Steve Leimberg's Charitable Planning Email Newsletter - Archive Message #194

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From: Steve Leimberg's Charitable Planning Newsletter

Subject: Jeff Baskies & Jonathan Blattmachr Follow-Up on Taxable CLATs: An Oft-Overlooked and Little-Known Exception Makes Them Even More Attractive

In Charitable Planning Newsletter #191, **Jeff Baskies** presented a number of powerful reasons for advisors and clients to consider taxable CLATs in the discussions of how to use the $5.12 million exemption. Now, joined by **Jonathan Blattmachr**, they explore a little-known exception to the private foundation rules and CLATs. The authors highlight another important opportunity for clients to consider taxable CLATs this year – to set up CLATs that are not subject to the excess business holdings and jeopardy investments limitations in Sections 4943 and 4944 which may be very important for closely-held business owners.

And so again it appears, 'taxable CLATs' are a technique that may not be getting enough attention and it may be that the timing has never been better to create and fund taxable CLATs. Jonathan and Jeff provide members with a helpful reminder that there is much to gain by adding taxable CLATs to "end of year" gift tax planning discussions.

Jonathan G. Blattmachr, with Dallas Attorney and ACTEC Fellow **Michael L. Graham**, is co-author and developer of Wealth Transfer Planning, a software system that provides specific client advice about estate planning matters and automatically prepares client documents, such as wills, revocable trusts, GRATs and much more. You can learn about Wealth Transfer Planning at www.interactivelegal.com. Jonathan also is the author of five books and hundreds of articles and is now a director of **Eagle River Associates**, a wealth management firm in New York.

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 their commentary:

EXECUTIVE SUMMARY:

With the $5.12 million gift tax exemption scheduled to expire on December 31, 2012, advisors and clients are looking for opportunities to use the exemption optimally based on client's needs and interests. Sometimes, the techniques to use are simple and obvious (e.g. a single client with a single child asks to create a "dynastic" trust for the child and descendants and use her gift exemption on a transfer of cash or marketable securities to it). Other planning opportunities have added levels of difficultly, based on the clients' needs and the advisors' creativity.

Some clients are interested in gifting life insurance policies; others are forgiving notes from prior estate planning transactions. Many clients are creating (one or more) inter vivos credit shelter trusts (sometimes called "SLATs"), some of which are being created and funded under the laws of states that permit self-settled irrevocable trusts (states with domestic asset protection legislation like Delaware, Nevada, Alaska and others). Many clients are pushing the edges of the dangerous "reciprocal trust doctrine." Some clients are creating taxable GRATs. 2012 gifting is undoubtedly taking on dozens of other forms, many of which are explored in the new book on 2012 planning that Jonathan has just had published with **Marty Shenkman** and **Bob Keebler** titled: Estate Planning: Tax Planning Steps To Take Now. There are three ways to order:

- **Kindle Version**: Available on amazon.com
- **PDF Version:** Available from The Ultimate Estate Planner, Inc. at www.ultimateestateplanner.com or 1-866-754-6477
- **Hard Copy**: Available from Keebler & Associates, LLP at (920) 593-1705 or by email at Emily.Rosenberg@keeblerandassociates.com.

One way to use some or all of the exemption that thus far appears to be getting too little attention is the "taxable CLAT," meaning that the value of the taxable remainder is not structured to have a zero value. As expressed in Charitable Planning Newsletter #191, **Jeff Baskies** presented a number of powerful reasons for advisors and clients to consider taxable CLATs in the discussions of how to use the $5.12 million exemption. We won't rehash that discussion except to suggest a review of the prior **LISI** commentary.

The reason for the follow up article, however, is to highlight a little-known exception that makes using taxable CLATs even more powerful, and to show how this exception may make taxable CLATs this year particularly helpful and important for clients with closely held business interests.

FACTS:

CLATs: Basic Private Foundation Rules

As we know, CLATs are subject to the private foundation rules. Essentially, the code says that except as expressly otherwise provided, certain split interest trusts (which include CLATs) are treated as if they are private foundations and are subject to the private foundation rules, generally those contained in Sections 4941, and 4943-4945.

In particular, Section 4947(a)(1) states in part:

> 26 USC § 4947 - APPLICATION OF TAXES TO CERTAIN NONEXEMPT TRUSTS
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> (a) Application of tax
>
> (1) Charitable trusts
>
> For purposes of part II of subchapter F of chapter 1 (other than section 508(a), (b), and (c)) and for purposes of this chapter, a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law), shall be treated as an organization described in section 501(c)(3). For purposes of section 509(a)(3)(A), such a trust shall be treated as if organized on the day on which it first becomes subject to this paragraph.
>
> (2) Split-interest trusts
>
> In the case of a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, section 507 (relating to termination of private foundation status), section 508(e) (relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3),section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) shall apply as if such trust were a private foundation. This paragraph shall not apply with respect to—
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> (A) any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B),

(B) any amounts in trust other than amounts for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such other amounts are segregated from amounts for which no deduction was allowable, or

(C) any amounts transferred in trust before May 27, 1969.

Section 4941 provides taxes on self-dealing.

Section 4943 provides taxes on excess business holdings.

Section 4944 provides taxes on investments which jeopardize the charitable purpose of the entity ("jeopardy investments").

Section 4945 provides taxes on taxable expenditures.

Sections 4943 and 4944 are of primary significance for clients who own closely held business interests and might have an interest in taxable CLATs.

With certain exceptions for trusts created before 1969, generally speaking section 4943 imposes an annual tax equal to 10% of the value of any excess business holdings in a CLAT. The definition of excess business holdings is complex and depends on the percentage held in the CLAT, the percentage held by "disqualified persons" but generally the only safe haven is the 2% de minimis rule in Section 4943(c)(2)(C).

And Section 4944 taxes jeopardy investments. Again the tax is 10% of the value of the jeopardy investments. However, there are additional taxes on the foundation managers (the CLT trustee) and on the foundation (the CLT) if the investment is not removed from jeopardy.

The additional taxes are 25% and 5%. Here is a key but almost secret rule relating to charitable lead ANNUITY trusts (CLATs): it's not just the acquisition of a jeopardy investment that can result in the imposition of a tax under Section 4944 but even retaining one given to the trust also may result in the tax. Treas. Reg. 1.170A-6(c)(ii)(D) requires the governing instrument must prohibit both the acquisition and the retention of assets which would give rise to tax under Section 4944, if the present value on the date of transfer of the income interests for charity exceeds 60% of the trust. That could mean that the owner of a closely-held business who wishes to preserve his or her company for the family through the use of a charitable lead trust would not be able to do so because the jeopardy investment rule would come into play after the gift of the business interest is made to a lifetime CLAT or a bequest of it is made to one at death.

Practically, this means a client cannot fund an inter vivos CLT with a family owned and controlled closely held business, unless an exception applies (as noted below). Of course, this Section is very frustrating to clients as the closely held business is precisely the asset many wealthy families wish to use to fund the CLT. CLTs of course work best where they are funded at times of low interest rates (today) with assets that are expected to appreciate in excess of the assumed rates (often clients assume the value of their businesses will be the most highly appreciating asset they own).

Taxable CLATs: The Exception

There is an exception, however, in the private foundation rules applicable to split interest trusts like taxable CLATs. Essentially, Section 4947 exempts certain taxable CLATs from the application of excess business holdings and jeopardy investment taxes, where the value of the deduction (the income interest) was 60% or less of the aggregate fair market value of all amounts in the trust.

Section 4947 (b) provides in pertinent part:

> (b) Special rules
>
> … (3) Sections 4943 and 4944
>
> Sections 4943 and 4944 shall not apply to a trust which is described in subsection (a)(2) if—
>
> (A)all the income interest (and none of the remainder interest) of such trust is devoted solely to one or more of the purposes described in section 170(c)(2)(B), and all amounts in such trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 have an aggregate value not more than 60 percent of the aggregate fair market value of all amounts in such trusts, or…

Thus, Section 4947(b)(3) provides a "get out of jail free" card if the income interest in the CLAT is less than 60% (the "60% exception"). Obviously, the 60% exception didn't help as much in the past as creating a CLAT with an income interest worth no more than 60% would have meant paying taxes in most situations as the gift tax exemption was "only" $1 million. However, with a $5 million exemption, a much larger transfer is now possible, making the leveraging of the taxable CLAT funded with a closely held business much more attractive.

Taxable CLATs: How the Exception Helps Clients

For example, using the current 1% AFR available for transfers in October and November, a CLT with an annual payment to charity equal to 5% of the initial fair market value of the assets transferred would only need to last 12 years to reduce the FMV of the income interest below 60% (56.28%). A quick NumberCruncher analysis shows that a client could transfer assets worth $11,700,000 to a 12 year CLAT with a 5% annual payout and qualify for the 60% exception (the deductible portion is 56.275%) and also keep the gift under the $5.12 million exemption ($5,115,766.50 in this example).

However, using the 5.2% AFR available for transfers in October 2007 (5 years ago), and the $1 million gift exemption, a CLT with an annual payment to charity equal to 5% of the initial fair market value of the assets transferred lasting for 12 years could not be funded with more than $1.7 million and stay below the $1 million exemption. While a $1.7 million gift would keep the income interest below 60% (43.821%), obviously, the leverage is nearly 7 times greater ($11,700,000 worth of a closely held business is nearly 7x more than $1,700,000 worth) in 2012 using the current interest rate/gift tax exemption.

Obviously, with a higher gift exemption and a lower AFR, clients are able to fund a much larger portion of a closely held business into a taxable CLAT today. This makes the technique much more attractive. Per the examples above, a client might transfer over $10 million worth of a closely held business into a taxable CLAT today, avoid the application of the two key private foundation rules, "only" have to pay out 5% per year for 12 years, and pass the business to her family members.

Plus, the examples assume FMV for the business interests transferred, and assuming the FMV of the non-marketable and non-controlling interests the clients will gift comes after discounts (which could range for 30-60%+), the leveraging is even greater. A client might transfer $20 million of value to a taxable CLAT today, use the $5 million exemption, and still qualify for the 60% exception allowing the closely held business assets to remain in the CLAT without penalty.

CLATs: Don't Forget the Charitable Component

Finally, in addition to the gift and excise tax planning opportunities presented by taxable CLATs and the 60% exception, any discussion of CLATs should not ignore the charitable component.

Using the numbers in the example above, funding a CLAT with $11,700,000 and paying out 5% per year ($585,000) for 12 years, over $7 million will pass to charity, presumptively a family foundation or a donor advised fund at a community foundation. Assuming it earns 5% per year, that means in addition to all the other family tax planning the taxable CLAT offered, the client's family can also disburse $350,000/year to charities of their choosing forever.

COMMENT:

As we are all talking with clients about taxable gifting before year-end, one approach to use some of the gift tax exemption is suggesting taxable CLATs to business owner clients as a technique that really is "new" given the leveraging and such available in the current interest rate environment as well as the gift tax exemption.

The 60% exception offers a valuable planning opportunity making the concept of taxable CLATs even more attractive than ever. 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!

Jeff Baskies

Jonathan Blattmachr

CITE AS:

CITES:

IRC Sections 4941, 4943, 4944, 4945 and 4947.