

## **Charitable Lead Annuity Trusts- Not for the Faint of Heart**

**Take-Away:** A charitable lead annuity trust, or CLAT, is a seldom used estate planning strategy due primarily to its complicated rules. However, in certain limited situations, a CLAT might be a useful tool to generate an immediate large charitable income tax deduction, but only so long as the donor is also charitably inclined.

**Background:** A charitable lead annuity trust (CLAT) is a split-interest trust that pays a fixed annuity to one or more charities for a defined period, after which the trust remainder then passes to noncharitable beneficiaries, often the settlor's children (usually not, though, donor's grandchildren due to the generation skipping transfer tax ETIP allocation rules.) A CLAT can at times be used to generate a large, immediate, charitable income tax deduction that the donor can then use to mitigate the income tax burden that results from a one-time large liquidity event, such as the sale of a business with substantial gain recognition. Yet, there are some strange rules that are associated with a transfer of cash or property to a CLAT the donor needs to be aware of before making the transfer. Some CLAT specifics, quirks, and drawbacks are addressed in the following paragraphs.

**Income Taxes:** The major difference between a CLAT and a charitable remainder trust (CRT) is that a **CLAT is not exempt from income tax**. In contrast, a CRT is exempt from income taxation. [IRC 664(c).]

**Transfer Taxes:** Funding a CLAT during lifetime generates a federal gift tax deduction. [IRC 2522(c)(2)(B).] If it is a testamentary transfer by a decedent to a CLAT, that transfer of assets will qualify for the federal estate tax charitable deduction. [IRC 2055(e)(2)(B).]

**Valuation:** The value of the donor's transfer to the CLAT is the present value of the annuity interest paid to the charity that is determined using the IRC 7520 interest rate that is in effect at the time of the transfer to the CLAT. From this present value calculation, the value of the taxable transfer to the CLAT's noncharitable remainder beneficiary is derived, and on which the donor's gift tax (if any) is due. [This 'subtraction' calculation is much like how the taxable gift is identified when a principal residence is transferred to a QPRT.]

**Calculation:** The amount of the charitable income tax deduction is determined by the present value of the guaranteed annuity interest to be paid to the charity. [IRC 170(f)(2)(B) and IRC 7520.] The amount of cash contributed, or the fair market value of property that is transferred to the CLAT is consequently *not relevant* to determine the donor's allowable charitable deduction. Those values play no role in the actuarial computation, and they thus have no bearing on the value of the charity's lead interest in the CLAT. In other words, the asset appreciation or ordinary income character of the contributed property to the CLAT will not affect the amount of the charitable deduction that the donor can claim.

**Two CLAT Forms- Grantor CLAT:** As a generalization, a CLAT comes in two alternate forms. The CLAT is either classified as a *grantor* trust for income tax purpose, or it is classified as a nongrantor trust. As a nongrantor trust, the CLAT pays its own income tax liability for the amount of gross income that is not paid to charity, but no immediate charitable deduction to be claimed by the donor. [IRC 642(c).] Thus, this either/or classification an important distinction when it comes to claiming the charitable deduction. Unlike an outright gift where the donor permanently parts with all economic value, a grantor CLAT allows the donor to claim a full 'upfront' charitable deduction even though the donor's family may ultimately receive substantial value when the charity's annuity interest in the trust comes to an end.

**Grantor Trust Classification:** If the CLAT is set-up as a *grantor* trust, the settlor can claim an **immediate** charitable income tax deduction (or his/her estate can claim the federal estate tax charitable deduction if a testamentary CLAT is funded) equal to the present value of the annuity stream that is paid to the charity-annuitant. The obvious trade-off for that 'up-front' charitable income tax deduction is that the settlor will be treated as the owner of the entire *grantor* CLAT for income tax purposes and he/she must report all trust income and capital gains during the entire annuity payment period on the settlor's personal income tax return. [IRC 170(f)(2)(B).]

**Recapture:** The 'up front' immediate charitable deduction that can be claimed by the donor to a CLAT comes with a price, as just noted, which is that the donor must be treated as the owner of the CLAT and he/she is taxed on the trust's income for the entire charitable annuity term. Recapture is the mechanism that enforces the 'bargain' the donor made to be able to claim an immediate charitable deduction. If the grantor dies during the charity's

annuity payment period, some of the previously claimed charitable deduction will be recaptured.

**Statute vs Regulation:** The ‘recapture’ of the earlier claimed charitable deduction reflects only the charitable value that actually materialized before the donor’s death. The donor must include in his/her income the amount of the previously allowed charitable deduction, reduced by the discounted value of all trust income taxable to the donor before the grantor-trust status ends, *but* without reference to the actual amounts actually paid by the CLAT to the charity. As a result, the statutory formula can produce an outcome that bears little relationship to the charitable benefit actually delivered by the CLAT, especially when trust income is high but the annuity payment to the charity is more modest. In this narrow situation, the statutory recapture formula may be significantly more favorable to the donor than a method that is tied to the actual charitable payout. Unfortunately, the IRS Regulation on this statutory recapture rule and how the recapture amount is calculated under the statute is something of a mismatch, but this difference has not been ‘fixed’ in over 50 years. [Regulation 1.170A-6(c)(4).] Consequently, it is important to follow the Regulations, not the statute, when calculating the recapture the amount the donor must report.

**Key Point:** Only a CLAT that is classified as a *grantor* trust is eligible for an **immediate charitable deduction** by its donor. Nor will there be any additional charitable deductions claimed as annuity payments are made from the CLAT to the beneficiary-charity.

**AGI Deduction Limitations:** A contribution to a *grantor* CLAT is treated as a contribution **for the use of a charity**, and not a contribution ‘to’ the charity. [Regulation 1.170A-8(a)(2).] This ‘*for the use of*’ classification dramatically reduces the applicable adjusted gross income (AGI) percentage limitations under IRC 170(b) which controls the amount of the donor’s charitable tax deduction. Accordingly, even though the donor received an income tax charitable deduction, the AGI limits for a CLAT are not nearly as favorable as those for either an outright gift to charity or the donor’s contribution to a CRT, which are in those situations treated as transfers ‘to’ a charity for AGI limitation purposes.

**AGI Limits:** Therefore: (i) the 60% AGI limit for cash gifts to a public charity is not available for a cash gift to a CLAT, even when the CLAT is funded with cash and the ‘lead’ charitable beneficiary is a public charity; and (ii) the usual 30% AGI limit for contributions of long-term

appreciated capital gain property to public charities does not apply regarding a gift of property to a CLAT. Instead, because a contribution to a CLAT is always **for the use of charity**, the applicable AGI percentage ceilings are: (i) 30% of AGI for *cash* contributions to a CLAT, regardless of whether the 'lead' charity is a public charity or a private foundation; and (ii) 20% of AGI for long-term appreciated capital gain property transferred to a CLAT, regardless of whether the 'lead' charity is a public charity or private foundation. Recall, too, that these AGI limitations apply to the present value of the charity's annuity interest determined under IRC 7520, not to the amount of cash actually contributed or the fair-market value of the property actually transferred to the CLAT.

**No Contemporaneous Written Acknowledgement:** A transfer to a CLAT is expressly exempt from the contemporaneous written acknowledgement requirement of IRC 170(f)(8). [Regulation 1.170-13(f)(13.)] That is because it is a grantor trust. Accordingly, a transfer to a grantor CLAT is exempt from that written acknowledgement requirement, regardless of the size of the donor's contribution to the CLAT.

**Revenue Procedure 2007-45:** This Revenue Procedure contains the IRS's sample grantor trust CLAT form. It uses the power of substitution under IRC 645(4) as the basis for the CLAT's grantor trust tax classification. However, the Procedure warns that an improperly structured substitution power may constitute self-dealing, which is why that form specifies that the substitution power must: (i) be held by an independent third party; (ii) who is not the donor, the trustee, or any disqualified person (IRC 4946); and (iii) be exercisable solely in a nonfiduciary capacity, all to avoid the self-dealing prohibition under IRC 4941.

**Shark-Fins:** There are even more unusual rules (or perceived abuses) that apply to CLATs, such as the back-loaded CLAT, that carries the highly suggestive name 'Shark-Fin CLAT,' which pays only a modest annuity amounts for most of the annuity payment period, followed by one very large payment near the end of the annuity period. If the donor to the Shark-Fin CLAT survives the grantor trust annuity period, there is no recapture. If, however, the donor dies during the annuity payment period, the regulatory method to recapture allows an offset only for the small amount that is actually paid to the charity. Because the charitable benefit has not occurred, the resulting recapture can be catastrophic. Suffice it to say that a Shark-Fin CLAT will be on the IRS's 'watch-list.'

**Conclusion:** For a philanthropic high-net-worth donor who wants to secure a substantial end-of-year charitable income tax deduction, while possibly shifting wealth to family members over time at a low, or no, transfer tax cost, a CLAT might be a useful strategy to consider. The ability to front-load a multiyear charitable stream into a single present value charitable deduction could make a grantor CLAT attractive to some donors. Balanced against that deduction opportunity is the complex, technical, and candidly often unintuitive, rules that must be followed.

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