

Early Termination of CLAT and DAFs

Take-Away: A charitable lead annuity trust, or CLAT, is a powerful estate planning tool to exploit a charitable deduction and potentially pass future appreciation to heirs without any transfer tax cost. The use of a donor advised fund, or DAF, as the charitable lead beneficiary could provide some additional flexibility.

Background: A charitable lead annuity trust (CLAT) is an irrevocable trust that pays a fixed, annual amount to a charity for a specific term, after which the remaining CLAT assets are distributed to beneficiaries, often the settlor's heirs with reduced (or sometimes eliminated) federal transfer taxes. If structured as a *grantor* CLAT the settlor can claim an upfront federal income tax deduction contingent on the settlor paying the taxes on the CLAT's income. Thus, a CLAT could result in a significant transfer of wealth to heirs (the CLAT remainder beneficiaries) at low, or possibly no, federal gift or estate tax cost. The risks to a CLAT are: (i) if the CLAT assets do not outperform the IRC 7520 rate used to value the annuity stream, the transfer tax benefits could be lost; and (ii) if the CLAT is set-up as a *grantor* CLAT, the settlor must pay the tax on the income generated by the CLAT's assets, even if that income is paid out to the CLAT charitable beneficiary. If the CLAT assets grow faster than expected, that could warrant an acceleration of the charity's interest, adding considerable flexibility to the CLAT strategy.

Private Letter Ruling 202614004: Private letter ruling 202614004, released by the IRS on April 2, 2026 was a surprise to many advisors regarding the early termination of a CLAT as it permitted accelerated annuity payments to a donor advised fund (DAF) but did not that the CLAT termination would be an act of self-dealing, nor a taxable expenditure, or a taxable termination of a private foundation.

Facts: The CLAT provide for fixed annual annuity payments to the DAF for a 20-year term. At the end of the CLAT 20-year term the remaining assets, if any, were to pass to a noncharitable remainder beneficiary. That remainder beneficiary also served as the CLAT trustee. After 10 of the 20-year term the CLAT held assets valued in excess of the remaining annuity payment obligation. Accordingly, the DAF requested a single, undiscounted lump sum distribution of all remaining annuity amounts to immediately be used for its charitable purposes.

Ruling Request: The requested CLAT termination was premised on the state law that permits a trust's termination or modification if continued administration of the trust is unnecessary to accomplish the trust's purposes, or termination of the trust would increase the trust's efficiency. [See MCL 700.7101 and 700,7411 for comparable provisions.] The CLAT trustee agreed to the proposed distribution, contingent upon a court order that authorized the CLAT's early termination. Specific rulings were asked of the IRS regarding the accelerated annuity payment and termination of the CLAT because the private foundation rules apply to split-interest trusts, like a CLAT. The request was that the proposed acceleration and termination of the CLAT would not cause adverse tax consequences under several Tax Code sections. [IRC 4941, 4945, 507, and 4947(a)(2).]

IRS Rulings: Three important rulings were provided by the IRS to the proposed acceleration of the DAF's annuity and the consequent termination of the CLAT and distribution to its remainder noncharitable beneficiary.

IRC 4941 and 4945: Self-Dealing: The IRS found that the proposed annuity acceleration and CLAT termination would not trigger any income tax because the DAF is owned and controlled by a public-charity sponsoring organization. IRC 4941 imposes a tax on acts of self-dealing between a private foundation and a disqualified person, which includes beneficial interest holders in the case of a trust. The Regulations expressly exclude public charities (other than those solely for testing for public safety) from the definition of *disqualified person* for the purposes of self-dealing. [Regulation 53.4946-1(a)(8).] Accordingly, the involvement of the DAF's sponsor brings the proposed CLAT accelerated payment within that exclusion. In short, the accelerated distribution to the DAF would not constitute *self-dealing*.

IRC 4945-Taxable Expenditure: This Tax Code section imposes a tax on taxable expenditures, meaning a private foundation's use of funds for a noncharitable purpose. Because the DAF is controlled by the sponsoring organization, and the proposed accelerated annuity payment to the DAF furthered a charitable purpose, the IRS found that the distribution did not qualify as a taxable expenditure.

IRC 507(c)- Termination of Private Foundation: This Tax Code section imposes a tax on the termination of an organization's private foundation status. However, the Regulations

prevent the imposition of tax on trust distributions mandated by the trust instrument and not subject to the trustee's discretion before the expiration of all charitable beneficial interests. [Regulation 53.4947-1(e)(1).] While the CLAT required annuity payments over a longer period of time, it required payment to the DAF, and it the trust did not give the trustee any discretion over the amount. Consequently, the IRS found that the proposed acceleration of the annuity to the DAF did not apply to IRC 507. In short, *"a trust payment is no less mandatory, nor is it deemed discretionary with the trustee, merely because all parties agree to make the charitable payment earlier than required by the trust document."*

Lingering Question: One question that the IRS did not formally address in its PLR is the effect of the accelerated annuity payment on the trust's charitable deduction for income and transfer tax purposes. A CLAT can generate a charitable deduction only if it provides for a *"guaranteed annuity interest*, which means a determinable amount payment at least annually for a specific term, with an ascertainable, aggregate value at the time of the trust's funding. [Regulation 25.2522(c)-3(c)(2)(vi)(a).] Had the proposal included a payment to the DAF at a discounted present value, it would not have constituted a guaranteed annuity interest due to the question regarding the annuity's interest value at the CLAT's funding; rather the value would vary depending on the timing of any prepayment made in the trustee's discretion. In this PLR, the proposal was to cash out the DAF by stating that the accelerated annuity payment would be made on an undiscounted basis.

Conclusion: With charities desperate for financial support in light of the federal government's cutback in grants and other financial support, the ability to terminate a CLAT early under state law without incurring adverse federal taxes is an important planning opportunity to consider for those philanthropically inclined.

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