

**SOPHISTICATED CHARITABLE GIFTING AND PLANNING:  
THE FROZEN T-CLAT**

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# TESTAMENTARY CHARITABLE LEAD TRUSTS: A POWERFUL PLANNING TOOL

## A. INTRODUCTION.

A charitable lead trust ("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. This presentation will be focusing on the use of a CLT in a testamentary setting.

**EXAMPLE.** Assume that Jack wishes to leave \$1,000,000 to his favorite charity at his death. If he leaves an outright devise his estate will enjoy a \$1,000,000 charitable deduction and his heirs will be out \$650,000 (assuming a death in 2012 when the marginal estate tax bracket is 35%, this is the net after tax amount available to the heirs if no charitable devise). If, instead, Jack established a CLT at his death to pay \$100,000 per year to the charity for 10 years with the remainder, if any, to pass to his family, then assuming a 7520 rate of 1.4% and a total return 6%, it would require that the trust be funded with only \$800,000 to produce annual payments of \$100,000. Furthermore, at the end of the trust term his heirs would receive \$481,252 free of transfer taxes, plus an additional \$103,000 at his death ( $\$1,000,000 - \$800,000 \times 65\%$ ).

The actuarial value of the term interest being paid to a charity or charities will give rise to an estate tax deduction pursuant to §2055(a) of the Internal Revenue Code of 1986, as amended (hereinafter referred to as the "Code"). 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. In this regard, 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 case study presented below combines several different planning techniques into an integrated plan that enhances the benefits to the remainder beneficiaries both during and at

trust property, determined annually (CLUT).

4. The Treasury Regulations (hereinafter referred to as "Treas. Reg.") contain numerous other requirements (See, e.g., Treas. Reg. 20.2055-2).
5. The IRS has issued through Revenue Procedures sample CLT forms with alternate provisions (Rev. Proc. 2007-45; Rev. Proc. 2007-46; Rev. Proc. 2008-45; and Rev. Proc. 2008-46).
6. All charitable beneficiaries of a qualified CLT must be a charity contributions to which are deductible under Code Section 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).
7. 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., PLRs 9631021 and 9840036). Unlike a charitable remainder trust, the charitable term can exceed 20 years but must satisfy the applicable rule against perpetuities.

Unlike the charitable remainder annuity or unitrust, 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 recently, 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.

- a. 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 ghoulish 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. The IRS believed that these types of charitable lead trusts had been marketed in a package which included the name of a seriously ill individual and access to his or her medical records. A token payment was made to the ill individual who served as a measuring life.
- b. 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

9. 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. When valuing split interests, the Code employs a presumed interest or discount rate equal to 120% of the Federal midterm rate under Code Section 1274(d)(1), rounded to the nearest 2/10ths of One (1) percent, for the month in which the valuation date occurs or for either of the preceding two months (Code Section 7520(a)). This rate is generally referred to as the section 7520 rate. The lower the section 7520 rate, the higher the value of the charitable lead interest and, coincidentally, the estate tax charitable deduction. The January 2012 section 7520 rate is 1.4% and the November and December 2011 and 2012 rates are 1.4% and 1.6%, respectively, so that a January 2012 decedent's CLT would use the lower January 2012 rate. For the last 4 years, the section 7520 rate has been at historic lows, ranging between a high of 4.2% and a low of 1.4%. The effect of the section 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 section 7520 rates the annuity payment necessary to zero-out will be as follows:

<u>Section 7520 Rate</u>	<u>Required Annuity</u>
1.4%	\$107,870
2%	\$111,330
3%	\$117,240
<b>4%</b>	<b>\$123,300</b>
5%	\$129,510
6%	\$135,870
9%	\$155,820

10. In the case of a CLUT, the section 7520 rates do not significantly effect 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.
11. 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. On the other hand, the CLUT shares any appreciation (or depreciation) between the charitable and non-charitable interests.
11. A testamentary 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 no non-skip person has an interest in the trust, it will be subject to GST as a taxable termination. 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

transaction as occurring between the dynasty trust and the CLT, creating a potential for exposure to a liability under Code §4941.

The Regulations to Code §4941 provide that certain transactions not 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:

- (i) the . . . trustee of a revocable trust [which includes a trust that has become irrevocable because of the grantor’s death] either:
  - (a) possesses a power of sale with respect to the property;
  - (b) has the power to reallocate the property to another beneficiary; or
  - (c) is required to sell the property under the terms of any option, . . .
- (ii) such transaction is approved by . . . court having jurisdiction over the trust;
- (iii) such transaction occurs before . . . a revocable trust . . . is considered subject to §4947 . . . ; and
- (iv) the . . . trust . . . receives an amount which equals or exceeds the fair market value of the [trust’s] interest . . . ; and
  - (a) results in the [trust] . . . receiving an asset as liquid as the one it gave up;
  - (b) results in the foundation receiving an asset related to the active carrying out of its exempt purposes; or
  - (c) is required under the terms of any option which is binding on the . . . 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 PLR’s 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 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. We finally have clarity on this issue as the Service recently issued PLR

One of the Grandchildren, "Granddaughter" is wealthy in her own respect and will not be in need of the use of any inheritance from Grandma. Granddaughter wishes to minimize any transfer taxes, obtain some income tax step-up in basis to the IW shares and be able to control and enjoy this inheritance and provide further transfer tax savings to her estate.

**E. PLAN STRUCTURE.**

On page 20 is a flow chart reflecting the overall plan.

1. Formation of Limited Partnership ("Granddaughter LP").

(This presentation is not intended to present an analysis of the features and requirements of a Limited Partnership and assumes a general familiarity of this portion of the subject matter. There are a mass of materials available on the subject as well as significant case law that is still developing.)

- a. Grandma and Granddaughter form a corporation to act as the general partner of the limited partnership, fund the corporation with \$100,000.00 each, and equally own the corporation ("GP"). In light of *Strangi*, it may be more appropriate for Granddaughter to own all of GP.
- b. GP forms a limited partnership ("LP"), contributing \$180,000.00 in exchange for a 2% interest, and Grandma contributes \$8,820,000.00 in the form of shares in IW in exchange for a 98% limited partnership interest.
- c. It is anticipated that Grandma will make present interest gifts of limited partnership interest in LP each year to Granddaughter and her family in amounts equal to the annual exclusion (Code §2503(b)).

2. Formation of Granddaughter Family Trust ("Family Trust").

- a. Grandma is the grantor of an irrevocable trust for the benefit of Granddaughter, her spouse (as long as he is married to and living together with Granddaughter), her lineal descendants, and her lineal ascendants (other than Grandma). Granddaughter and Trust Company are the Trustees.
- b. Grandma nominally funds the Family Trust and allocates GST exemption so as to create a zero inclusion ratio (Code §§2631(a) and (c); 2642).

3. Formation of Revocable Trust ("Charitable Trust").

- a. Grandma is the grantor and trustee of a Revocable trust that is funded with her

at Grandma's death (Treas. Reg. §20.2055-2(e)(2)(vi)(a)).

- b. Valuation Date. This is either the date of Grandma'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 and is 120% of the federal midterm rate (rounded to the nearest two tenths of one percent) in effect under Code §1274(d)(1) for the month in which the valuation date falls or for either of the two months preceding such month.
  - d. Guaranteed Annuity. A determinable 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)).
  - e. 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., Grandma'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.)
3. Formula Example. (The author gratefully acknowledges the contributions of Jonathan Gopman, Esq. who has worked extensively with CLT planning and for his permission to incorporate materials produced by him in this example.)
- a. As previously noted, in valuing the interests in a CLAT an estate is permitted to elect to use the most favorable of the §7520 rates available for the month in which the valuation date falls or for either of the two preceding months. Unfortunately (or fortunately), as previously discussed the §7520 rate fluctuates from month to month. Thus, the same annuity payment used in a CLAT 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.

1457. Table B provides the annuity factors for valuing term interests. (See Publication 1457, Actuarial Values Aleph Volume, Table of Contents at p.1.). On May 1, 2009, the IRS announced and issued new mortality tables effective for transactions occurring on or after May 1, 2009. (Table 2000CM is a table of IX values—the number of persons living at each age from 0 to 110 starting with a group of 100,000 people). The table is used to compute probabilities of survival from one age to another (divided the IX number at the older age by the IX number at the younger age). Manipulation of these probabilities underlies all of the factors involving mortality calculations that tax and estate planners perform.

- iv. The result determined in (ii) above is then interpolated between the two term-of-years annuity factors, to determine the additional number of whole months the CLAT must be in effect for the amount of the charitable deduction to be equal (or as nearly equal as possible) to the value of amount used to the fund the CLAT. The result produces the term of the CLAT.
- e. The taxpayer requested rulings on several issues including whether the CLAT satisfied the requirements under Code §2055(e)(2)(B) (and the regulations thereunder) to qualify for an estate tax deduction for the value of the charitable lead interest.
- f. The ruling approved the use of the special power of appointment to choose the CLAT to fund because both CLATs "will yield the same charitable deduction."
- g. 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). (It is important to remember that although indicative of the position which might be taken by the IRS in certain circumstances, private letter rulings may not be used or cited as precedent (Code §6110(j)(3)).
- h. By plugging in some numbers, one can see how the formula in PLR 9631021 operates:
  - i. Assume either CLAT would be funded with **\$1,000,000**, *i.e.*, one fourth of the residuary estate without reduction for any taxes, fees or other expenses of administration.

- viii. Obtain the terms-of-years annuity factors between which falls the result determined for trust C-11 from Table B.

21 years = **11.3784**

22 years = **11.6338**

Note: If a twenty-one year term is used in trust C-11 the remainder interest would be valued at **\$21,562.28** and if a twenty-two year term is used the remainder interest would be valued at **-\$399.77**. Thus, the term will be closer to 22 years if trust C-11 is selected.

- ix. Interpolate the result determined in vii. between the two terms-of-years annuity factors which it falls to determine the additional number of whole months trust C-I must be in existence for the amount of the charitable deduction to equal (or be nearly as equal as possible) to the value of amount used to the fund the trust. This will result in an annuity factor of approximately **13.20065789**. (**13.20065789(74,000) x 1.0237 = 999,999.99**).

(Algebraic equation (TB = "Table B Factor"):  $TB(74,000) \times 1.0237 = 1,000,000$ )

- x. Interpolate the result determined in viii. between the two terms-of-years annuity factors which it falls, to determine the additional number of whole months trust C-11 must be in existence for the amount of the charitable deduction to equal (or be nearly as equal as possible) to the value of amount used to the fund the trust. This will result in an annuity factor of **11.62915103**. (**11.62915103(84,000) x 1.0237 = 1,000,000**) (Algebraic equation:  $TB(84,000) \times 1.0237 = 1,000,000$ )

Once the Table B annuity factor is determined an actuary or the Internal Revenue Service can provide the exact term of the charitable lead interest or you can calculate it yourself.

- i. 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

Publication 1457 by reference to Table K. Table K is found in Section 4 of Publication 1457. Assume that the governing instrument in the example set forth below mandates that the annuity payment is made on the last day of the year. Thus, the first column of Table K is based on the interest rate used to value the lead and remainder interests. Every other column represents adjustment factors for the number of payments to be made on an annual basis. The adjustment factor for an annual payment with an 8.2% interest rate is found one row over in the column marked "Annually." Note that throughout Table K the adjustment factor in this column (*i.e.*, for one payment) for any interest rate is always "1.00".

- (b) The remaining variable, the annuity payment, can be determined by the use of an algebraic formula.
- (c) 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.
- (d) Take the following example where: (1) *F* = \$234,772,727; (2) *T* = 30 years (3) *R* = 8.2% (the AFR rate ); (4) *AP* = (the unknown until solved); (5) *REM* = -0- (the client's desired actuarial result); (6) *TB* = 11.0486; (7) *TK* = 1; and (8) *CLI* = \$234,772,727.

$$F - REM = CLI \quad (234,772,727 - 0 = 234,772,727)$$

$$TB(AP) \times TK = CLI \quad (11.0486(AP) \times 1 = 234,772,727)$$

$$11.0486AP = 234,772,727$$

$$AP = 234,772,727 / 11.0486$$

$$AP = \underline{21,249,092.82}$$

4. Sample Form: (Note: I take no responsibility for individual use of this sample provision. You use it at your own risk!)

- (c) Determine the Table K adjustment factor for the frequency of payments of the Annuity Amount and the §7520 rate (hereinafter referred to as "TK").
- (d) Divide 1 by TB (1/TB). The result of this equation will produce the zeroed out target percentage variable (hereinafter referred to as amount "TP").
- (e) Multiply TP by F (TP x F). The result of this equation will produce the Unadjusted Annuity Amount (hereinafter referred to as "UAP").
- (f) Multiply TK by UAP (TK x UAP). The result of this equation will produce the Annuity Amount.

**G. CONCLUSION.**

Creative planning with CLT's can produce significant opportunities to satisfy a client's charitable desires while still preserving significant wealth for the family. The formula CLT requires intensive number testing which will involve the use of software programs and fairly regular monitoring of the changes in the applicable federal rate.