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I. INTRODUCTION

Charitable Lead Trusts came into the lexicon of split interest trust involving charities as beneficiaries in the Tax Reform Act of 1969. Their initial usage was for income tax purposes to create a large charitable deduction in the year of inception and recognize the income over multiple years of the life of the lead interest. Over the years, planners have found other interesting uses of the Charitable Lead Trust, particularly during the last several years when interest rates have been greatly depressed. We will first go through the basics and then move on to examples of both inter vivos and testamentary planning techniques.

II. CHARITABLE LEAD TRUSTS - THE BASICS

A. A Charitable Lead Trust (“CLT”) is oftentimes referred to as the reverse of a Charitable Remainder Trust (“CRT”) because the annual payments of a CLT pass to charity with the remainder coming back to the family while a CRT pays out to the family during its term with the remainder passing to charity. This does a disservice to the CLT which, as we will see, is much more flexible than the CRT.

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

C. A CLT takes two basic forms: (1) a Charitable Lead Annuity Trust (“CLAT”); or (2) a Charitable Lead Unitrust (“CLUT”). From a planning perspective, these trusts can be established during lifetime or at death. If established during lifetime, they can be structured as either a grantor or a non-grantor CLT under which there will be differing income tax and charitable deduction consequences.

1. A grantor-CLT will produce an income tax charitable deduction in the year it is initially funded; however, as a grantor trust for tax purposes, the grantor must report the trust income annually during each year of its term. Furthermore, the percentage deduction limitation for transfers to the CLT will be considered a gift “for the use” of the charity rather than “to” the charity, resulting in the lower income tax percentage limitations of 30% (or even 20% if the trust is funded with long term capital gain property and the beneficiary is not a public charity). This technique is generally considered when the taxpayer has an unusually large income in a year where the

charitable deduction will produce a significant deduction and result in a shift of the deferred tax liability over the remaining term of the trust. Another income tax play - the non-grantor, non-qualified CLT is discussed below.

2. In the case of a non-grantor CLT, the trust is a separate taxpayer; however, unlike you and I, under Code § 642(c) it enjoys an unlimited charitable deduction in determining its taxable income.

D. A CLAT provides for the payment of a fixed dollar amount each year to one or more charitable lead beneficiaries, which sum may be stated as a percentage or fraction or formula for determining the fixed dollar amount determinable at the inception of the trust. There is no minimum payout required as in the case of a CRT. In addition, the actual amounts of the payments each year can vary so long as they are determinable at inception. (Treas. Reg. § 20.2055-2(e)(2)(vi) and PLR 9112009). The requirement of a "guaranteed annuity interest" will be satisfied as long as the payments are "determinable" at the inception of the CLT (for example, see, PLR 201216045). This feature will be discussed later when we look at the Shark Fin CLT.

1. It should be evident that in the case of a CLAT, the charitable interest does not benefit from any growth in the trust assets which growth all inures solely to the benefit of the remainder beneficiaries at the end of the trust term.

E. A CLUT provides for the payment of a specified percentage each year of the net fair market value, determined annually, of all of the trust property to one or more charitable lead beneficiaries. The methodology of annual valuation need not be limited to determining fair market value on January 1 but it must be the same manner of determination each year. For example, you could specify that the fair market value be an average of the quarterly fair market values.

1. In the case of a CLUT, the 7520 Rate does not significantly affect the valuation of the split interests. In fact, it has no effect when the unitrust amount is payable annually with a payment date the same as the annual valuation date.

2. The CLUT shares any appreciation (or depreciation) between the charitable and non-charitable interests.

F. A CLT will not be subject to the generation-skipping transfer tax ("GST") at its formation. However, if at the end of the charitable lead interest there is no non-skip person with an interest in the trust, it will be subject to GST as a taxable termination.

1. In the case of a CLAT, it is virtually impossible to allocate GST exemption to the trust at inception with any degree of certainty necessary to produce an inclusion ratio of zero at the end of the CLAT term. This is so because the formula to determine the applicable fraction is based upon the value of the trust property immediately after the termination of the charitable lead interest.

2. On the other hand, in the case of a CLUT, the applicable fraction is determined under the usual GST rules and can be applied at creation. (Code §2642(a)(2)). However, it is impossible to zero-out a CLUT actuarially.

G. In order to secure a charitable deduction for the value of the charitable lead interest, it is necessary for the trust document to contain specific provisions applicable to private foundations. (Code §§ 508(d)(2) and (e); Treas. Reg. § 1.508-2(b)(1)(vi)(a)). These provisions deal with prohibitions against self-dealing, retention of excess business holdings, jeopardy investments and taxable expenditures. These will be discussed later in the outline.

H. The charitable lead term may be a stated number of years, based upon a measuring life or lives, or based upon a combination of both (Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a) and (vii)(a)) or determinable by a formula (See, e.g., PLR 9631021 and PLR 9840036). Unlike a CRT, the charitable term can exceed 20 years but must satisfy the applicable rule against perpetuities**.**

I. Unlike the CRAT or CRUT, there is no requirement that the individual whose life measures the term of a charitable lead annuity or unitrust be a beneficiary of the trust. Until a few years ago, there was no requirement that the individual have any relationship to the trust, the donor, or the trust beneficiaries. However, the IRS has issued Treasury Regulations which limit the class of individuals who can be designated as a measuring life.

According to the IRS, the previous lack of guidance regarding the term of a charitable lead trust's charitable interest has resulted in the use of the so-called "ghoul trust". A ghoul trust is a charitable lead trust whose charitable term is measured by the life of an individual unrelated to the settlor. The individual serving as a measuring life is seriously ill, but not "terminally ill" as defined in the §7520 Regulations. As a result, the charitable interest is valued based on the actuarial tables. If the seriously ill individual dies prematurely, as is expected, the amount the charity actually receives will be significantly less than the amount on which the gift or estate tax charitable deduction was based. In order to curb these abusive transactions, the IRS has issued Treasury Regulations, which generally apply to transfers to inter vivos charitable lead trusts made on or after April 4, 2000, or to transfers made under wills or revocable trusts when the decedent dies on or after that date. Based on these rules, donors are prohibited from using an unrelated individual's (who is seriously ill, but not terminally ill) measuring life as the term of the charitable lead trust to artificially inflate the charitable deductions.

III. TESTAMENTARY CHARITABLE LEAD TRUSTS

A. Introduction.

A CLT is a split interest trust which provides payments to one or more charities for a specified term and upon the expiration of the term interest any remaining assets of the trust pass either outright or in further trust to designated beneficiaries, typically the children or grandchildren of the grantor or testator. A CLT may be established during the lifetime of the grantor or at death.

The actuarial value of the term interest being paid to a charity or charities will give rise to an estate tax deduction pursuant to Code §2055(a). During its term of operation, the CLT is not a tax exempt entity and will be taxed in accordance with the provisions of Subchapter J of the Code. Like a CLT established during lifetime as a non-grantor trust, the CLT will be entitled to an unlimited income tax deduction for the amount of the annuity payment paid each year during the term of the trust to the charitable beneficiaries. (Code §642 (c)(1)).

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

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

B. <u>Selected Testamentary Charitable Lead Trust Features and Requirements.</u>

1. A CLT created at death is generally referred to as a testamentary charitable lead trust.

1. The CLT may be established as either an annuity trust ("CLAT") or a unitrust ("CLUT"). We will only consider a CLAT for the reasons previously stated.

3. Code §2055(e)(2)(B) and Treas. Reg. § 20.2055-2 contain the statutory requirements to obtain an unlimited estate tax charitable deduction for all or some portion of the amount placed in a qualified CLT.

4. All charitable beneficiaries of a qualified CLT must be charities to which contributions are deductible under Code §2055. This permits non-domestic charities to qualify as well as private foundations. In fact, the trust need not identify any specific charity or charities as long as the trustee can only select from qualified charities (See, Rev. Rul. 78-101, 1978-1 C.B. 301 and PLR 9748009).

5. The effect of the length of the trust term can be seen in the following **EXAMPLE**:

Assume Jack dies in October 2015 and his will sets up a $1,000,000 CLAT with the annual annuity payments set as a formula designed to "zero-out" *the remainder interest so that 100% of the CLAT will produce a charitable deduction. If the 7520 Rate is 2%, then the annual annuity payment necessary to zero-out will be the following amounts depending upon the trust term*:

Trust Term	Annual Annuity
5	$212,160
10	**$111,330**
15	$ 77,830
20	$ 61,160

This example assumes a 0% growth rate over its charitable term. To the extent that actual total trust return exceeds 2%, the remainder beneficiaries will reap benefits at the end of the charitable term. Conversely, if the trustee is unable to outperform the 7520 Rate there will be little, if anything, remaining for the remainder beneficiaries. In order for the remainder beneficiaries to receive an amount equal to the original principal, the trust would need to generate slightly better than a 6% per annum growth rate over a 20 year trust term. The testamentary techniques described below are not concerned with the CLT returns as it will be holding a promissory note that will be amortized over the term of the CLT so at termination there will be virtually no risk to the remainder beneficiaries.

6. The estate tax charitable deduction is an amount equal to the actuarial value of the annuity or unitrust interest at the date of the decedent=s death. Unlike the income tax charitable deduction, there is no percentage limitation on the amount deductible as a charitable contribution. When valuing split interests, the Code employs a presumed interest or discount rate, the 7520 Rate, for the month in which the valuation date occurs or for either of the preceding two months (Code 7520(a)). The lower the 7520 Rate, the higher the value of the charitable lead interest and, coincidentally, the estate tax charitable deduction. For example, the March 2015 7520 Rate was 1.8% and the January and February 2015 rates were 2.2% and 2.0%, respectively, so that a March 2015 decedent=s CLT could use the lower of the January, February or March 2015 rates. In the last several years, the 7520 Rate has been at historic lows. As noted above, the effect of the 7520 Rate can be seen in the following **EXAMPLE:**

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

7520 Rate	Required Annuity

1.8%	$110,170
2.0%	**$111,330**
2.6%	$114,860
3.0%	$117,240
4.0%	$123,300
5.0%	$129,510

It should be apparent that the impact on the annuity payment is less effected by the 7520 Rate verses the length of the annuity term.

C. <u>Private Foundation Issues.</u>

A CLT is treated as a private foundation and the excise tax provisions under Code §§ 4941 to 4945 are applicable to the CLT. Typically, the trust document needs to contain specific prohibitions against their violation as required under Code §§ 4947(a)(c) and 508(e). Additionally, the excess business holdings and jeopardizing investments provisions of Code §§ 4943 and 4943 could come into play. These rules are quite complex and draconian; however, as we will see, there are exceptions that can be utilized to thread through them and reach a positive result. One additional complicating factor is that clients generally prefer to have their family private foundation be the recipient of the charitable lead payment. This can add an additional layer of complexity when dealing with issues such as “self-dealing” and “disqualified persons.”

Therefore, we must analyze whether the transactions we will review involve an act of “self-dealing” between a “disqualified person” and the CLAT. Self-dealing includes a sale or exchange between the CLT and a disqualified person as well as any direct or indirect furnishing of goods, services, or facilities between a private foundation and a “disqualified person.” The following are also prohibited transactions under the self-dealing rules: (1) purchase or sale of assets between the foundation and disqualified persons; (2) leasing property by the foundation from a disqualified person or an entity controlled by a disqualified person; and (3) compensation to a disqualified person unless the services provided are reasonable and necessary and the amounts paid are reasonable. In addition, Code §4941(d)(1)(B) provides that the lending of money or other extensions of credit between a disqualified person and a private foundation are acts of self-dealing.

There is a very important “out” of the self-dealing rules. It is referred to as the “administration exception”:

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

a. the . . . trustee of a revocable trust [which includes a trust that has become irrevocable because of the grantor=s death] <u>**either**</u>:

(i) possesses a power of sale with respect to the property;

(ii) has the power to reallocate the property to another beneficiary**; or**

(iii) is required to sell the property under the terms of any option, . . .

b. such transaction is approved by . . . court having jurisdiction over the trust;

c. such transaction occurs before . . . a trust . . . is considered subject to §4947 . . .; **and**

d. the . . . trust . . . receives an amount which equals or exceeds the fair market value of the [trust=s] interest . . .; **and**

(i) results in the [trust] . . . receiving an asset as liquid as the one it gave up;

(ii) results in the foundation receiving an asset related to the active carrying out of its exempt purposes; **or**

(iii) is required under the terms of any option which is binding on the . . . trust. Treas. Reg. § 53.4941(d)-1(b)(3).

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

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

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

Again, Code §4941(d)(1)(B) would include an extension of credit between a private foundation (the CLT) and a disqualified person; however, Treas. Reg. § 53.4941(d)-2(c)(1) excludes notes received pursuant to a Treas. Reg. § 53.4941(d)-1(b)(3) transaction. (See, e.g., PLR 8006029 and PLR 200124029). If the transaction otherwise qualifies under Treas. Reg. § 53.4941(d)-1(b)(3), it should escape self-dealing under either the sale or exchange component or the creditor component. An interesting Private Letter Ruling issued last year contains an excellent analysis of the threading of exemptions under the administration exception (PLR 201448023).

Finally, we have to address the use of an interest rate on the promissory note at or close to the AFR rather than a market rate of interest. In 2012, the Service announced that it would no longer issue letter rulings pertaining to the Code §4941 exception for transactions during the administration of an estate or trust where a note is issued in a sale of property. There are at least three PLRs issued where the Service favorably ruled on purchase transactions under the administration exception that involved notes with interest rates pegged to the AFR. (PLR 200124029; PLR 20126019; and PLR 201129049). This issue appears to be aimed directly at the administration exception, discussed above, requiring the note that is received back for the property interest be “…an amount which equals or exceeds the fair market value of the … (transferred) interest.” One needs to be cautious in structuring these transactions using notes tied to the AFR when there remains such a large disparity between the AFR and “true market” interest rates.

> For example, if we structure a 20 year CLAT funded with a $1,000,000 promissory note when the AFR is 2%, the annual payment to zero out the CLAT at termination is $61,160. If the promissory note carries a 2.40% interest rate (the long term AFR), it will generate an annual payment of $63,543 that will fully amortize the note over the 20 year term.

This would produce enough cash flow annually for the CLAT to make its annual annuity payment and pay the nominal expenses of it operations. However, the transaction could be at risk if the Service starts to take any of the positions discussed above to view such a low interest rate on the promissory note as voiding the administration exception that is the backbone of these transactions.

IV. TESTAMENTARY CHARITABLE LEAD TRUST EXAMPLES

A. <u>The Frozen T-CLAT</u>.

The outgrowth for this technique was a plan I developed for a client in 2000. The client died in 2004 and the transaction was successfully implemented and withstood an audit of the estate tax return. (Donald R. Tescher and Barry A. Nelson, "The Frozen T-CLAT," Trust & Estates at p.33 (July 2004). The following example closely resembles that structure.

> ***Sarah is an eighty-eight year old widow with one adult child, one adult grandson, Sammy, and several great-grandchildren. Her gross estate is estimated at approximately $90,000,000.00 and consists principally of shares of stock of International Widgets, Inc. (▯IW▯), a publically traded company. The IW shares have an income tax basis of $.03 each and are currently trading at approximately $40.00 per share. Since Sarah is also the beneficiary of various trusts established by now deceased ancestors and her heirs are otherwise financially independent and secure, Sarah wishes to gift shares of IW worth $20,000,000 to her grandson, Sammy. Sarah has previously made substantial gifts and has utilized all but $500,000 of her unified credit and all but $200,000 of her generation skipping tax exemption.***
>
> ***Sarah=s advisors explain to her that the gift tax and generation skipping tax (▯GST▯) on a $20,000,000 gift to her grandson will be substantial. Furthermore, Sammy will get a carryover basis in the IW shares. Sarah suggests changing her will (or revocable trust) to simply devise the IW shares to Sammy at her death. Again, Sarah=s tax advisors point out to her the impact of both the estate tax and GST and the shrinkage that will occur to Sammy's inheritance.***
>
> ***Sammy is wealthy in his own respect and will not be in need of the use of any inheritance from his grandmother. Sammy wishes to minimize any transfer taxes, obtain some income tax step-up in basis to the IW shares, be able to control and enjoy this inheritance and provide further transfer tax savings to his estate. Sammy also has established the Sammy Family Foundation.***
>
> By deferring the actual transfer of the assets to a trust for the benefit of Sammy and his descendants until after Sarah dies, transfer taxes can be eliminated and the shares of stock will receive a (partial) basis step up.

Attached are four charts that show the life of a Frozen T-CLAT from the creation of the independent parts through the sale transaction, payouts during the CLAT term and after the end of the term.

1. Formation of the Structure.

   Sarah forms a limited partnership, Sarah Investments, LLLP ("LP"), with Sarah contributing $19,800,000.00 in IW stock in exchange for a 99% limited partnership interest.

   Sarah and Sammy form Sarah Holdings, LLC (▯GP▯) to act as the general partner of the limited partnership, and fund the LLC with $200,000.00

with Sammy owning 51% of the Membership interests and serving as the Manager.

Sarah also establishes a dynasty trust ("DT") for the benefit of Sammy, his spouse (as long as she is married to and living together with Sammy), his lineal descendants, and his lineal ascendants (other than Sarah). Sammy and Trust Company are the Trustees. Sarah nominally funds the Family Trust and allocates GST exemption so as to create a zero inclusion ratio. (Code §§2631(a) and (c); 2642).

Sarah is the grantor and trustee of a Revocable Trust ("RT") that is funded with her limited partnership interests in LP. At Sarah=s death a testamentary residual charitable lead trust ("CLT") is created.

The trustees of the RT and the DT enter into an option agreement granting an option to the DT to purchase from the RT all interests in GP and LP owned by RT at Sarah=s death. The purchase price is the fair market value of the GP and LP interests as finally determined for federal estate tax purposes in Sarah=s estate.

The option payment terms are based upon a formula tied back to the annual annuity amount determined under the testamentary CLT provisions in order to zero out the remainder interest and leave as little as possible remaining in the CLT at its termination. See the last paragraph III. C., above.

2. The CLAT Formula.

We are considering only the use of a CLAT for the following reasons:

a. It is not possible to obtain a zero value for the remainder (non-charitable) interest in a CLUT thereby causing some estate tax (and perhaps future GST) at Sarah=s death.

b. Although a CLUT offers an ability to do GST planning with some certainty, the plan described herein avoids GST through another mechanism. (See Code §2642(e)).

c. Additionally, because a CLUT annual payment to charity is not fixed based upon the initial net fair market value of the trust at inception, but rather the annual net fair market value, if the trust assets grow in value both the charities and the remainder beneficiaries share in future appreciation. In a CLAT only the remainder beneficiaries receive the benefit of asset growth or suffer if the trust assets decline in value. However, the Frozen T-CLAT freezes the CLT assets by funding the CLT with a promissory note.

3. Variables.

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

a. *Annuity Payment Term*. This may be expressed as a fixed term of years, without any limitation, or for the life or lives of a person or persons in being at Sarah's death. (Treas. Reg. § 20.2055-2(e)(2)(vi)(a)).

b. *Valuation Date*. This is either the date of Sarah=s death or the alternate valuation date if an election is made under Code §2032. (See Treas. Reg. § 20.2055(h).)

c. *Applicable Federal Rate*. The value of the charitable and remainder interests in a CLT is dependent upon an interest rate factor determined under Code §7520 for the month in which the valuation date falls or for either of the two months preceding such month. The same annuity payment may produce differing charitable deductions depending on when the donor dies. Fluctuations in the 7520 Rate also alter the other variables which are used to calculate the value of the lead and remainder interests in a CLAT.

d. *Guaranteed Annuity*. A <u>determinable</u> amount to be paid periodically, but no less often than annually, for the annuity payment term, which amount may be expressed in terms of a fraction or a percentage of the net fair market value, as determined for estate tax purposes, of the value of the trust assets on the appropriate valuation date. (Treas. Reg. § 20.2055-2(e)(2)(vi)(a)).

When drafting the documents during the donor's lifetime we need to plan to solve for the unknowns at death. After Sarah dies we will know the AFR Rate and the valuation, but we will not know the term and annuity stream necessary to zero out the remainder.

The applicable federal rate and the defined annuity payment are the most important variables which determine the ultimate charitable deduction to be claimed for the charitable lead interest. The most favorable of the §7520 Rates among the month in which the valuation date occurs and the preceding two months is that rate which is lowest. However, when planning now for an event that does not take place for an indeterminate period of time (i.e., Sarah=s death) requires the use of a formula provision to define the annuity payment necessary to produce the smallest remainder interest value. (See, e.g., PLR 199927031, PLR 9631021, PLR9128051, PLR 9118040, and PLR 9846022.)

4. Formula Example.

The solution to the problem caused by fluctuations in the 7520 Rate when drafting a CLAT to be established under a will or revocable trust is to utilize a formula provision to define the annuity payment necessary to produce the desired value of the remainder interest.

In PLR 9631021, T executed a will containing CLATs which use a formula provision to define the term and the annuity payment. According to the ruling, the charitable bequest would be funded with one-fourth of T's residuary estate "without reduction for any taxes, fees or other expenses of administration." The will grants T's daughter, D, a special power of appointment to choose to fund one of two with the charitable bequest. This special power must be exercised within nine months of T's death. If D is not living when T dies or is mentally or physically incapacitated, another individual is given the special power to select to fund either trust. In the event the special power is not exercised or if the CLAT selected does not qualify for a charitable contribution deduction, the will directs that the entire charitable bequest be transferred directly to certain charities designated in the will. The will also states that it is T's intention that the power holder choose to fund the CLAT which would result in a charitable deduction for estate tax purposes as close as possible to the value of the trust.

The formula provisions determined the annuity amount by multiplying the amount passing to the CLAT selected by the power holder by the applicable 7520 Rate. The formula mandated the use of the 7520 Rate equal to the lowest of the interest rates under Code §7520 for the month in which the applicable valuation date falls or either of the two months preceding the month in which the applicable valuation date falls. As previously explained, use of the lowest applicable 7520 Rate produces the largest deduction with the lowest annuity amount.

The formula provision was applied to calculate the term of the annuity interest utilizing IRS Publication 1457, Actuarial Values Book Aleph, in order to arrive at the term of years necessary to zero out the remainder interest.

The Internal Revenue Service approved the use of the formula provision used in the letter ruling to define the term and the annuity because "the amount of the annual annuity payment [would] be a determinable amount, ascertainable as of the date of the taxpayer's death" and so the formula provision established a "specified term" within the meaning of Treas. Reg. § 20.2055-2(e)(2)(vi).

An even more liberal private letter ruling was issued in 2012 as PLR 201216045. In that Ruling the trust defined the annuity amount as "…an amount that will produce a present value under 7520 for the non-charitable remainder interest equal to zero or as close to zero as possible without exceeding zero." The annuity payments were to extend over 10 years. The decedent's estate filed a court proceeding requesting the court to construe the formula for determining the annuity amount and requesting that the court approve ascending annuity payments with a 120% increasing payment each year over the term. The probate court was provided schedules showing a comparison between a straight line annuity payment verses the variable ascending annuity payment with the latter producing a greater amount to the Foundation recipient. The court ruled that the two formulas were actuarial equivalents and either formula would be permitted under the trust provision. A Ruling request was made and the Service ruled, in part, that the terms of the CLAT as construed by the probate court met the requirements for a qualified CLAT and that the terms of the CLAT on the decedent's death provided for a deductible guaranteed annuity interest.

Note that it is possible to manipulate the concepts found in PLR 9631021 to meet a client's disparate objectives. For instance, a client might feel more comfortable *knowing* the maximum number of years the charitable lead term will run before the CLAT distributes its remainder interests outright or in further trust for the benefit of family members. By identifying the variables which become fixed at a donor's date of death, an algebraic formula can be developed to satisfy such a client's estate planning objectives. The variables which will become fixed on a donor's date of death can be identified: (i) The value of the fund to be distributed to a CLAT must become fixed on the date of a donor's death or the alternate valuation date; (ii) The value of the desired remainder interest is known, *i.e.,* the client wants his or her estate to be able to claim as close to a one hundred percent charitable deduction as is possible for the value of the fund to be distributed to the CLAT; (iii) The value of the lead interest also becomes a fixed variable because it will equal the value of the fund minus the value of the desired remainder interest; (iv) The applicable 7520 Rate is fixed (this should be the lowest rate of the three month period).

The remaining variables are the annuity payment, the annuity factor and the adjustment factor. The annuity factor and the adjustment factor are provided by reference to the appropriate tables in IRS Publication 1457. A term of years annuity factor is obtained from Table B of IRS Publication 1457 and the adjustment factor is obtained by appropriate reference to Table K in the same Publication 1457. The remaining variable, the annuity payment, can be determined by the use of an algebraic formula.

> The variables which must be used in this formula can be stated as set forth in the following example and an algebraic equation formulated to determine the unknown, i.e., the annuity payment (1) *F* = Fund; (2) *T* = *Term;* (3) *R* = *§7520* Rate; (4) *AP* = Annuity Payment; (5) REM = Remainder Value; (6) TB = Table B Factor; (7) TK = Table K Factor; and (8) CLI = Charitable Lead Interest.

Take the following example where:

> (1) *F = $1,000,000*; (2) T = 30 years (3) R = 2.0% (the AFR rate); (4) AP = (the unknown until solved); (5) REM = -0- (the client's

desired actuarial result); (6) TB = 22.3965; (7) TK = 1; and (8) CLI = $1,000,000.

F - REM = CLI (1,000,000 - 0 = 1,000,000)
TB(AP) x TK = CLI (22.3965 (AP) x 1 =1,000,000)
22.3965AP = 1,000,000

AP = 1,000,000/22.3965

<u>AP = 44,650</u>

Much of the groundwork in developing this formula approach emanated from the 1998 materials done by Jonathan E. Gopman, "The Formula CLAT and the Super Formula CLAT: Estate Planning With Charitable Lead Annuity Trusts Established at Death," 23 Tax Mgmt. Est. Gifts and Trusts Journal, pp. 186, 203(1998). Today we have programs like Steve Leimberg's Numbercruncher, and other similar programs that can produce the same result as the formula above in a matter of seconds. However, one still needs to express the method for determining the annuity payment in the decedent's documents so as to satisfy the requirement of a determinable amount.

B. <u>The Leveraged Redemption CLAT</u>

The T-CLAT described above can be utilized in a slightly altered form through use of a leveraged redemption transaction.

Let's assume the same basic facts used above except that at Sarah's death the LP interests are to be allocated 30% to Sammy and 70% to the testamentary CLAT under Sarah's revocable trust. Assuming a $9,000,000 fair market value (discounted value) for the LP at Sarah's death, the LP would agree to redeem a part of Sammy's interest sufficient to provide cash to satisfy the estate tax (Sammy's mother has died in the interim so that he has stepped up a generation and is not subject to GST) and redeems all of the remaining interest that would otherwise fund the CLAT based upon the same equivalent value used to redeem Sammy, with a promissory note over a 20 year term paying interest only annually at the rate of 6.116% (or perhaps a slightly higher rate to generate a small expense fund in the CLAT). In order to zero out the CLAT, the annual annuity payments would need to be $385,308, the same amount as the minimum note payments.

At the end of the term, the note will pass out free of transfer taxes. Assuming that the $6,300,000 of assets attributable to the CLAT note represent $8,400,000 of undiscounted assets in the LP, then the hurdle rate to earn in order to satisfy the annual note payments is really 4.587%.

As opposed to the Frozen T-CLAT, this transaction avoids possible attacks by the Service that the interest rate is not a market value rate.

In all other respects, the leveraged redemption transaction can be structured to satisfy the administration exemption under the Code §4941 Regulations. Likewise, the Frozen T-CLAT could be restructured to an interest only balloon note set at the same rate as the annuity payout rate and establish a sinking fund in the partnership in order to pay off the note at maturity to the remainder beneficiaries. (For a detailed discussion of this technique and others using CLAT's for both income tax and transfer tax planning, see Stacey Eastland's materials from the 49th Heckerling Institute on Estate Planning (January 2015); and "The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift," Richard S. Franklin and Jennifer A. Birchfield Goode, ACTEC Law Journal Volume 39, Number 8 (Winter 2013)).

V. SELECTED INTER VIVOS CLT STRUCTURES

Much has been written on the use during lifetime of various CLT structures designed to obtain an upfront charitable deduction and avoid or minimize the future recapture income tax hits resulting from grantor trust status. (cf. "Split Interest Trusts Created by Entities (and More)" by Jonathan Blattmachr and Diana S.C. Zeydel, 49th Heckerling Institute on Estate Planning (January 2015); "Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse", Paul S. Lee, Turney P. Berry, and Martin Hall, 37 ACTEC L.J. 93 (Summer 2011). An overview of the article is below:

A. The SHARK- FIN or RELATED CLAT.

In the testamentary context where we are relying upon the administration exception to qualify the transaction to avoid the self-dealing rules, we are concerned with the front-end funding of the CLAT and less concerned with the back-end annuity payout where there are no recapture issues as no income tax charitable deduction was afforded. We previously discussed and described several PLRs where the Service has approved alternative payout provisions that vary from a straight, equal, annual annuity. (See, Rev. Proc 2007-45, 2007-29 I.R.B. 89 and Rev. Proc. 2007-46, 2007-29 I.R.B. 102, which contain sample CLAT forms for inter-vivos and testamentary CLATs and specifically recognize that the annuity payments can be unequal; and PLR 20121604 discussed above).

Planners, apparently encouraged by the insurance industry, have taken this concept and speculated upon how far the envelope can be pushed. (Richard Fox and Mark Teitelbaum, "Validity of Shark-Fin CLAT's Remain in Doubt Despite IRS Guidance," LISI Charitable Planning Newsletter #162 (October 2010); David Pratt, Scott L. Goldberger and Paul S. Lee, "Biting Back: Responding to the Attack on Shark-Fin CLAT's," LISI Charitable Planning Newsletter #163 (October 2010); Paul S. Lee, Turney P. Berry and Martin Hall, **"**Reeling, Rolling and Reining in "Shark-Fin" CLATs**,"** LISI Charitable Planning Newsletter #168 (November 2010) and Paul S. Lee, Turney P. Berry and Martin Hall, "Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhourse," ACTEC Law Journal, Vol. 37, No. 1,93 (Summer 2011) ; Jonathan Blattmachr; " Some Recapture Considerations and Other Problems Relating to

Charitable Lead Trusts," LISI Charitable Planning Newsletter #172 (February 2011)). The Blattmachr and Zeydel article cited above analyzes a multiple of funding possibilities for back-loading the CLAT.

The basic structure of the shark-fin CLAT is that the annual annuity payments during the term are very modest with a balloon payment in the final year of the CLAT term. Going back to the leveraged redemption CLAT discussed above, let's modify the structure to fund the CLAT inter vivos with a preferred partnership interest with a fixed annual preferred return sufficient to permit the CLAT to make level annual annuity payments and, in the final year, redeem out the preferred interest for cash in an amount sufficient to provide the funds needed to fund the large final payment to satisfy the required annuity amount. In fact, the Eastland article referenced above from the 49th Heckerling Institute on Estate Planning has a similar example. Further examples are contained in the Lee, Berry and Hall ACTEC Journal article cited above. Other uses of preferred partnership planning are discussed in Section VI, below.

B. The NON-GRANTOR, NON-QUALIFIED CLT.

Many taxpayers are being faced with additional income tax burdens resulting from the imposition of the 3.8% net investment income tax ("NII") coupled with phased out benefits from direct charitable giving discussed at the beginning of the materials.

> **EXAMPLE**: ***Sam has a portfolio of over $50,000,000 that generates annual income of between $1,500,00 and $2,000,000, in addition to his other assets and income, most of which is subject to the NII. Between phase-outs and charitable contribution carryovers, any additional charitable giving generates no income tax benefit. Sam is very charitable and his annual charitable giving averages about $750,000. The solution is for Sam to create an irrevocable non-grantor trust that will function similar to a CLAT but will not qualify as a CLAT. Sam will fund the trust with $25,000,000 of his portfolio. The terms of the trust provide that all income will be distributed annually to charitable recipients he selects each year. Sam also retains a testamentary special power of appointment over the trust principal.***

The creation of the trust and its funding produces no income, gift or transfer tax charitable deductions for Sam. Consequently, it is not subject to private foundation rules unlike qualified split interest trusts. (Code §4947(2)(A)). Furthermore, there is no completed gift by Sam at formation. The trust will be a separate taxpayer and will calculate its tax liability under the provisions of Subchapter J of the Code. This will include an unlimited charitable deduction. The trust avoids grantor trust status because the allocation of income among charitable beneficiaries is an exception under Code § 674 as is the testamentary power of appointment over the principal. (Code §§ 674(b)(4), 674(b)(3)). While Sam gets no charitable deduction, he avoids tax on the trust earnings and can control ultimate distribution of the trust by exercise of his testamentary power over the principal.

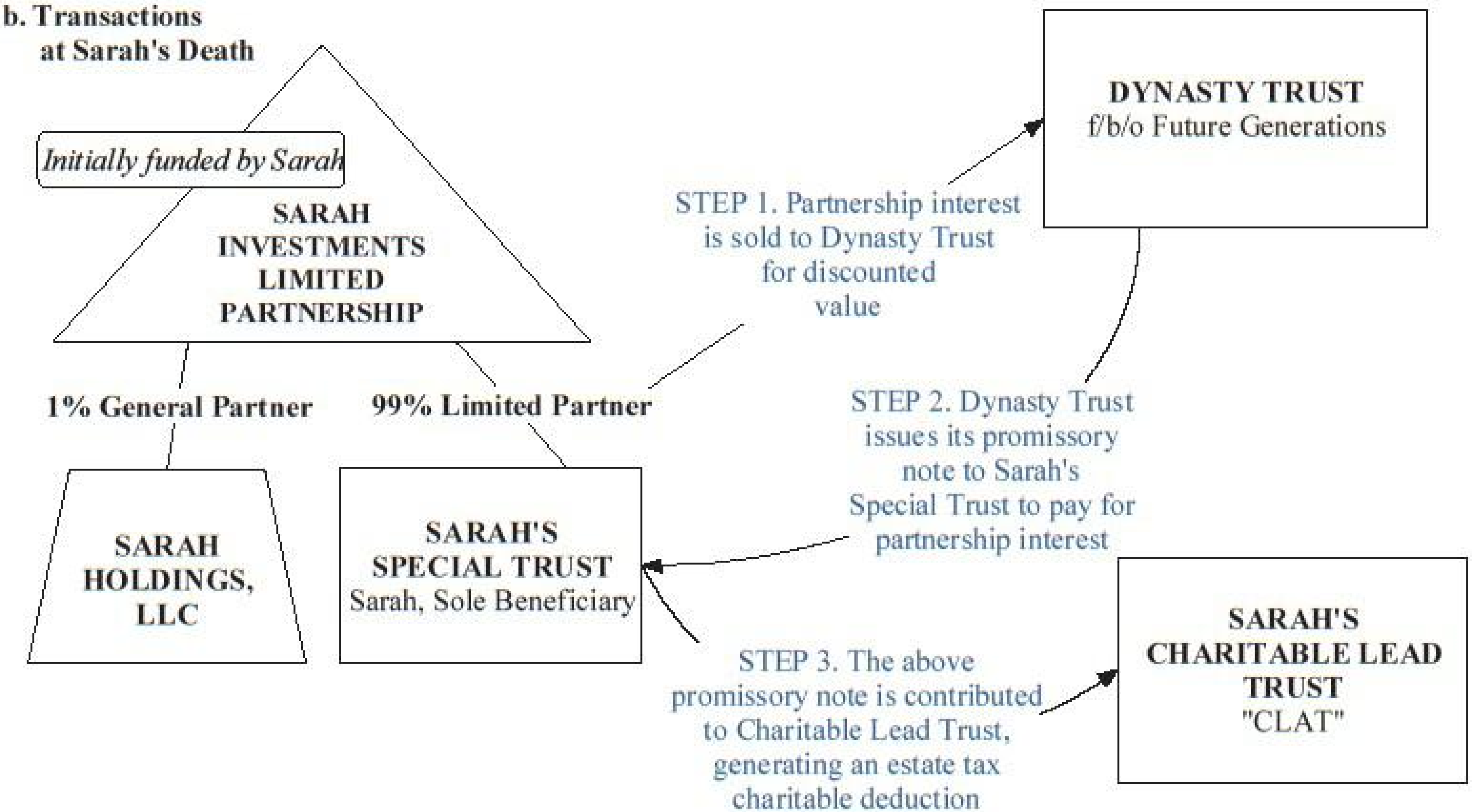
FROZEN T-CLAT

A. During Sarah's Lifetime

~ Sarah establishes and funds a new limited partnership
~ During Sarah's lifetime, Sarah (through her trust) is 99% limited partner, and can receive distributions from the partnership
~ Sarah will share control of general partner (with children or other designated individuals)

FROZEN T-CLAT

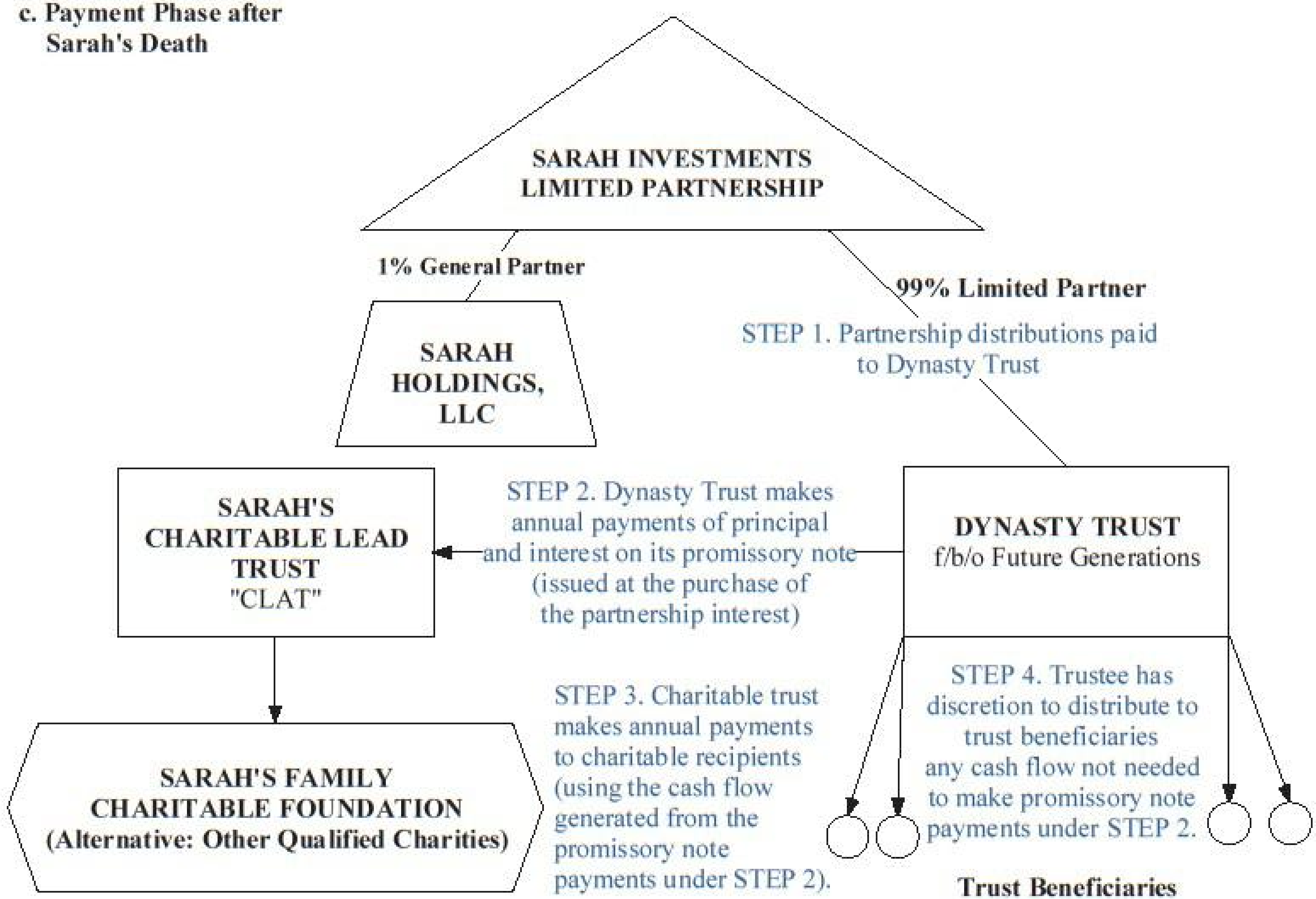
b. Transactions at Sarah's Death



~ At Sarah's death, a Dynasty Trust established for future generations purchases the 99% limited partnership interest
~ It pays for the purchase with a promissory note. Due to partnership structure, the purchase price should be less than the value of the underlying partnership assets.
~ The promissory note is immediately transferred to a charitable lead trust, generating an estate tax deduction.
~ The net estate tax effect is that only de minimis estate taxes will arise from the 99% limited partnership interest that was owned by Sarah's trust at her death.

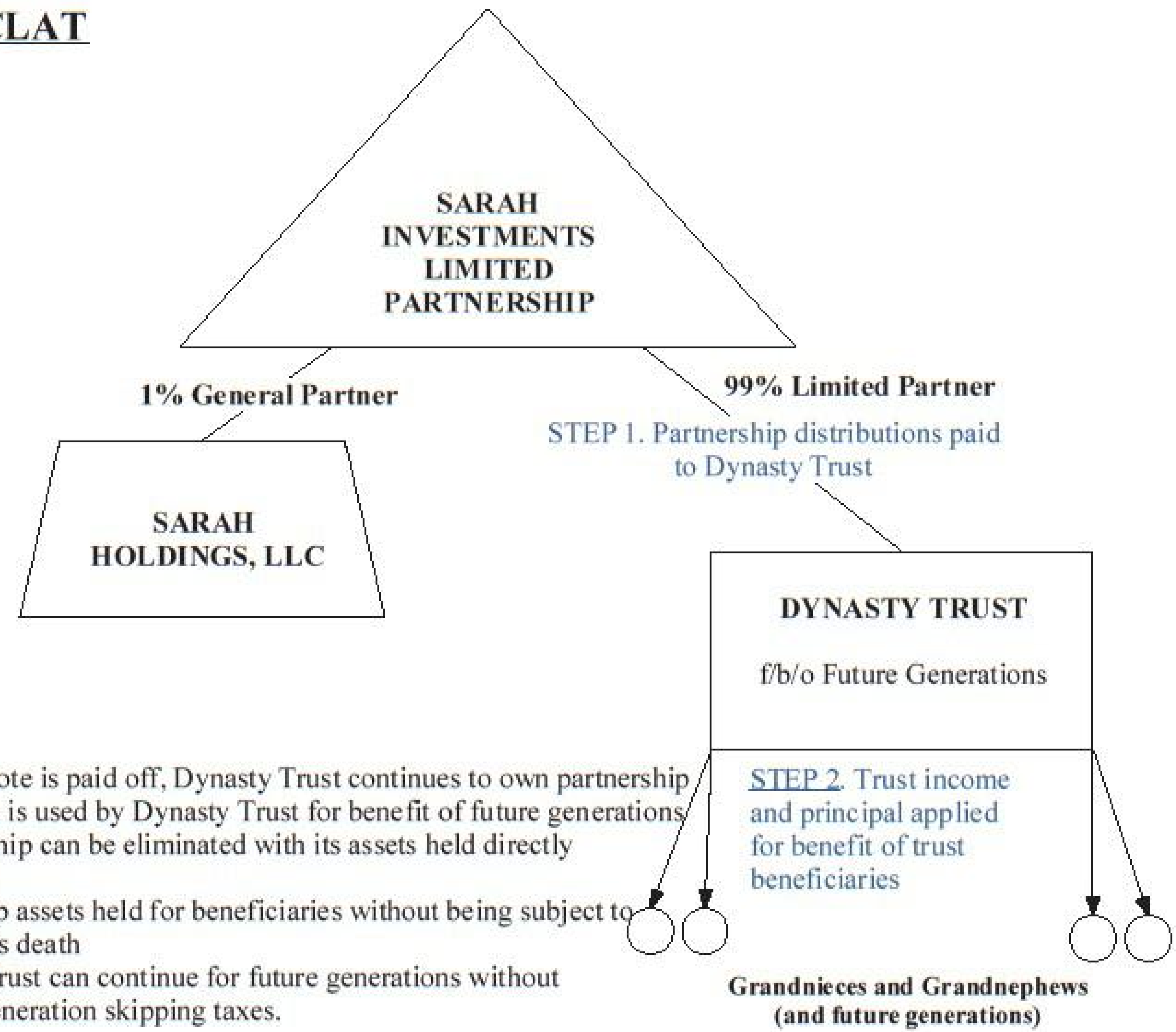
FROZEN T-CLAT

c. Payment Phase after Sarah's Death



FROZEN T-CLAT

d. Final Phase



~ After promissory note is paid off, Dynasty Trust continues to own partnership
~ Partnership income is used by Dynasty Trust for benefit of future generations
~ If desired, partnership can be eliminated with its assets held directly by Dynasty Trust
~ Benefit: Partnership assets held for beneficiaries without being subject to estate tax at Sarah's death
~ Benefit: Dynasty Trust can continue for future generations without further estate or generation skipping taxes.