

The Shark-Fin CLAT – Go For a Swim, or Stay Out of the Water?

ABA Tax Section/RPTE Joint Meeting, Boston MA, October 1, 2016

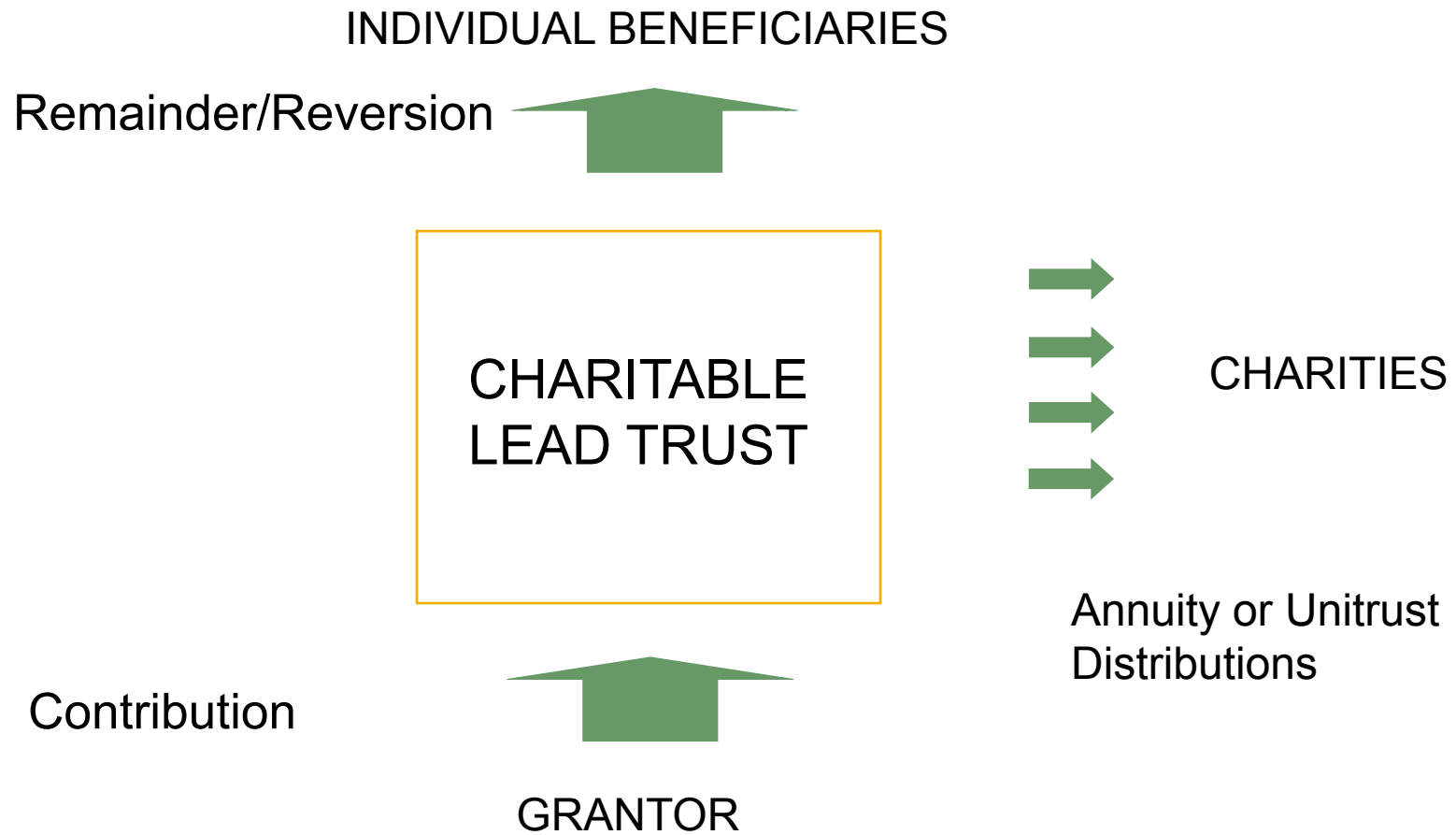
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Basic Structure

- Lead interest payable to one or more charities
 - ❑ Annuity or unitrust
 - ❑ Term of years, or for one or more designated measuring lives
- Remainder to individuals, or reversion to donor
- In current form since TRA 1969

Basic Structure



Basic Structure

- Wealth transfer vehicle
 - ❑ Properly structured lead interest qualifies for gift and estate tax charitable deduction: Treas. Reg. §§20.2055-2(e)(2)(vi) and 25.2522(c) – 3(c)(2)(vi)
- No upfront income tax charitable contribution deduction
 - ❑ Exception - CLT structured as grantor trust: IRC §170(f)(2)(B)

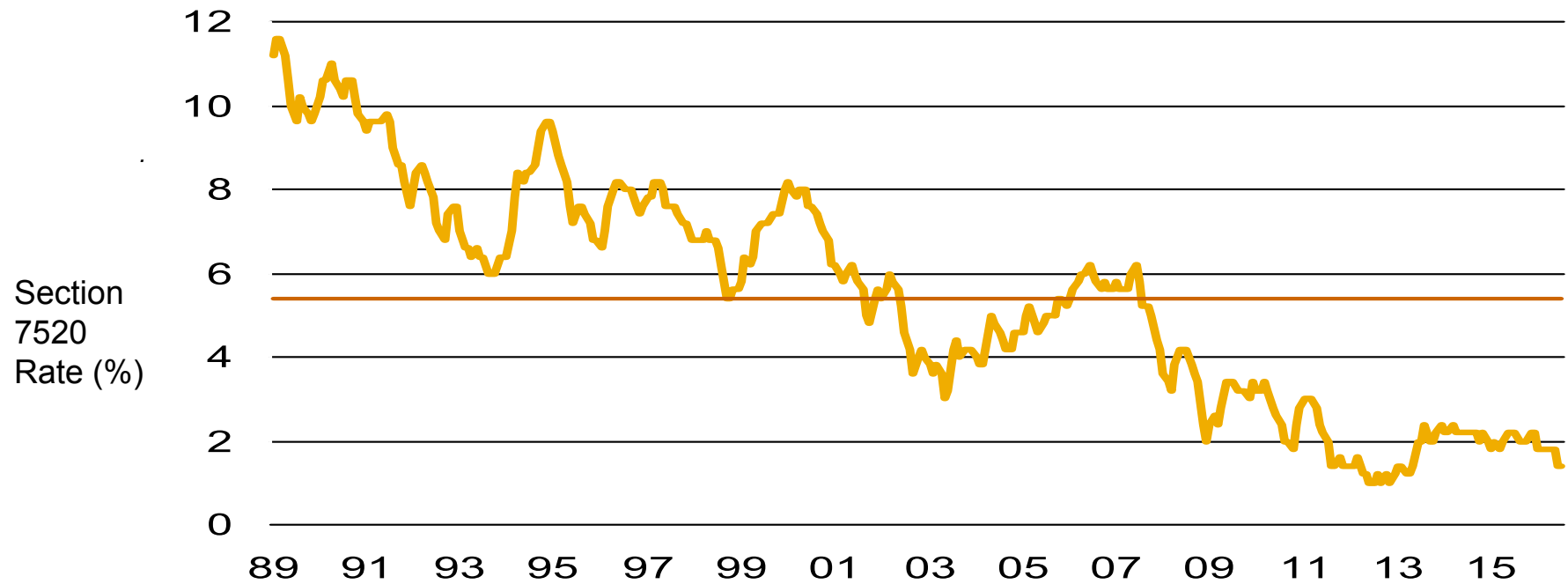
Basic Structure

- Trust itself not tax-exempt, but certain private foundation excise tax provisions nevertheless applicable: IRC §508(e)
 - ❑ Prohibition against self-dealing and taxable expenditures
 - ❑ Prohibition against jeopardy investments and excess business holdings UNLESS present value of lead interest less than 60% of aggregate value of funding assets
 - ❑ CLAT must prohibit not only purchase but also retention of jeopardy investments: Treas. Reg. §§20.2055-2(e)(2)(vi)(e) and 25.2522(c)-3(c)(2)(vi)(e); Treas. Reg. §53.4944-1(a)(2)(ii)(a)

Why Recent Interest?

- First comprehensive guidance in 2007 and 2008: Rev. Procs. 2007-45, 2007-46, 2008-45, and 2008-46
- Low interest rate environment since 2008
 - Valuation of lead interest tied to 120% of Federal mid-term rate in effect for month of transfer or either of 2 months preceding transfer: IRC §7520(a)

Why Recent Interest?



3 Month Rule for Charitable Gifts

- § 7520(a) election
- Sept. 2016 rate is 1.4%
- Effective through Nov. 2016

Section 7520 Rate Average
May 1989 – Sept. 2016 = 5.4%

Why Recent Interest?

- **Interest rate sensitivity**
 - ❑ Unitrust valuation minimally impacted by interest rate changes
 - ❑ Annuity valuation highly sensitive to interest rate changes
 - All other things being equal, lower §7520 rate produces higher present value for annuity stream, and lower present value for remainder
 - Possible to “zero-out” remainder value with lead annuity interest

Why Recent Interest?

Example of “Zeroing Out”

- Assume 10 year term CLAT, funded currently with \$1 million, paying level annuity at end of each year

$$\begin{aligned}
 \text{Remainder Factor} &= \left(\frac{1}{1+i} \right)^t \left\{ \begin{array}{l} t = \text{term} \\ i = \$7520 \text{ rate} \end{array} \right. \\
 &= \left(\frac{1}{1+0.014} \right)^{10} = 0.870202747 \\
 \text{PV of Annuity (\$1M)} &= \left(\frac{1 - \text{Remainder Factor}}{i} \right) \times \text{Required Annuity} \\
 \$1,000,000 &= \left(\frac{1 - 0.870202747}{0.014} \right) \times \text{Required Annuity} \\
 \text{Required Annuity} &= \frac{1,000,000}{9.271232} = \$107,861
 \end{aligned}$$

Why Recent Interest?

- Required annuity under same facts but at average §7520 rate (5.4%) is \$132,032
- Required annuity under same facts but at highest §7520 rate (11.6%) is \$174,095

Successful Wealth Transfer

- CLATs “fail” for 2 reasons
 - ❑ If remainder zeroed-out and actual return equal to or less than §7520 rate, more likely than not that no assets remain at end of term
 - Redeployment not possible because all assets distributed to charity
 - Compare GRAT
 - ❑ If remainder zeroed-out and return exceeds §7520 rate over term of CLAT, path of return may nevertheless cause CLAT to fail
 - Low returns/losses in early years most significant

Successful Wealth Transfer

- Example:

\$10M funding, 10-year term, 6% §7520 rate, \$1.36M level annuity, zeroed-out remainder, compound annual return = 9.3%

Year	Return Path 1	Return Path 2	Return Path 3
1	10.1%	-22.1%	9.3%
2	1.3%	-11.9%	9.3%
3	37.6%	-9.1%	9.3%
4	23.0%	21.0%	9.3%
5	33.4%	28.6%	9.3%
6	28.6%	33.4%	9.3%
7	21.0%	23.0%	9.3%
8	-9.1%	37.6%	9.3%
9	-11.9%	1.3%	9.3%
10	-22.1%	10.1%	9.3%
Annual Growth Rate	9.3%	9.3%	9.3%
Remainder Value	\$8M+/-	-0-^{**}	\$3.4M

- Path of return problem lessened if draw down lower in early years

*Return Path 1 represents annual return of S&P 500 from 1993-2002; Return Path 2 is reverse pattern of those returns. Source: AllianceBernstein

**CLAT would not only have no remainder value, but also insufficient funds to pay year 9 and 10 annuities in full.

CLAT Design

- Definition of “guaranteed annuity”
 - ❑ No minimum or maximum; contrast CRTs: IRC §664(d)(1) and (2)
 - ❑ No probability of exhaustion rules; contrast CRATs: Rev. Rul. 77-374, 1977-2 C.B. 329
 - ❑ Requirements
 - Determinable amount
 - Paid periodically (not less than annually)
 - For specified term, or for one or more measuring lives: Treas. Regs. §§20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi)

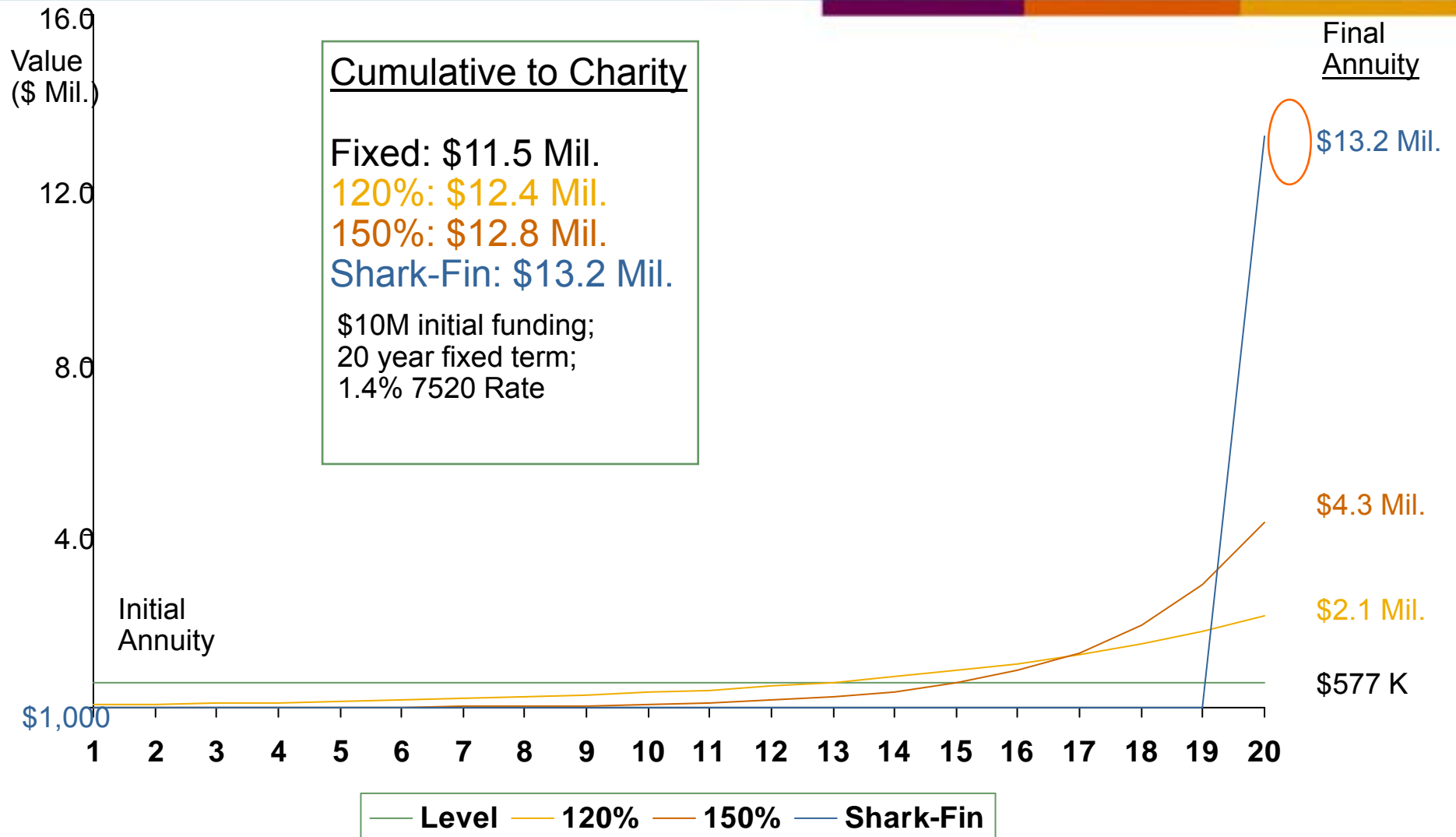
CLAT Design

- Annuity paid by CLAT does not need to be same amount each year
 - ❑ Increases permissible, provided payments determinable at outset: Rev. Proc. 2007-45, §§3 and 5.02(2); Rev. Proc. 2007-46, §§3 and 5.02(2); PLR 2012-16-045
 - ❑ No guidance on permitted escalation
 - Contrast 20% maximum annual increase for GRATs: Treas. Reg. §25.2702-3(b)(1)(ii)(A) and (B)
- On the other hand, annuity paid by CRAT is fixed
 - ❑ IRC § 664(d)(1)(A)- “sum certain”
 - ❑ Treas. Reg. §1.664-2(a)(1)(ii)- “stated dollar amount . . . same as to each recipient or as to total amount payable for each year . . .”

CLAT Design

- Possible structures
 - ❑ Periodic or stepped fixed increases
 - ❑ Fixed annual escalator (e.g., 20% increase every year)
 - ❑ Fixed periodic escalator (e.g., 20% increase every 3 years)
 - ❑ Modest annual payments with balloon payment at end of term – “Shark-fin”

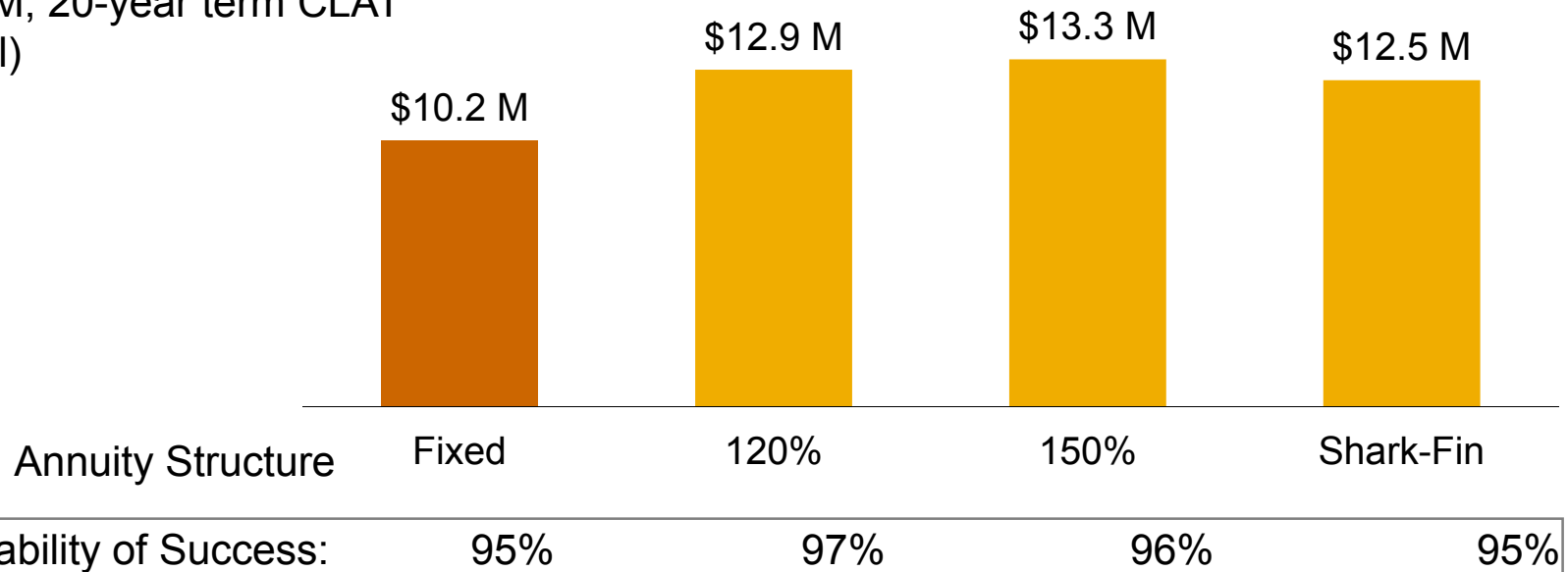
CLAT Design



CLAT Design

- Does backloading produce results?

Median wealth transferred*
\$10 M, 20-year term CLAT
(Real)



*Median inflation-adjusted non-grantor CLAT remainder assuming \$10 million zeroed-out 20-year CLAT, Section 7520 rate of 1.4%, invested 100% global equity. Probability of success defined as remainder interest >\$0. Source: AllianceBernstein Proprietary Model.

CLAT Design

- Tail off attributable to income taxes
- Non-grantor CLAT entitled to claim deduction under IRC §642(c) for lead payments
 - ❑ Limited to lesser of taxable income and payment to charity
 - ❑ No carry-back or carry-forward other than election to treat payments made in following taxable year as made in previous taxable year: IRC §642(c)(1)
 - ❑ Unused charitable deduction in final year does not carry out to remainder beneficiaries: IRC§ 642(h)(1) and (2)

CLAT Design

- Income ordering provisions – e.g., worst in, first out – do not work
 - ❑ Ineffective under IRC §681 unless have economic substance independent of tax consequences: IRS GCM 39,161 (Mar. 3, 1984)
 - ❑ Similarly ineffective under IRC §642: Treas. Reg. §§1.642(c)-3 and 1.643(a)-5 (only operable if impact amount paid to charity, which is not permissible)
- Consequently, distributions must consist of same proportion of each class of items of income as total of each bears to total of all classes, increasing potential tax friction

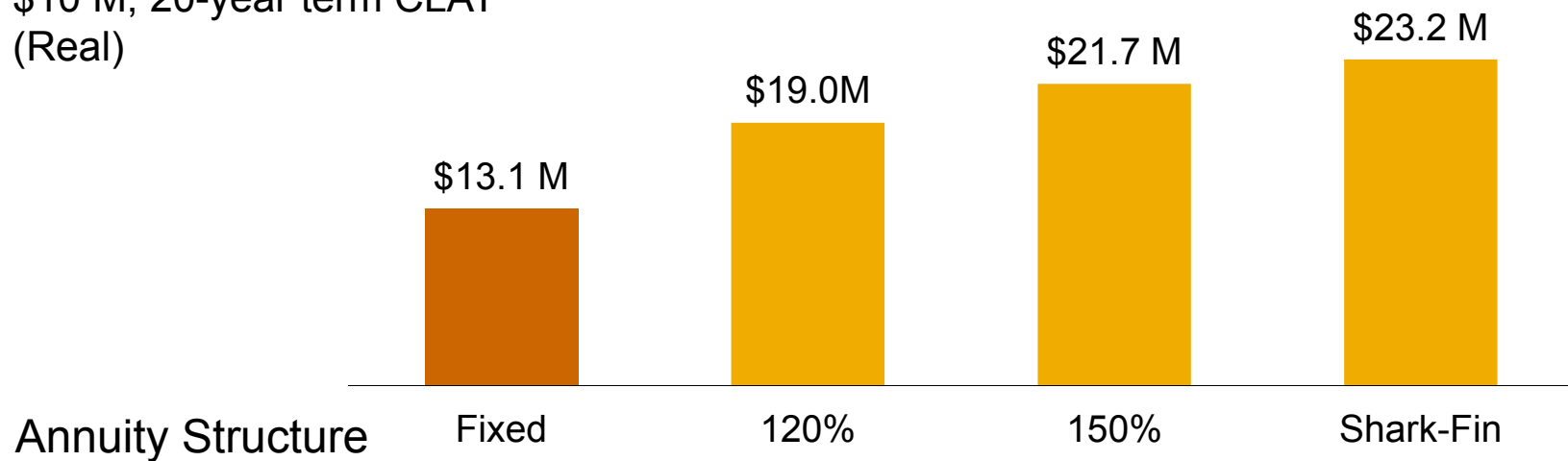
CLAT Design

- UBTI presents additional potential drag
 - ❑ No §642(c) deduction for UBTI: IRC §681(a)
 - ❑ Deduction permitted subject to percentage limitations applicable to individuals: IRC §512(b)(11)
 - ❑ But no punitive tax
 - Contrast 100% excise tax applicable to CRTs under IRC §664(c)(2)
- Back-loading may, however, minimize UBTI effect since otherwise allowable deduction is minimal in initial years

CLAT Design

- Better potential results if CLAT structured as grantor trust?

Median wealth transferred*
\$10 M, 20-year term CLAT
(Real)



Probability of Success:	95%	98%	>98%	>98%
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*Median inflation-adjusted grantor CLAT remainder assuming \$10 million zeroed-out 20-year CLAT funded at Section 7520 rate of 1.4%, invested 100% global equity. Probability of success defined as remainder interest >\$0. Source: AllianceBernstein Proprietary Model.

Grantor CLAT Issues

- Basis for grantor trust treatment
 - ❑ Substitution of assets: IRC §675(4)
 - Cannot be held by grantor due to self-dealing issues: Rev. Proc. 2007-45, §§7.11 and 8.09; Rev. Proc. 2008-45, §§7.11 and 8.09
 - Not per se rule: Rev. Proc. 2007-45, §8.09; Rev. Proc. 2008-45, §8.09
 - ❑ Independent trustee permitted to add remainder beneficiaries, or remainder distributions with consent of non-trustee, or spray power held by related or subordinate trustee: IRC § 674(c)
 - 100% grantor trust?

Grantor CLAT Issues

- Basis for grantor trust treatment
 - ❑ Power to purchase life insurance: IRC §677(a)(3)
 - Grantor trust only if life insurance purchased?
 - ❑ Power to accumulate or distribute income for or to donor or spouse: IRC §677
 - Undermines leverage of wealth transfer
 - ❑ Foreign trust: IRC §679
 - Exposure to tax under IRC §684?

Grantor CLAT Issues

- Grantor receives up-front income tax deduction: IRC §170(f)(2)(B); Treas. Reg. §1.170A-6(c)
 - ❑ But gift “for use of” charity: IRC §170(b)(1)(B)(i)
 - ❑ Five-year carry-forward should be available
- Grantor taxed on all income and gains earned and realized in trust
 - ❑ Applies even though income distributed to charity
 - ❑ Distributions in kind of appreciated assets cause grantor to realize capital gain: Rev. Proc. 2007-45, §8.02(2); Rev. Proc. 2008-45, §8.02(2); PLR 2009-20-031

Grantor CLAT Issues

- If grantor status terminates, up-front deduction subject to recapture: IRC §170(f)(2)(B); Treas. Reg. §1.170A-6(c)(4)
 - ❑ Conflict between Code and Regulations about method of calculating recapture
 - Code: total deduction received minus discounted value of all income taxed to donor prior to loss of status
 - Regulations: total deduction received minus discounted value of all amounts required to be and actually paid to charity prior to loss of status
 - Difference intentional, but which approach prevails? Code per Rev. Proc. 2007-45, §8.01(5); Rev. Proc. 2008-45, §8.01(5)

Grantor CLAT Issues

- What happens when trust terminates at grantor's death?
 - ❑ Recapture requires loss of status "before the termination" of lead interest: Treas. Reg. §1.170A-6(c)(4)
 - ❑ What if final annuity payment due at grantor's death and not actually paid until after death?
 - Vest final annuity in charitable annuitant as of due date?

Grantor CLAT Viability

- Despite issues, escalating or back-loaded grantor CLAT may open up vehicle to be funded with certain assets previously considered unsuitable
 - ❑ Closely held business interests
 - ❑ Private equity investments
 - ❑ Single stock positions
 - ❑ Life Insurance

Fixed Term or Measuring Life

- Measuring life limitations: 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)
 - Donor
 - Donor's spouse
 - Individual who, with respect to all non-charitable remainder beneficiaries, is either lineal ancestor or spouse of lineal ancestor of those beneficiaries; rule satisfied if less than 15% probability that persons who are not lineal descendants of measuring life will receive trust property
- Response to so-called “ghoul” or “vulture” trust planning

Fixed Term or Measuring Life

- Special actuarial rules
 - Mortality component of IRS Tables cannot be used if measuring life is terminally ill: Treas. Reg. §§1.7520-3(b)(3), 20-7520-3(b)(3), and 25-7520-3(b)(3)
 - Terminal illness if at least 50% probability that will die within 12 months
 - If survive 18 months or more, presumed not to be terminally ill

Fixed Term or Measuring Life

- 110 year exhaustion test
 - ❑ Guaranteed annuity not considered payable for entire term if annuity expected to exhaust fund prior to end of term using applicable §7520 rate
 - ❑ For this purpose, each measuring life assumed to live until age 110
 - ❑ If applicable, special factor required to be used: Treas. Reg. §25.7520-3(b)(2)(v), ex. 5
- Cannot zero-out
 - ❑ Impact reduced by limiting trust to lesser of term and life, but still cannot reach zero value for remainder

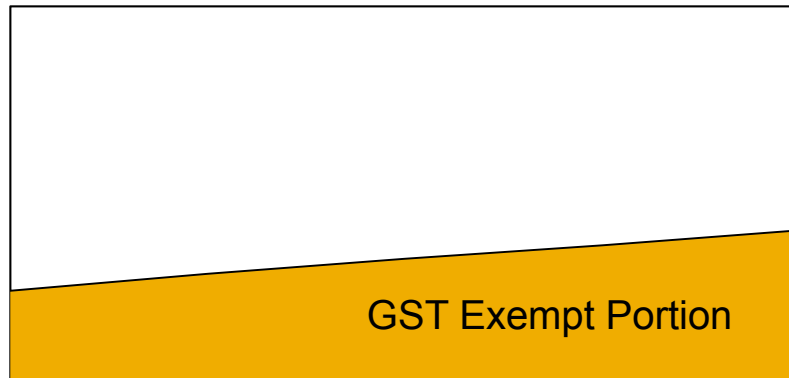
Generation-Skipping Planning

- CLAT remainder value can be zeroed-out; CLUT remainder value cannot

<u>CLAT Annuity</u>		<u>Resulting Remainder Value or Taxable Gift</u>
\$611,569	Section 7520 rate = 2% \$10 M funding contribution; 20-year term	\$ 0
\$550,411		\$1,000,000
<u>CLUT Unitrust</u>		<u>Resulting Remainder Value or Taxable Gift</u>
7%		\$2,412,830
8%		\$1,952,680
9%		\$1,576,350
10%		\$1,269,860
11%		\$1,020,670
11.1%		\$1,000,000

Generation-Skipping Planning

CLAT Assets

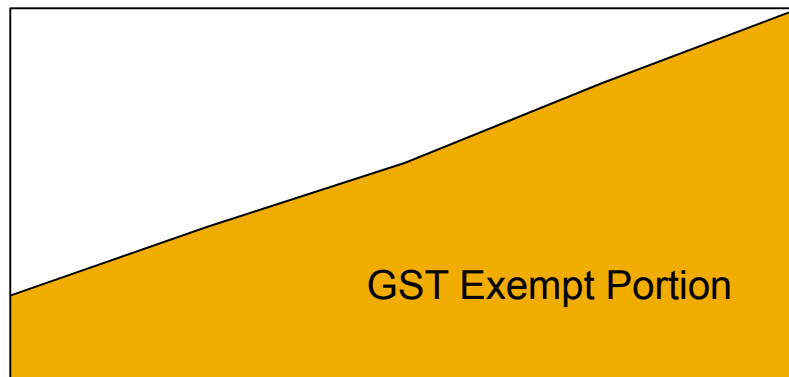


Inclusion ratio and benefit of GST tax exemption: based on final value

GST tax exemption: compounded by §7520 rate

$\$1.0 - \$5.34 \text{ M} \times 2\% (\$7520 \text{ rate})$
 $\times 20 \text{ Years (Term of CLAT)} = \$1.49 - \$7.94 \text{ M}$

CLUT Assets



Inclusion ratio and benefit of GST tax exemption: based on starting value

Compounded by actual investment performance

Generation-Skipping Planning

Option 1:

\$10 M -- 20 year grantor CLUT

11.027% unitrust payout

\$1 M taxable gift

\$1 M of GST tax exemption applied

Entire CLUT remainder free of GST Tax

Option 2:

\$9 M -- 20 year grantor CLAT

50% annual escalator; FMV annuity stream = funding assets

+

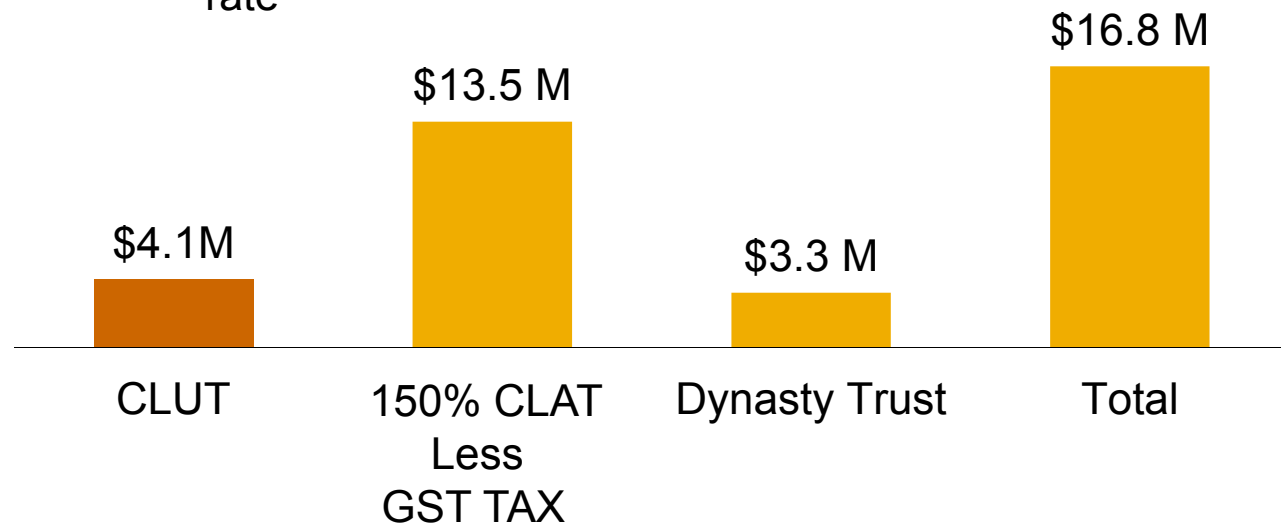
\$1 M taxable gift to separate dynasty trust

\$1 M of GST exemption applied

Entire CLAT remainder subject to GST Tax

Generation-Skipping Planning

Median wealth transferred*
 \$10 M funding, 20-year term, 1.4% 7520
 rate



Probability of Success:	100%	>98%	>98%	>98%
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*Wealth values are based on estimates of range of returns for applicable capital markets over next 20 years. Data do not represent any past performance and are not a promise of actual future results.

**GST Taxes are assumed to be at a 40% rate. Global equities defined as 35% US value, 35% US growth, 25% developed international and 5% emerging markets.

Source: AllianceBernstein Proprietary Model

Summary

- **Interesting planning opportunities available:**
 - ❑ Low Section 7520 rates favor annuity based planning
 - ❑ Ability to back-load charitable payout and avoid early year impact of low or negative investment returns
- **Issues to consider:**
 - ❑ How should annuity payments be structured?
 - ❑ Grantor or non-grantor CLT?
 - ❑ Application of private foundation rules
 - ❑ Fixed term or life? If term, how long?
 - ❑ Investment policy