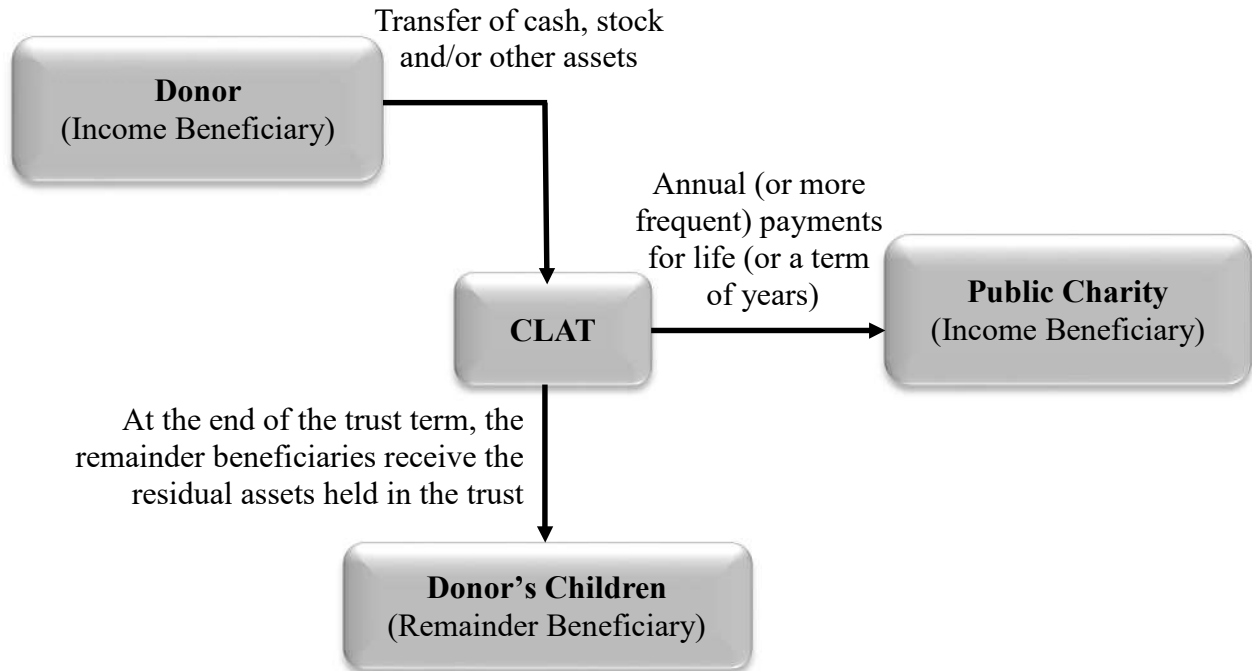


#17: Inter Vivos Charitable Lead Annuity Trust (CLAT)

An inter vivos charitable lead annuity trust (CLAT) is a split-interest trust created by a donor during the donor's life that pays an annuity to charity for a term of years or for the life of the donor or another individual. At the end of the term, any assets remaining in the trust pass to non-charitable remaindermen, generally the donor's children.



Gift Tax Benefits

CLATs for a term of years produce gift tax benefits in the same way as grantor retained annuity trusts (GRATs). The gift taxes can be zeroed out and if the assets produce a return in excess of the IRC § 7520 rate, value will remain in the trust to pass tax-free to the remaindermen at the end of the trust term.

Lifetime CLATs cannot be zeroed out, however, because of the exhausting corpus rule of Reg. § 20.7520(b)(2). The IRS valuation tables assume that the trust assets grow at the § 7520 rate. Thus, if the annuity payout exceeds the § 7520 rate, as it would if the payment was set to zero out the CLAT, the assets would be exhausted before they returned the full value of the annuity. To address this overvaluation issue, the regulations require that the annuity payments can be valued only up to the time the trust assets would run out, given the payout rate and the assumed growth at the § 7520 rate. The result of applying the exhausting corpus rule is that a lifetime CLAT will always produce a taxable gift. The older the donor, the larger the taxable gift will be. Nevertheless, lifetime CLATs can still produce very favorable gift tax results if the return on the trust assets substantially exceeds the IRC § 7520 rate.

Example 1. Taxpayer (T), age 61, transfers \$1,000,000 to a lifetime CLAT in November 2023 when the most favorable § 7520 rate available is 5.0%.⁵⁶ The CLAT pays an annual annuity of \$80,471 to charity. If not for the exhausting corpus rule, this payment would zero out the CLAT. Because of the rule, however, there is a taxable gift of \$120,846. Suppose that the CLAT produces a return of 10% and T dies 22 years later after reaching T's Table 2010 CM life expectancy. The amount left in the CLAT when T dies is \$2,394,424 and it passes to T's heirs with no further tax consequences. To provide T's heirs with the same value after 22 years from an outright gift of the same \$120,846, the transferred assets would have to grow at approximately 14.54%. Thus, the inter vivos CLAT provides substantial leverage if the § 7520 rate is favorable.

Advanced Gift Tax Applications

Lifetime CLATs as a Bet-to-Die Strategy. Reg. § 1.7520-3(b)(3) provides that taxpayers transferring interests in property can use the tables prescribed under IRC § 7520 unless the person who is the measuring life has an "incurable illness or other deteriorating physical condition, resulting in a 50-percent or greater chance of dying within one year." The regulations go on to state that if the person lives for at least eighteen months after the transfer, it creates a rebuttable presumption that the 50-percent test was satisfied.

This makes it possible for taxpayers with life expectancies of more than one year, but far less than the average life expectancy reflected in the IRS tables, to make large tax-free transfers.

Example 2. Assume the same facts as in Example 1 except that T is expected to live for only three years so the charity only receives three \$78,872 annuity payments before T dies. Again assuming a 10% growth rate, the value of the CLAT is \$1,064,641 at that time. Thus, T's heirs receive \$1,064,641 on a taxable gift of \$120,845. Assuming that T has no remaining applicable exclusion amount, the gift tax payable on that gift is \$48,338 (40% x \$120,845). Applying a 6% discount rate, the present value of the amount received by the heirs is \$893,893 as of the time of the gift. Thus, the effective gift tax rate on the transfer is only 5.416% ($\$48,338 / \$893,893$).

Shark Fin CLATs. The more that annuity payments in a lead annuity trust can be back loaded, the greater the tax-free transfer the trust will produce if the assets grow faster than the IRC § 7520 rate. Reg. § 25.2702-3(b)(1)(ii)(A) provides that GRAT payments cannot increase by more than 20% from one year to the next. There is no comparable limitation on CLATs. Therefore, several commentators recommend extremely back-loaded CLATs, commonly referred to as shark fin CLATs. It is not clear how these CLATs will be received by the IRS and the courts though.

T transfers \$1,000,000 to a zeroed out CLAT at a time when the most favorable IRC Section 7520 rate is 4.0%. Assume the trust produces a total return of 10%. With level annuity payments the

⁵⁶ A CLAT can use the § 7520 rate for the month of the transfer or the rate for either of the two previous months. The lower the § 7520 rate, the smaller the value of the remainder interest and the more favorable the transfer, the 2.0% rate is selected.

CLAT will produce a tax-free transfer of \$628,803. With 20% increasing payments the tax-free transfer increases to \$785,088. What would happen with maximum backloading-- a single payment at the end of the CLAT term. Given the 10% return the value of the trust assets would be \$2,593,742 after 10 years (\$1,000,000 appreciated at 10% for 10 years). The amount of the balloon payment at the end of the term would be \$1,480,244 (\$1,000,000 appreciated at 4% for 10 years). This would leave a tax-free transfer of \$1,113,498 (\$2,593,742 - \$1,480,244).

Income Tax Benefits

There are two kinds of CLATs for income tax purposes, **grantor CLATs** and **non-grantor CLATs**. With a grantor CLAT, the donor receives an income tax charitable deduction for the full present value of the lead interest at the time the trust is created. The donor then pays the trust's tax liability each year under the grantor trust rules.

A grantor CLAT increases the basic gift tax benefit of an inter vivos CLAT in two ways. First, payment of the CLAT's income tax produces an additional tax-free transfer to heirs. Second, the upfront deduction may be worth more than the later tax cost. The donor receives the deduction when the trust is created, but the tax on the trust's income is deferred. Moreover, the upfront deduction may offset ordinary income now, while the income the donor is taxed on later may be capital gains taxed at a lower rate. However, grantor CLATs are not helpful for reducing the 3.8% net investment income tax (NIIT) because all trust income is added to the donor's other income on his or her Form 1040.

With a non-grantor CLAT, the donor receives no income tax deduction when the trust is created. However, since the CLAT is a taxable entity, it receives an income tax charitable deduction under IRC § 642(c) as annuity payments are made to the charitable lead beneficiary. Thus, in effect, the CLAT is subject to income tax only on income in excess of the annuity payment amount.

Non-grantor CLATs can be used to reduce the 3.8% NIIT. Outright gifts to charity and transfers to charitable remainder trusts do not reduce the NIIT because they produce below-the-line deductions under IRC § 170 that do not reduce the donor's modified adjusted gross income (MAGI) or net investment income (NII). By contrast, non-grantor CLATs produce charitable deductions that can indirectly benefit the donor. When a CLAT makes its annual annuity or unitrust payments to the charitable lead beneficiary, the NII of the CLAT is reduced by the share of the § 642(c) deduction allocable to the NII distributed to the charity; thus, reducing the amount of NIIT on the CLAT. Consider the following comparison.

<u>Individual IRC § 170 Deduction</u>	
Wage Income	\$260,000
Interest Income	\$100,000
Dividend Income	<u>\$50,000</u>
MAGI	\$410,000
Less: Threshold Exemption	<u>(\$250,000)</u>

Subtotal	\$160,000
Lesser of Excess over Threshold or NII	<u>\$150,000</u>
NII Tax at 3.8%	<u>\$5,700</u>

Trust – IRC § 642 Deduction

Interest Income	\$100,000
Dividend Income	<u>\$50,000</u>
MAGI	\$150,000
Less: Charitable Deduction	<u>(\$150,000)</u>
AGI	\$0

NII Tax at 3.8%	<u>\$0</u>
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*Does not reflect the charitable limitations

Because the deduction leaves more in the trust to pass to the non-charitable remaindermen, it indirectly provides the donor with a charitable deduction against the NIIT.

Disclosures

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