Steve Leimberg's Charitable Planning Email Newsletter - Archive Message #191

Date: 02-Oct-12

From: Steve Leimberg's Charitable Planning Newsletter

Subject: Jeff Baskies: Is it Time to Talk About Taxable CLATs?

"As everyone is painfully aware at this point, the $5.12 million gift tax exemption is scheduled to expire on December 31, 2012. Naturally, using the exemption before it expires is a very hot topic among high net worth families and their advisors.

We are all seeing a sharp increase in the creation of a variety of gifting vehicles to lock in this exemption before it expires. Clients are creating inter vivos credit shelter trusts (sometimes called 'SLATs'), self-settled irrevocable trusts (in states with domestic asset protection legislation like Delaware, Nevada, Alaska and others), the oh-so-dangerous 'non-reciprocal' reciprocal trusts, gift-splitting 'dynasty' trusts for children and descendants and implementing a variety of other techniques.

One way to use some or all of the exemption that appears to be getting too little attention is the 'taxable CLAT.' It may be that the timing has never been better to create and fund taxable CLATs."

Now, **Jeff Baskies** provides members with a helpful reminder that there is much to gain by adding taxable CLATs to "end of year" gift tax planning discussions.

Jeffrey A. Baskies is an honors graduate of Trinity College and Harvard Law School. Jeff is a Florida Bar certified expert in Wills, Trusts and Estates law who has an emphasis in his practice on issues relating to Florida Homestead law. Jeff practices at **Katz Baskies LLC**, a Boca Raton, FL, boutique trusts & estates, tax & business law firm. In total, Jeff has more than 100 published articles. He has been a frequent **LISI** contributor, and his articles have also been published in Trusts & Estates, Estate Planning, Probate Practice Reporter, Probate and Property, the Florida Bar Journal, Lawyers Weekly USA and other journals. He's been frequently quoted as an expert estate planner in the Wall Street Journal, the New York Times, the Boston Globe, Forbes Magazine and other news publications. Jeff has been listed in Best Lawyers in America (including recently being named the 2013 South Florida Trusts and Estates "Lawyer of the Year" by Best Lawyers), in the Worth magazine list of the Top 100 attorneys in the country (3 times), in Florida Trend's Legal Elite, in Florida SuperLawyers (including listing as one of the "Top 100" attorneys in Florida – 2009-2012) and in other similar publications. Finally, Jeff is the new author of the 2013 edition of West publishing's book, Estate, Gift, Trust, and Fiduciary Tax Returns: Planning and Preparation. He can be reached at www.katzbaskies.com.

Here is his commentary:

EXECUTIVE SUMMARY:

As everyone is painfully aware at this point, the $5.12 million gift tax exemption is scheduled to expire on December 31, 2012. Naturally, using the exemption before it expires is a very hot topic among high net worth families and their advisors.

We are all seeing a sharp increase in the creation of a variety of gifting vehicles to lock in this exemption before it expires. Clients are creating inter vivos credit shelter trusts (sometimes called "SLATs"), self-settled irrevocable trusts (in states with domestic asset protection legislation like Delaware, Nevada, Alaska and others), the oh-so-dangerous "non-reciprocal" reciprocal trusts, gift-splitting "dynasty" trusts for children and descendants and implementing a variety of other techniques.

One way to use some or all of the exemption that appears to be getting too little attention is the "taxable CLAT". Taxable CLATs are inter vivos Charitable Lead Annuity Trusts (could be the grantor or non-grantor variety) where the remainder has a value in excess of $0. It may be that the timing has never been better to create and fund taxable CLATs.

August and September's Section 7520 rate was 1%, which as we know was the lowest since the Treasury began keeping track and publishing rates. We also now know that the October Section 7520 rate went up, albeit slightly, to 1.2%. Nevertheless, for clients wishing to utilize taxable CLATs and lock in the best rate ever, certainly there are less than a few months left to get started, because the grantor can apply the rate for the month the CLAT is created or the rate for either of the two preceding months – whichever is the most favorable (i.e. the lowest AFR). Thus, the 1% September AFR can be used for CLATs funded in October and November as well (even though the October AFR is 1.2%).

What sorts of clients might benefit from taxable CLATs? Well, many clients might benefit from considering using them. Obviously, CLATs should appeal to clients with significant charitable desires, particularly those with existing foundations or family funds at community foundations. Secondly, clients who annually make substantial charitable gifts would benefit from funding CLATs. Finally, for clients willing to gift more than their remaining gift tax exemption, the taxable CLAT presents a great opportunity.

For example, a favorite client has a little over $1 million of gift tax exemption left. He called to discuss how to utilize it before year-end. Instead of adding all of it to a dynasty trust he previously created, the client has decided to add $500,000 to that dynasty trust and to simultaneously fund a taxable CLAT with $1 million. He asked us to design the payout on the CLAT so the remainder value on funding will be approximately $500,000,

and he wanted to fund the taxable CLAT with $1 million (which conveniently meant a payout of approximately 5%/year).

As explained in more detail below, the taxable CLAT was a perfect fit for this client, and perhaps it should be considered for many more clients as well.

FACTS:

CLATs: Gift Tax Issues

Inter Vivos Charitable lead annuity trusts ("CLATs") are irrevocable trusts that make current distributions to charity of a defined annual amount (the "annuity") for a predetermined term (which could be based on a life or based on a set term of years). At the end of the term, whatever is left in the CLAT (the remainder) passes to individual beneficiaries selected by the client (presumably the client's family members).

CLATs work particularly well in periods of low interest rates (as we obviously are experiencing now) as the low rates increase the value of the income streams and thus reduce the value of the taxable gifts. Thus, CLATs allow clients to transfer significant wealth at reduced gift tax cost, as a result of the gift tax deduction

CLATs may be designed to have a zero gift tax cost by calculating the income stream equal to the value of the assets funding the CLAT. These are sometimes called "zeroed-out CLATs". Zeroed-out CLATs are a very appealing technique to clients who want to make gifts but have used their exemptions. They are also very useful in will/revocable trust planning.

However, CLATs don't have to be zeroed-out. For clients with gift tax exemption remaining, creating CLATs with taxable remainders (sometimes referred to as "taxable CLATs") may be a powerful wealth transfer tool that is currently being overlooked.

CLATs: Income Tax Issues

In addition to the gift tax planning opportunities, CLATs also present income tax planning opportunities as well. CLATs come in two varieties: grantor CLATs and non-grantor CLATs.

With a non-grantor CLAT, the grantor gets no up-front income tax deduction (although of course does get the up-front gift tax deduction) but is not required to include the CLAT income on his returns during the CLAT term.

With a grantor CLAT, the grantor receives an up-front income tax charitable deduction equal to the actuarial value of the income stream, but in exchange for the up-front deduction, the client will report the annual income on his return during the CLAT term.

So the client gets a deduction which can be taken in the year the CLAT is created, but the CLAT is taxed for income tax purposes as a "grantor trust".

In some instances, grantor CLATs will be preferred. For example, for a client expecting a big income tax hit in one year (e.g. selling a business or depreciated real property), bunching the deductions in the current year may be valuable. That client may already be considering a large outright charitable gift, but perhaps will prefer the grantor CLAT instead.

For a client with gift tax exemption available, funding a taxable grantor CLAT may be a very powerful vehicle. However, this technique may not be around much longer. As **Jerry McCoy** highlighted in a May 24th **LISI** commentary "Is this the End for Grantor CLTs", it is part of President Obama's 2013 budget proposal to reduce the appeal of grantor trusts, including grantor CLATs by including grantor trust assets in the estates of the grantors who funded them. See Charitable Planning Newsletter #186.

While we don't know if the President's budget proposal will blossom into actual tax law, as Jerry concluded: "taxpayers who are now considering creating a grantor CLT might want to complete such a transfer promptly, in order to come within the benefit of the proposed transition rule. And at a minimum, advisors should watch this issue."

CLATs: Don't Forget the Charitable Component

Finally, in addition to the gift and income tax planning opportunities presented by CLATs, they are also a number of non-tax advantages that should not be overlooked.

First, taxable CLATs can take a lot of money that would otherwise have gone to taxes and instead focus that money on philanthropic purposes. That's something positive for clients, for their families and for our world, hopefully. Second, assuming most taxable CLATs will fund either donor advised funds at community foundations or family foundations, the funds passing via the income interest in the taxable CLAT will likely create a very substantial future stream of charitable distributions. Both are good and positive results.

COMMENT:

As virtually all planners are talking with clients at this time about taxable gifting before year-end, one way to use some of the gift tax exemption that appears to be getting too little attention is the "taxable CLAT".

In the case of the client mentioned above, using the current AFR (1% - which is lower than the 1.2% AFR in October, but it is still available as clients may use the AFR from any of the two months prior to the establishment of the CLAT), a 5% annual payout from the CLAT for 10 years (on a $1 million dollar CLAT) produced a taxable remainder (i.e.

gift) of about one-half, or in this case, $526,000. That was perfect for this client, who wanted to use part of his gift exemption to "top off" a grantor/dynasty trust and part to fund a CLAT. Assuming the client's CLAT earns about 5%/year, his children should receive the whole $1 million in a decade.

In this example, the client's children receive more money during the client's life with the taxable CLAT than they would have received if the client gave them the full $1 million now. Assuming the funds grow at 5%/year, in a decade, the children will get $1 million from the CLAT plus the $500,000 gifted to the dynasty trust will grow (assuming the same 5%/year) to $814,000. Therefore, after 10 years, this plan produces an assumed $1.814 million to the client's children/family.

Had the client given the full $1 million gift to his children now, they would have $1.629 million a decade later at the same assumed 5% annual growth rate.

Thus, in this example where the client had limited tax-free gifting, by adding the taxable CLAT, the client will actually pass more wealth to his family during his lifetime, while simultaneously giving $500,000 to charity.

Of course, in this example, the big difference is that after the gifting, the client will have $500,000 less in his name as he has to give away $1.5 million to fund both the $500,000 gift to the dynasty trust plus the $1 million gift to the taxable CLAT. However, assuming (a) the client will not pay a gift tax to give more funds to his children during life, (b) the funds he would have retained would grow in his estate and be taxed in the future at higher rates and (c) the family would have to wait until the client's death (which hopefully will be several decades off) before receiving the benefits of the retained funds, the family is very well off having chosen to use the taxable CLAT for part of the gift!

Finally, for this client, and others, we should not ignore the benefits of the added gift charitable gift. The client's existing family foundation (over which the children will exclusively manage this portion) receives $500,000, which at 5% per year, means the family will give away an extra $25,000 to favored charities forever (or until they decide to give away more and use up the foundation). Other clients will enjoy similar benefits. When planning for other clients, it may be easier to pay the taxable CLAT annuity payments to a donor advised fund at a community foundation and let the children be the donor advisors.

Technically, the client/donor can be a donor advisor as well; whereas, the donor/client must be walled off from and must not manage the funds in a private foundation. The benefits of such additional philanthropy should not be overlooked. On the one hand, that's a lot of money that may otherwise have gone to taxes which instead will be used for philanthropic purposes. On the other hand, at 5% per year, for this client that's an

additional $25,000/year the family will give to charity forever as a result of the client's new taxable CLAT. Both are good and positive results.

As you can see, there is much to gain by adding taxable CLATs to "end of year" gift tax planning discussions.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Jeffrey A. Baskies

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