitled to receive trust corpus.

C. Using Appreciated Property to Pay Charity

1. The grantor trust rules have been described as, for income tax purposes, treating the grantor as if the grantor owned such property. While this is a simple rule of thumb, there are a number of instances where that is not the case. The most important is the tax treatment of distributions of appreciated property in-kind to satisfy a charitable payment in a grantor CLAT.

2. 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. Citing Revenue Ruling 83-75,⁸³ 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.”⁸⁴

3. Surprisingly, with respect to grantor CLATs, the IRS also takes the same position, notwithstanding the fact that if the grantor “owned” the appreciated property and gave the same property charity (whether in satisfaction of an enforceable pledge or not), no capital gain would be triggered and the grantor would be entitled to a charitable income tax deduction.⁸⁵

a. 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. This was because the trustees of the CLAT proposed to satisfy the annual payment requirement with appreciated securities, rather than paying from income. 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.”⁸⁶ The IRS cited, as support for its position, *Kenan v. Commissioner*⁸⁷ (which dealt with the satisfaction of a non-charitable beneficiary’s interest in trust assets) and two revenue rulings,⁸⁸ one of which dealt with a non-grantor CLAT and the other being its own promulgated inter-vivos CLAT form.

b. The IRS distinguished Revenue Ruling 55-410,⁸⁹ 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,” 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. Finally, the IRS pointed out that the grantor received a charitable deduction when the CLAT was created and before any annuity payments

⁸³ Rev. Rul. 83-75, 1983-1 C.B. 114.

⁸⁴ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4).

⁸⁵ See generally §§ 170(a) and (e).

⁸⁶ Substitution power of administration under § 674(5).

⁸⁷ 114 F.2d 217 (2d Cir. 1940).

⁸⁸ Rev. Rul. 83-75, 1983-1 C.B. 114 and Rev. Proc. 2007-45, 2007-29, I.R.B. 89.

⁸⁹ Rev. Rul. 55-410, 1955-1 C.B. 297.

were made to the charity, but an individual would not be entitled to a charitable deduction upon making a pledge to charity. As a result, the IRS ruled that grantor would recognize gain on the distribution of appreciated securities in satisfaction of the annuity amount.

c. In my opinion, the ruling is poorly decided. The supporting cites for the IRS's position are not on point in that they deal with non-charitable beneficiaries and non-grantor trusts. Moreover, enforceable pledges are, in fact, bona fide claims that can be enforced against the donor, and the fact that the grantor received a charitable deduction upon contribution is of no consequence here. The grantor was not claiming an additional charitable deduction for the payment to charity. Furthermore the perceived abuse of receiving an 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 Section 170(f)(2)(B), as discussed in more detail later in this outline. All of that being said, this is the IRS's position on the satisfaction of a charitable annuity in a grantor CLAT with appreciated assets.

D. Grantor to Non-Grantor Trust Status

1. Introduction

a. When a grantor either relinquishes the power that affords him or her grantor trust status or dies during the term of the CLAT, then the trust becomes a non-grantor trust.

b. Under those circumstances, two significant things must be considered:

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

2. Income Tax Consequences

a. 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.⁹⁰ Typically the simple relinquishment of grantor trust powers does not involve any consideration. As a result, 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),⁹¹ there should be no income tax consequences 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 Section 1015.

b. 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.⁹² Notwithstanding the foregoing, the IRS may take the position that the treatment should be the

⁹⁰ See Treas. Reg. § 1.1001-2(c), ex. 5, Rev. Rul. 77-402, 1977-2 C.B. 222, and Madorin v. Commissioner, 84 T.C. 667 (1985).

⁹¹ Treas. Reg. § 1.1001-2.

⁹² See Crane v. Commissioner, 331 U.S. 1 (1947), Rev. Rul. 73-183, 1973-1 C.B. 364, Blattmachr, Gans & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 96 J.

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 Section 1014 would seemingly apply.

c. In the unusual circumstance where a Non-Grantor CLAT is converted to a Grantor CLAT,⁹³ the conversion will not be considered a transfer for income tax purposes.⁹⁴

3. Recapture

a. 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.”⁹⁵

b. 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 is a grantor trust.

c. 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 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.”⁹⁶

d. As such, there remains the possibility that as long as amounts payable 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 little or no income becomes taxable to the grantor.

e. 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

Tax’n 149 (Sept. 2002), and Manning & Hesch, “Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements,” 24 Tax Mgmt. Estates, Gifts & Tr. J. 3 (1999).

⁹³ This would occur if there is an appointment of related or subordinate trustee to replace an independent trustee under § 674. There are other circumstances where this would occur but they would likely be considered self-dealing transaction under the private foundation rules.

⁹⁴ Ltr. Rul. 200923024.

⁹⁵ § 170(f)(2)(B).

⁹⁶ Treas. Reg. § 1.170A-6(c)(4). See Treas. Reg. § 1.170A-6(c)(5), ex. 3.

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 CLATs).

4. The Remaining Section 642(c) Deduction

a. 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 Section 642(c) deduction.⁹⁷

b. As such, recapture of the deduction under Section 170(f)(2)(B) is not a loss of the deduction. Rather, the deduction is converted to a charitable deduction under Section 642(c). In the case of a CLAT it may often produce a larger aggregate deduction than the original deduction. Take 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 \$14.8 million in deduction in the last year of the trust when it is a non-grantor trust.

c. 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 Section 642(c) deduction, with all of the limitations noted above but just as importantly, without any AGI threshold limitations at all. 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 that capital gain can be fully offset by the Section 642(c) deduction which is equal in value to the payment to charity.

5. Income Tax Planning: Grantor to Non-Grantor Trust Status

a. One of the significant benefits of contributing to a grantor CLAT is the resulting income tax deduction under section 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 section 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.

b. 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 section 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 section 642(c) deduction. Because this deduction is limited to the 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

⁹⁷ Treas. Reg. § 1.170A-6(c)(5), ex. 3, 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.”

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 \$604,842 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.

VII. PRIVATE FOUNDATION RULES

A. Generally

1. CLATS are split interest-trust, and as such, the Section 508(e) requirements must be satisfied and the governing instrument must prohibit the violation of the private foundation rules. In pertinent part the Code provides, “[i]n 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.”⁹⁸

2. If, however, the present value (as determined under Section 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 Section 4943 excess business holdings and Section 4944 jeopardy investments.⁹⁹

3. If the private foundation rules are violated, any of the following may result:
- a. Disallowance of income, estate or gift tax charitable deductions;¹⁰⁰ and
 - b. Imposition of excise taxes.¹⁰¹

B. Governing Instrument Language

1. Section 508(d)(2) provides “[n]o gift or bequest made to an organization shall be allowed as a deduction under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made... to ... a trust described in section 4947 in a taxable year for which it fails to meet”¹⁰² the governing instruments requirements of Section 508(e).

⁹⁸ § 4947(a)(2).

⁹⁹ § 4947(b)(3)(A); Treas. Regs. §§ 1.170A-6(c)(2)(i)(D), 20.2055-2(e)(2)(vi)(e), 25.2522(c)-3(c)(2)(vi)(e), and Rev. Rul. 88-82, 1988-2 C.B. 336.

¹⁰⁰ § 508(d)(2).

¹⁰¹ §§ 4941-4945.

¹⁰² § 508(d)(2)(A).

2. 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 Section 4942.

3. In addition to the foregoing, the governing instrument must prohibit the trust from:

- a. Engaging in self-dealing under Section 4941(d);
- b. Retaining excess business holdings under Section 4943(c);
- c. Making any jeopardy investments under Section 4944; and
- d. Making taxable expenditures under Section 4945(d).¹⁰³

C. Self-Dealing

1. Section 4941 imposes a series of excise taxes on amounts involved in an act of self-dealing and for the failure to correct the act.¹⁰⁴

2. An act of self-dealing includes, in pertinent part, the direct or indirect:

- a. Sale or exchange, or leasing, of property between a private foundation (CLAT) and a disqualified person;
- b. Lending of money or other extension of credit between a private foundation and a disqualified person;
- c. Furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- d. Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; and
- e. Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.¹⁰⁵

3. A “disqualified person,” in the context of CLATs, include:

- a. A “substantial contributor,”¹⁰⁶ which includes the creator of the trust 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

¹⁰³ 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 outline.

¹⁰⁴ §§ 4941(a) and 4941(b)

¹⁰⁵ § 4941(d)(1).

¹⁰⁶ § 4946(a)(1)(A).

the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person.”¹⁰⁷

b. A “foundation manager,”¹⁰⁸ which includes any officer, director, or trustee of a foundation or any individual having similar powers or responsibilities;¹⁰⁹ and

c. A “family member”¹¹⁰ 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.”¹¹¹

d. Trusts in which persons described above own more than 35% of the total beneficial interests.¹¹²

4. Notwithstanding the foregoing, these are not necessarily strictly applied. Section 4941(d)(2) provides:

a. The lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge and if the proceeds of the loan are used exclusively for the exempt purpose;¹¹³

b. The furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for the exempt purpose;¹¹⁴

c. The furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;¹¹⁵

d. The payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive;¹¹⁶

e. Any transaction between a private foundation and a corporation which is a disqualified person, pursuant to any liquidation, merger, redemption, recapitalization, or other corporate

¹⁰⁷ § 507(d)(2)(A).

¹⁰⁸ § 4946(a)(1)(B).

¹⁰⁹ § 4946(b)(1).

¹¹⁰ § 4946(a)(1)(D).

¹¹¹ § 4946(d).

¹¹² § 4946(a)(1)(G). Beneficial interest is determined in accordance with the attribution rules under § 267(d). *See* § 4946(a)(4).

¹¹³ § 4941(d)(2)(B).

¹¹⁴ § 4941(d)(2)(C).

¹¹⁵ § 4941(d)(2)(D).

¹¹⁶ § 4941(d)(2)(E).

adjustment, organization, or reorganization, shall not be an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.¹¹⁷

5. The reasonable and necessary compensation exception above allows for the grantor of a CLAT to act as trustee and to receive compensation for those services. In addition, the IRS has ruled that it is not an act of self-dealing for the payment of fees to an investment management company owned by the owner's descendants.¹¹⁸

6. In addition to the foregoing, the Treasury Regulations 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).¹¹⁹ This 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.¹²⁰

D. Excess Business Holdings

1. Section 4943 imposes an excise tax on the value of the "excess business holdings" of a private foundation.

2. 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.¹²¹ For unincorporated entities like partnerships and limited liability companies, the percentage ownership requirement is replaced with profits, capital and beneficial interest concepts.¹²²

3. Business Enterprise Defined

a. 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 Section 513 of the Code.¹²³

b. A business that derives more than 95% of its gross income from "passive sources" will not constitute a "business enterprise" within the meaning of Section 4943, and a foundation's investment in such an entity will not constitute a "business holding."¹²⁴ Gross income from passive sources include dividends, interest, payments with respect to securities loans and annuities, royalties,

¹¹⁷ § 4941(d)(2)(F).

¹¹⁸ Ltr. Rul. 200018062.

¹¹⁹ Treas. Regs. § 53.4941(d)-1(b)(3).

¹²⁰ Ltr. Rul. 200124029 and Ltr. Rul. 200024052.

¹²¹ § 4943(c)(2)(A).

¹²² Treas. Regs. § 53.4943-3(c).

¹²³ Treas. Regs. § 53.4943-10(a)(1).

¹²⁴ § 4943(d)(3)(b).

whether measured by production or by gross or taxable income from the property in question, rents, gain from the sale or exchange of property (other than inventory or stock in trade).¹²⁵

4. Generally, where a private foundation acquires excess business, the foundation has five years from the date it acquires such holdings to dispose of them in order to avoid the imposition of the excise tax.

E. Jeopardy Investments

1. 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 determined 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).”¹²⁶ 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.¹²⁷

2. 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” require close scrutiny.¹²⁸

3. Importantly, the Treasury Regulations provide, “Section 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.”¹²⁹

4. 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.

¹²⁵ § 4943(d)(3) and § 512(b)(1), (2), (3) and (5) with certain modifications.

¹²⁶ Treas. Reg. § 53.4944-1(a)(2)(i).

¹²⁷ See e.g., Tech. Adv. Memos 9205001 and 9627001 and Ltr. Rul. 9451067.

¹²⁸ Treas. Reg. § 53.4944-1(a)(2)(i).

¹²⁹ Treas. Reg. § 53.4944-1(a)(2)(ii)(a).

VIII. INVESTMENT IMPLICATIONS AND INTERESTING APPLICATIONS

A. Generally

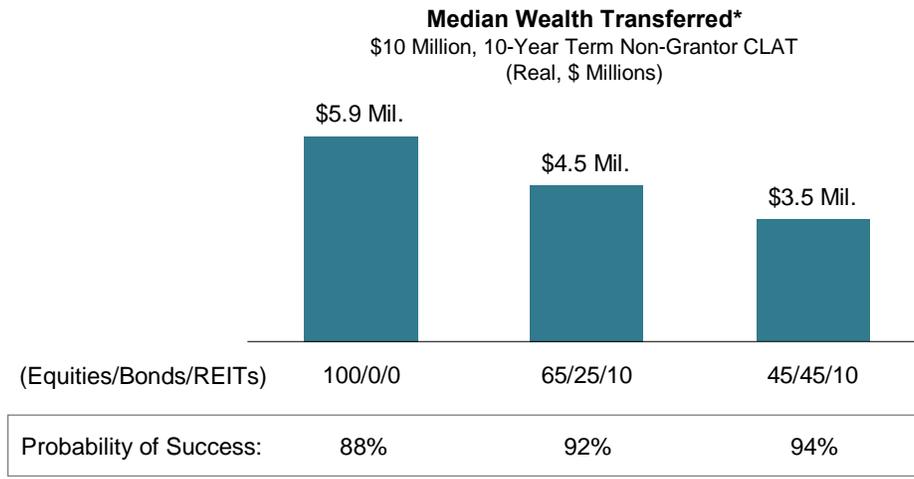
1. CLTs do not have the same restrictions on investments as CRTs. Under the Treasury Regulations, “[a] trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.”¹³⁰ This restriction is not applicable to CLTs. 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.”¹³¹ 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 income tax deduction should be limited to a lesser amount than would be calculated under Section 7520. The examples do not focus on situations involving the investments of the trust. Notwithstanding that fact, because this test is based upon the “all the conditions and circumstances” it could conceivably be used to limit or disallow the charitable income and transfer tax deduction. For example, if the trust required the trustee to only invest in deferred annuities that had a return less than the Section 7520, then it is quite possible the tax deduction would be reduced using the lower discount rate of return of the deferred annuities.

2. From an investment standpoint, the ability to back-load the annuity payments in a CLAT allows the trustee to invest in higher volatility (and hopefully higher returning) asset classes and strategies. Because failure with a CLAT is so unforgiving, with a traditionally structured CLAT, the trustee had to balance the competing interests of lower volatility portfolios that had higher probabilities of success but lower return potential against higher volatility portfolios that had had lower probabilities of success but higher return potential. With a sufficiently long term and a deferral of the bulk of the charitable payments to the end of the term, the trustee does not have to be as concerned with volatility, particularly at the beginning of the term. As the following 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.

¹³⁰ Treas. Reg. § 1.664-1(a)(3). See Ltr. Rul. 7802037 where a charitable income tax deduction was denied because the trust document required the trustee to invest in tax exempt securities.

¹³¹ Treas. Reg. §§ 1.170A-6(c)(3)(iii), 20.2055-2(f)(2)(iv), and 25.2522(c)-3(d)(2)(iv).

Higher Probabilities of Success at the Cost of Potential Wealth Transfer

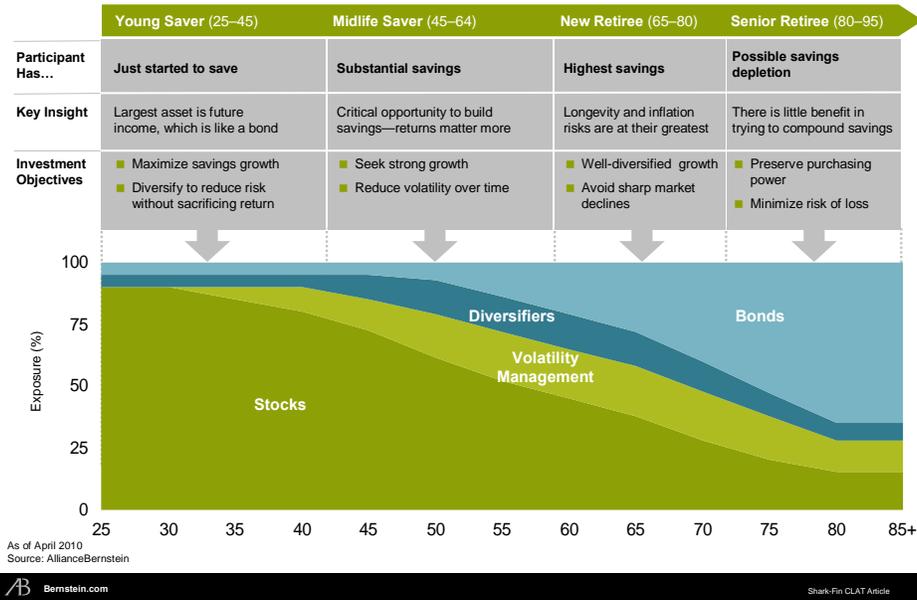


*Median inflation-adjusted non-grantor CLAT remainder assuming \$10 million zeroed-out 10-year CLAT funded at the December 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >\$0. Equities defined as 35% US Value, 35% US Growth, 25% Developed International and 5% emerging markets. Bonds are intermediate term taxable bonds.

3. The foregoing is 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 pointed out above, higher probabilities of success and higher potential wealth transfer can best be achieved by back-loading the annuities in some manner.

4. One logical investment implication with back-loaded payments is a concept called “glide path” investing that is common in retirement and educational funding planning (Section 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 from it (living expenses, tuition, etc.). As the theory goes, the more time a portfolio has to be invested without any outlays, the more volatile the portfolio can be. Thus, over time, as one gets closer to the outlays, depending on the size of the expenses, tuition payments or annuities to charity, the more diversified the portfolio should become, as the following chart on retirement glide path investing shows:

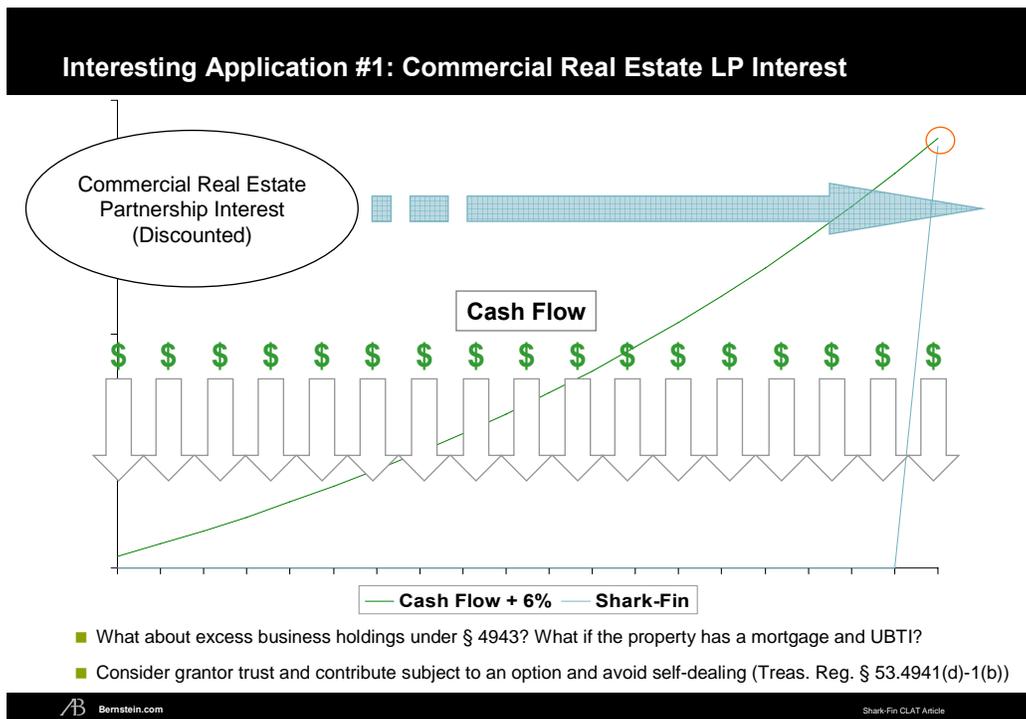
Glide Path Design: Determined by Life Stage Circumstances and Objectives



5. In addition to the foregoing, the flexibility to back-load the annuity payments in a CLAT provides a new window of opportunity for planners to contribute certain types of assets and do certain types of planning that historically were not practical. This was because the nature of the assets were such that requiring a mandatory payment each year put the asset at risk to either having to be sold or transferred to charity at a time when the asset had no liquidity or very little value.

6. 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.

B. FLP Interests Holding Commercial Real Property



1. Interests in family limited partnerships and LLCs (collectively, “FLPs”) that held commercial real property, in years past, were poor candidates to contribute to CLATs. What worried many planners is that cash flows from the property might fall (as they’ve done rather precipitously over the last 3 years since the 2007 global credit crisis ensued) and there would be insufficient cash to make the annuity payment. The choices at that point were rather 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.¹³²

2. Now, with the apparent ability to back-load the charitable payments, along with very low Section 7520 Rates, interests in FLPs are suddenly candidates for contribution to CLATs. With small payments at the outset of the CLAT term, cash flows from the real property and distributed into the CLAT can accumulate and compound on themselves, providing significant cushion for the larger payments to charity toward the end of the term. Given that CLATs do not have the same type of mortality risk that GRATs do, terms on CLATs can be very long and given a sufficiently long term, it’s highly likely that there will be sufficient cash or liquid securities to satisfy the large charitable payments toward the end of the term.

3. One private foundation rule concern specific to commercial real property is the existence of debt. In general, a grantor can transfer mortgaged property to a charitable lead trust. If, however, the mortgage was acquired immediately prior to the transfer, unrelated business taxable income problems may arise.

¹³² The latter might be considered acquisition indebtedness and thus debt-financed income if the borrowing is seen as “reasonably foreseeable” at the time the property is acquired by the trust. Treas. Reg. § 1.514(c)-1(a)(1)(iii).

a. Private Letter Ruling 7808067 is instructive. In this ruling, real property subject to a mortgage was transferred to CLAT. The IRS ruled that there was no acquisition indebtedness for purposes of determining whether the trust had debt-financed income under the unrelated business taxable income rules because the mortgage had been placed on the property more than 10 years prior to the transfer. Interest on the mortgage, depreciation, amortization of leasehold, commissions, management, 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. 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). The IRS also ruled that the jeopardy investment provisions were not violated by holding the real estate.

b. Keep in mind, with respect to debt-financed income, as mentioned in the private foundation rules portion of this outline, the existence of UBTI if the CLAT is a grantor trust is of no consequence. If, however, the grantor dies during the term of the CLAT, the trust will become a non-grantor trust and at that point the existence of UBTI should be addressed. As mentioned above, this will reduce the otherwise allowable deduction under Section 642(c), which may not be of much consequence. However, if the CLAT wishes to dispose of the investment, planners should consider contributing the interests in the FLP subject to an option to be purchased from the CLAT at fair market value. The Treasury Regulations provide that under the right terms, this purchase from the CLAT by a disqualified person (like the estate of the grantor) will not be considered an act of self-dealing.¹³³

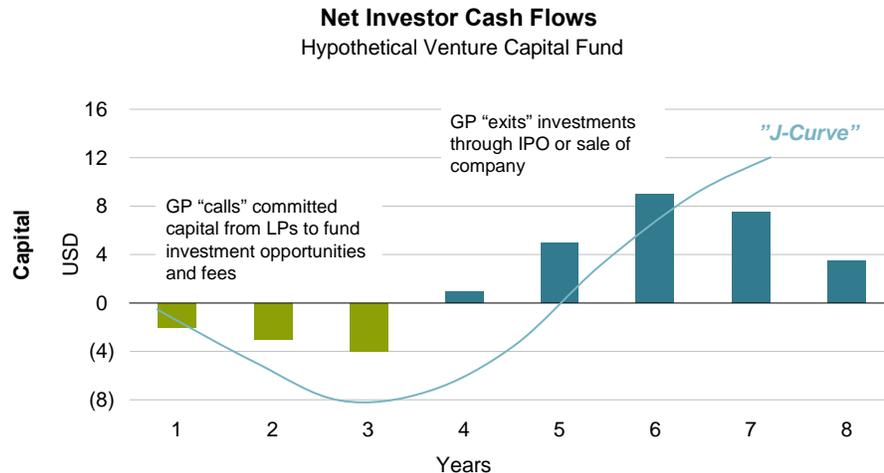
c. Also, remember, if property is encumbered by debt exceeding the grantor's basis in the property, there will be recognition of gain.¹³⁴ Furthermore, as mentioned in the intentionally defective grantor trust section above, the change from grantor to non-grantor trust status when a debt encumbering property exceeds the trust's basis will also cause recognition of gain to the grantor.

¹³³ 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."

¹³⁴ Treas. Reg. § 1.1001-2.

C. Private Equity Interests

Interesting Application #2: Private Equity Investments



AB Bernstein.com

Shark-Fin CLAT Article

1. Private equity investments, in particular venture capital investments, commonly have no liquidity or value at the outset of the investment. This is due in part to the nature of the underlying investment and due to the fact that these are commonly offered through a fund that 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, hopefully, appreciating far above the original investment (through sale of the company, IPO or other liquidity event).

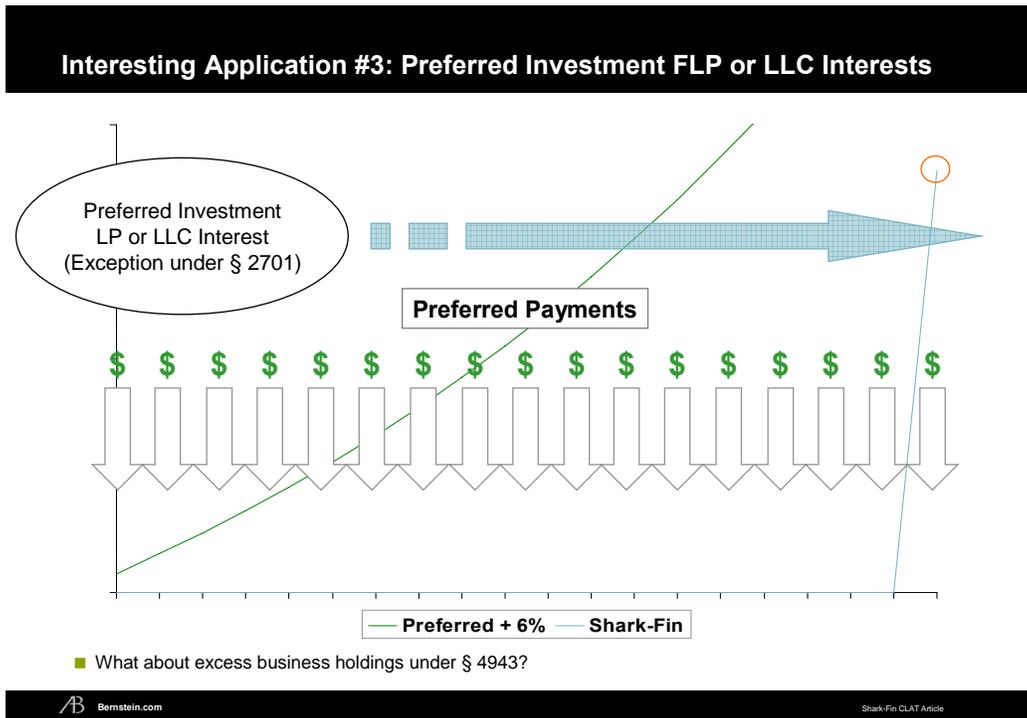
2. Private equity investments, which in years past were not candidates for CLATs, can now be contributed to a Shark-Fin or other back-loaded annuity CLAT so the charitable payments can be matched to when the private equity investment is expected to have liquidity and value.

3. 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 probably fail, which is common to this particular type investment. Assuming the CLAT is not being used to satisfy enforceable charitable pledges of the grantor, the failure of the CLATs should not have adverse consequences to the grantor. The thought here is by separating these investments, the spectacular returns of a few of them would 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.

4. Under any circumstance where private equity investments are the sole asset of the CLAT, one must be concerned about the jeopardy investment rules, as discussed above. As mentioned above, the gratuitous transfer of a speculative investment to a CLAT is not considered a jeopardizing investment.¹³⁵

¹³⁵ Treas. Reg. § 53.4944-1(a)(2)(ii)(a).

D. Preferred Investment FLP Interests



1. The contribution of preferred interests in an FLP holding investment securities is a prime candidate for contribution to a back-loaded CLAT. Anytime, however, a preferred interest in an FLP is created or transferred, Section 2701 must be considered. There are a myriad of ways that Section 2701 can be implicated and a full discussion is beyond the scope of this outline, but here's an example of how this type of planning can be accomplished.

2. First, assume a grantor creates an investment partnership with \$20 million of cash and diversified liquid securities. The contribution of those assets will not be a taxable event for income tax purposes¹³⁶ or for transfer tax purposes because the grantor receives back 100% of the partnership interests.

3. Second, the grantor recapitalizes the investment partnership into preferred and common shares, initially retaining 100% of the preferred and the common. This is not a taxable event. For transfer tax purposes, this qualifies under the "vertical slice exception"¹³⁷ of Section 2701 and as such does not cause a taxable gift.

4. Third, the grantor structures the preferred interest with a \$10 million liquidation preference and having a preferred yield determined according to the factors set out in Revenue Ruling 83-120.¹³⁸

¹³⁶ See §§ 721(e) and 351(b).

¹³⁷ Treas. Reg. § 25.2701-1(c)(4).

¹³⁸ Rev. Rul. 83-120, 1983-2 C.B. 170.

a. Many commentators¹³⁹ and the Service in rulings¹⁴⁰ have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120, pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for valuing preferred interests, based upon 3 primary factors:¹⁴¹ yield, preferred payment coverage and protection of the liquidation preference. For purposes of this discussion, assume the preferred payment coverage and protection of the liquidation preference are satisfactory, since we are dealing with only \$10 million liquidation preference in an investment partnership with \$20 million of liquid assets.

b. This leaves yield to be determined. Yield of the preferred interest is compared against with the dividend yield of “high-grade, publicly traded preferred stock.” The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that “[i]f the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock.”¹⁴²

c. Today, publicly-traded preferred stock yields have increased dramatically because the vast majority of the market is in the worst performing sectors over the last 3 years since the global credit crisis ensued, namely, financial services, commercial real estate and oil, gas and other commodities. As a result, today, yields on preferred stocks are significantly higher than the Section 7520 Rate (some in the double digit percentages).

d. Assume for this illustration that it is determined that the preferred interest should yield 8% or \$800,000 per year against the \$10 million liquidation preference.

5. Fourth, the grantor gifts his or her entire 8% \$10 million preferred interest to a Shark-Fin or other back-loaded CLAT. The gift of the preferred qualifies for the “junior equity interest exception”¹⁴³ to Section 2701. As an exception, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. Assume that the gift of the preferred FLP interest is entitled to a 20% valuation discount. Now, the gift of the 8% \$10 million preferred interest, which was worth \$10 million before the discount, now has a gift tax value of \$8 million. This increases the effective yield on the preferred interest from 8% to 10%.

6. Finally, the math and the leverage is quite simple. The grantor has made an \$8 million gift that has an effective guaranteed return of 10%, which is being contributed to a CLAT that has an internal rate of return equal to the Section 7520 Rate of 2.0%. It guarantees an arbitrage of 8.0 % 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 cash or in-kind) will continue to stay in the CLAT, further compounding for the remainder of the term.

¹³⁹ See, e.g., Hatcher and Manigault, “Warming Up to the Freeze Partnership,” *Estate & Personal Financial Planning* (June 2000).

¹⁴⁰ See, e.g., Ltr. Rul. 9324018.

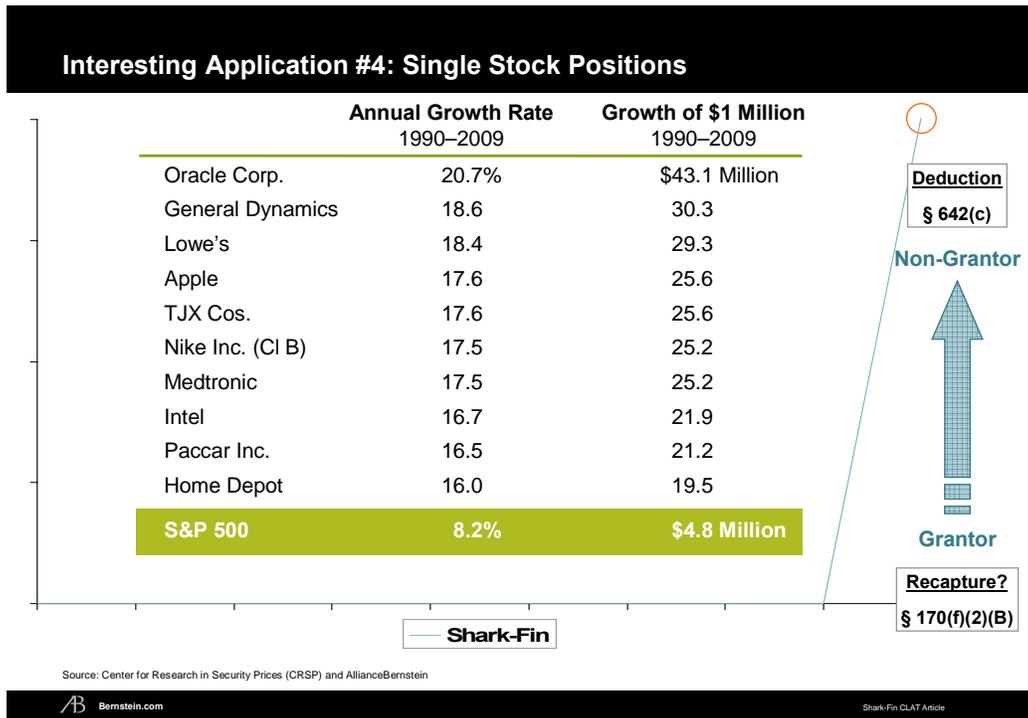
¹⁴¹ The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

¹⁴² Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

¹⁴³ § 2701(c)(1)(B)(i) and Treas. Reg. § 25.2701-2(b)(3)(i).

7. Based on Bernstein's Wealth Forecasting Model and a grantor Shark-Fin CLAT providing for \$1,000 payment for 19 years and a \$11.2 million payment in the 20th year,¹⁴⁴ the median value¹⁴⁵ 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 \$25.8 million, plus the remainder beneficiaries will receive a preferred interest in the FLP with \$10 million of liquidation preference and an 8% yield.

E. Single-Stock or Concentrated Stock Positions



1. 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 disbelief that a diversified portfolio will 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.¹⁴⁶ However, the only economic benefit to the grantor (and the grantor's family) is the tax savings resulting from the charitable income tax deduction.

2. 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." Said 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. The issue is

¹⁴⁴ Based upon the applicable annuity and remainder factors from Table S at a section 7520 rate of 1.8%.

¹⁴⁵ As with all of the figures in this outline, we assumed globally diversified equities.

¹⁴⁶ § 170(e)(5).

how to effectively transfer the concentrated stock position to the next generation (and perhaps, also to charity).

3. A back-loaded CLAT 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 the fixed payments to charity will not lock-in the losses of the stock when it has negative volatility. Also, with a Section 7520 Rate as low as it is today at 2.0%, a grantor may be able contribute a stock whose dividend alone already exceeds the Section 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 Section 7520 Rate return can theoretically be covered by the dividend yield alone.

4. One critical issue to consider is whether a Non-Grantor CLAT or a Grantor CLAT should be utilized.

a. 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 one used the 20 year Shark-Fin, long-term capital gain would be triggered in the 20th year equal to the \$14.8 million minus the total dividends paid on the stock (originally \$10 million) and any compounded earnings on those dividends. The \$10 million up-front 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 decent 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 avoid recognizing capital gain, given the dire penalties for self-dealing (sale or exchange between a private foundation and a disqualified person¹⁴⁷), it may not be practical to do so.

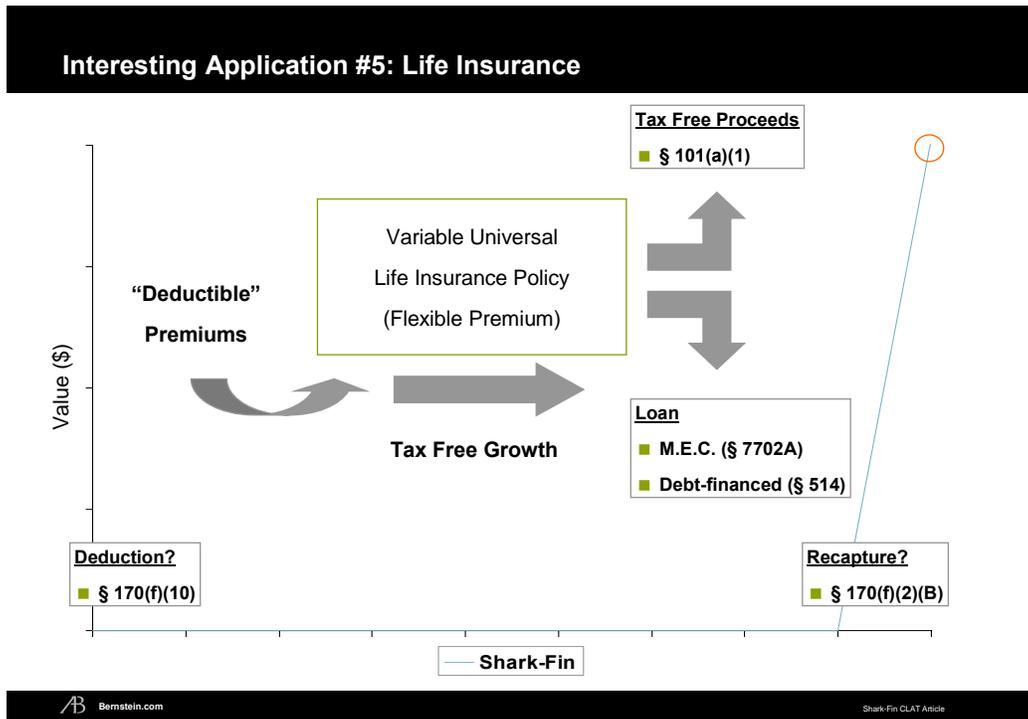
b. Given the foregoing grantor trust liability, for concentrated stock positions, perhaps a better option is to utilize a Non-Grantor CLAT. It will not result in an income tax deduction to the grantor, but because the Section 642(c) charitable deduction is not limited by a percentage of contribution 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 Section 642(c) deduction.

c. One interesting planning option is to initially 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 Section 170(f)(2)(B) equal to the original deduction amount minus the discounted value of the dividends declared on the stock and

¹⁴⁷ § 4941(d)(1).

the tax on the reinvestment of the dividends, but as discussed above, recapture is not as dire as it might seem. More importantly, now that the CLAT is a non-grantor trust, any resulting gain from the payment in-kind to in the last year or years will be fully sheltered by the charitable deduction (\$14.8 million in the 20th year in the Shark-Fin example).

F. Life Insurance



1. Introduction

a. A planning idea that has surfaced utilizes the “intentionally defective” Shark-Fin CLAT structure in conjunction with the purchase of a life insurance contract (one with an internal account like a universal, variable or whole life policy) on the life of the grantor. The hope is it will provide income tax deduction under Section 170(a) to the grantor upon funding of the CLAT, but because all or a portion of the contributed assets are now growing inside the policy, very little or no grantor trust liability will result over the term of the grantor CLAT (one of the perceived disadvantages of the grantor CLAT structure but interestingly grantor trust status never seemed a problem with a GRAT or an installment sale to an IDGT).

b. A full discussion of the technique is beyond the scope of this outline, but getting a personal income tax deduction, little or no grantor trust liability, no recapture of the deduction upon the end of the term of the CLAT and a life insurance policy transferred out of the estate of the grantor is theoretically possible. However, planners must be wary of a number of technical issues including the modified endowment contract rules under Section 7702A, the charitable split-dollar rules under Section 170(f)(10), the recapture rules and the private foundation rules (as discussed in more detail above).

2. Basics of the Plan

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

b. 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 pay up the policy but without causing the policy to be a modified endowment contract under Section 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. For purposes of this example, let’s assume the premiums purchase \$60 million in death benefit.

c. The trustee then lets the assets grow inside the policy for the remainder of the 20 year term. Effectively what you have created is \$10 millions of personal income tax deduction, which is equal to the premiums paid, and no grantor trust liability.

d. 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.

e. 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 Section 101(a)(1), which is more than enough to pay charity the \$14.8 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 Section 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 Section 2053.

(3) In most circumstances, from an economic standpoint, the family is better off if the grantor dies during the term (although the grantor is not too fond of being dead).

f. In the more likely event 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 \$14.8 million, the trustee takes \$14.8 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 \$4.8 million. Both of these are non-taxable from an income tax standpoint because the policy is not a modified endowment contract. Trustee pays charity \$14.8 million.

(2) It is highly likely that even after withdrawing \$14.8 million of funds from the policy, there is still significant net cash value in the policy. The assets have been growing tax free, and if those assets are invested in globally diversified equities, the median amount after all payments to charity and after-inflation will be \$28.5 million. Of course, that figure does not 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).

(3) This policy now passes to the remainder beneficiaries who can:

(a) 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;

(b) 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

(c) Reduce the death benefit to, say, \$40 million and have a fully paid up policy on which no additional premiums will be paid.

(4) It is likely that upon termination there is no recapture of the income tax deduction under Section 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." If the grantor CLAT ceases and then passes 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.

(5) In all, at least in theory, what this plan has created is \$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.

g. 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 (mortality). 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 outline, 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).

h. 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 with grantor CLATs. It bears reminding that pursuant to Revenue Procedure 2010-3,¹⁴⁸ the IRS has stated that 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."¹⁴⁹

i. The IRS has ruled that under certain circumstances an investment in life insurance will be considered a jeopardy investment under the private foundation rules.¹⁵⁰

¹⁴⁸ Rev. Proc. 2010-3, 2010-1 I.R.B. 110.

¹⁴⁹ *Id.* at § 3.01(54).

¹⁵⁰ Rev. Rul. 80-133, 1980-1 C.B. 258. *But see* Ltr. Rul. 8134114 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

j. One of the primary sticking points is to what extent the “charitable split-dollar rules” of Section 170(f)(10) are deemed to apply under these circumstances.

3. Charitable Split-Dollar Rules

a. 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”¹⁵¹

(1) “The organization directly or indirectly pays, or has previously paid, any premium on any personal benefit contract with respect to the transferor, or”¹⁵²

(2) “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.”¹⁵³

b. 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.”¹⁵⁴ 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.”¹⁵⁵

c. There is an exception for certain life insurance contracts held by charitable remainder trusts but not for CLTs.¹⁵⁶

d. A CLAT is not an organization described in Section 170(c), so Section 170(f)(10)(A)(i) is not applicable. However, I think Section 170(f)(10)(A)(ii) is more problematic.

(1) 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.

(2) 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 beneficiary 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 Section 7520 (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

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.

¹⁵¹ § 170(f)(10)(A).

¹⁵² § 170(f)(10)(A)(i).

¹⁵³ § 170(f)(10)(A)(ii).

¹⁵⁴ § 170(f)(10)(B).

¹⁵⁵ § 170(f)(10)(H).

¹⁵⁶ §§ 170(f)(10)(C) and (E).

contract would only benefit charity. Finally, it seems clear that the charitable split-dollar rules were not intended to apply to this situation. Indeed, the legislative history to Section 170(f)(10) indicates that such Section was designed to stop charitable split-dollar arrangements that provide little benefit to charity.¹⁵⁷

e. 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 Section 170(f)(10)(A)(ii) would not be applicable. That is 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 includible in the estate of the transferor for 3 years following the transfer.¹⁵⁸

f. 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.¹⁵⁹ The excise tax is imposed upon a Section 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.”¹⁶⁰

g. 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.

IX. CONCLUSION

A. With Section 7520 Rates as low as they are today, the back-loaded CLAT, whether a Shark-Fin or not, seems to be a valid planning technique that can, from a wealth transfer standpoint, compete against the more popular sales to IDGTs and GRATs with significant advantages over both of those vehicles.

B. The Internal Revenue Code assumes that any asset contributed to a CLAT will have a total return equal to the section 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 government assumes the excess accumulation is zero the grantor makes no gift to the children.

C. 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.

¹⁵⁷ S. Rep. No. 120, 106th Cong., 1st Sess. 206–207.

¹⁵⁸ § 2035(a)(2).

¹⁵⁹ § 170(f)(10)(F).

¹⁶⁰ § 170(f)(10)(F)(ii).

D. 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 in years past were not 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 provide significant cushion 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 more easily manage volatility in the portfolio, which hopefully results in higher overall returns over the term of the CLAT.

E. Concerns about back-loaded CLATs on policy grounds are misplaced. If the section 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 section 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 section 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 1.8% may not be achieved in certain investment environments even over a long period of time.

F. 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.

G. Because the value of the grantor's gift is determined using the section 7520 rate in effect when the CLAT is created, doing so when the rate is low is more efficient than when it is high. As of this writing the lowest the rate has ever been is 2%, which is also the current rate. Thus creating CLATs now rather than waiting until the grantor dies is desirable.

H. 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 section 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 section 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.

I. Careful estate planners and planned giving officers should consider how this technique, in both its grantor and non-grantor trust forms, can be used to maximize their clients' wealth transfer and charitable goals.

**APPENDIX:
NOTES ON THE WEALTH FORECASTING SYSTEM**

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	4.5%	4.8%	5.1%	1.0%	9.6%
Int.-Term Diversified Municipals	3.5	3.8	3.6	4.5	7.5
Int.-Term Taxables	4.5	4.8	5.7	4.8	8.7
US Value	9.5	11.0	3.8	21.8	14.7
US Growth	9.1	11.1	2.3	24.8	15.7
Developed International	9.8	12.1	3.6	26.3	16.9
Emerging Markets	7.9	11.9	3.0	35.9	25.6
Inflation	2.6	2.9	n/a	1.3	9.4

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 30-year periods.
Reflects Bernstein's estimates, and the capital market conditions of June 30, 2010.



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1. Purpose and Description of Wealth Forecasting Analysis: Bernstein's Wealth Forecasting Analysis is designed to assist investors in making long-term investment decisions regarding their allocation of investments among categories of financial assets. Our new 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 his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, and how different asset allocations might impact his/her long-term security; (3) The Capital-Markets Engine: Our proprietary model, which uses our research and historical data to create a vast range of market returns, 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.

2. 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 allocation will be maintained reasonably close to its target. 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/her personal portfolio and entirely of stocks in his/her 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

3. **Modeled Asset Classes:** The following assets or indexes were used in this analysis to represent the various model classes: U.S. Value (S&P/Barra Value Index, 15% annual turnover), U.S. Growth (S&P/Barra Growth Index, 15% annual turnover), Developed International (MSCI EAFE Unhedged, 15% annual turnover) and Emerging Markets (MSCI Emerging Markets Index, 20% annual turnover).

4. **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 Capital Markets Projections page at the end of these Notes. 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 28.8%. 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 the volatility of fixed income assets is different for different time periods.

5. **Technical Assumptions:** Bernstein's Wealth Forecasting System 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 that summarize the current condition of the capital markets as of June 30, 2010. Therefore, the first 12-month period of simulated returns represents the period from June 30, 2010 through June 30, 2011, and not necessarily the calendar year of 2010. A description of these technical assumptions is available on request.

6. **Tax Rates:** The federal income tax rate represents Bernstein's estimate of either the top marginal tax bracket or an "average" rate calculated based upon the marginal-rate schedule. The federal capital gains tax rate is represented by the lesser of the top marginal income tax bracket or the current cap on capital gains for an individual or corporation, as applicable. Federal tax rates are blended with applicable state tax rates by including, among other things, federal deductions for state income and capital gains taxes. The state tax rate generally represents Bernstein's estimate of the top marginal rate, if applicable. The Wealth Forecasting System uses the following top marginal tax rates unless otherwise stated: In 2010, a federal income tax rate of 35% and a federal capital gains tax rate of 15%. For 2011 and beyond, the federal income tax rate becomes 39.6% and the federal capital gains tax rate becomes 20%.

7. **Intentionally Defective Grantor Trusts (IDGTs):** The Intentionally Defective Grantor Trust (IDGT) is modeled as an irrevocable trust whose assets are treated as the grantor's for income tax purposes, but not for gift or estate tax purposes. Some income- and transfer-tax consequences associated with transfers to and the operation of an IDGT remain uncertain, and the strategy may be subject to challenge by the IRS. Hence, this technique requires substantial guidance from tax and legal

advisors. The grantor may give assets to the trust, which will require using gift tax exemptions or exclusions, or paying gift taxes. The IDGT is modeled with one or more current beneficiaries, and one or more remainder beneficiaries. Distributions to the current beneficiaries are not required, but the system permits the user to structure annual distributions in a number of different ways, including 1) an amount or a percentage of fiduciary accounting income (FAI) (which may be defined to include some or all realized capital gains); 2) FAI plus some principal, expressed either as a percentage of trust assets or as a dollar amount; 3) An annuity, or fixed dollar amount, which may be increased annually by inflation, or by a fixed percentage; 4) A unitrust, or annual payment of a percentage of trust assets, based on the trust's value at the beginning of the year, or average over multiple years; or 5) any combination of the above four payout methods. Because the IDGT is modeled as a grantor trust, the system calculates all taxes on income and realized capital gains that occur in the IDGT portfolio each year, based on the grantor's tax rates and other income, and pays them from the grantor's personal portfolio. The IDGT may continue for the duration of the analysis, or the trust assets may be distributed in cash or in kind at a specific point in time or periodically to (1) a non-modeled recipient, (2) a taxable trust, or (3) a taxable portfolio for someone other than the grantor. If applicable, an installment sale to an IDGT may be modeled as a user-entered initial 'seed' gift followed by a sale of additional assets to the trust. The system will use one of two methods to repay the value of the sale assets plus interest (less any user-specified discount to the grantor): 1) user-defined payback schedule, or 2) annual interest-only payments at the applicable federal rate (AFR) appropriate for the month of sale and the term of the installment note, with a balloon payment of principal plus any unpaid interest at the end of the specified term.

8. **Grantor Retained Annuity Trusts:** The Grantor Retained Annuity Trust (GRAT) is a wealth transfer vehicle which receives its initial funding from the grantor and transfers annuity payments to the grantor's personal portfolio each year. The annuity amounts, which are determined in advance, may be fixed (the same amount each year) or increasing (growing each year by no more than 20% of the previous year's amount). The annuity payment is made first from available cash, and then from other portfolio assets in kind. Because the GRAT is modeled as a grantor trust, the system calculates all taxes on income and realized capital gains that occur in the GRAT portfolio each year, based on the grantor's tax rates and other income, and pays them from the grantor's personal portfolio. When the GRAT term ends, the remainder, if any, may be transferred in cash or in kind (as the user specifies) to (1) a non-modeled recipient, (2) a continuing grantor trust, or (3) a taxable trust. If the remainder is transferred in kind, the assets will have carryover basis.

9. **Non-Grantor 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 variable (so long as the present value of the annuity is ascertainable at the time the trust is funded). 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 recipient(s). 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.