## Low Interest Rates Make Charitable Lead Annuity Trusts Attractive

We have previously alerted you to the estate and tax planning opportunities in using a Grantor Retained Annuity Trust (a "GRAT") in this time of low interest rates and sharply reduced asset values. A Charitable Lead Annuity Trust (a "CLAT") is another strategy that can work well in this environment.

Like a GRAT, a CLAT is designed to shift wealth to children in a tax-efficient manner. Under the terms of a CLAT, a dollar-specific annuity payment is made to charity periodically (at least annually) for the term of the trust. At the end of the CLAT's term, the remaining assets are distributed to one or more non-charitable beneficiaries (usually children[1]). CLATs work well in a low interest rate environment because if the trust's investment performance exceeds the so-called "7520 Rate" (an interest rate published monthly by the IRS), then the excess earnings and growth at the end of the term pass to the remainder beneficiaries tax free. The lower the 7520 Rate, the larger the potential gift to the family.

CLATs are typically designed to reduce gift taxes on shifting assets to family members, not to obtain a charitable income tax deduction. If a charitable income tax deduction is claimed, the CLAT's income is taxable to the settlor of the CLAT throughout the term of the trust. If the settlor does not claim an income tax deduction, the CLAT's income is not taxable to the settlor.

A numeric example of a CLAT may best explain the benefits of the plan:

Assume that you contribute $1,000,000 to a CLAT that lasts for 15 years and pays 5% (or $50,000) annually to a charity of your choice.[2] With a 7520 Rate of 2% (see below), and assuming 7% growth of the assets, the result would be as follows:

Charitable Results:

- Charity receives $750,000 ($50,00 per year for 15 years).
- Gift tax charitable deduction in <u>current year</u>: $642,000 (the present value of $50,000 per year for 15 years). (Note, however, that you will not be taxed on the trust's income.)

Wealth Transfer Results:

- Taxable gift in current year of $357,000, resulting in maximum gift tax at 45% of $161,000), or possibly no gift tax if exemption is available.
- Remainder to family members (or a trust for their benefit) is $1,502,580.

For estate planning purposes, CLATs function in a manner similar to GRATs. The main difference is that the entire

1. *A CLAT is not suitable for wealth transfers to grandchildren.*
2. *A settlor's private foundation should not be the chosen charity, however, as the settlor's retained control over charitable distributions will defeat this planning if the settlor dies during the CLAT term. In contrast, a settlor's donor advised fund may be the chosen charity.*

contribution and the earnings remain in the CLAT for the entire CLAT term and pass to the charity (as to the annuity payments) or the remainder beneficiaries (the balance when the CLAT terminates). In a GRAT, the entire contribution plus the 7520 Rate returns to the donor, and only the appreciation above this rate passes to the remainder beneficiaries.

The 7520 Rate (which is used to value transfers to CLATs) was at a historical low in February of 2.0%. That rate rose to 2.4% for March, and will increase to 2.6% in April. Notably, however, for CLATs, the tax rules permit using the most favorable rate of the most recent three months. Thus, February's 2% rate is available for CLATs created until April 30. Further, it is expected that recent government activity in the markets may result in a lower May rate.

In sum, a CLAT can be especially useful for clients who have charitable goals, and want to blend their philanthropic goals with their wealth shifting goals. The low 7520 Rate reduces annuity payments to the charities, and increases the potential wealth transfer to the children.

CLATs are also used for income tax planning. As noted above, a CLAT can be structured to obtain an income tax deduction. Such a CLAT typically provides for annuity payments to charity, with the remainder reverting to the settlor. This structure provides no transfer tax benefit; rather, the purpose of such a CLAT is an up front income tax deduction without permanent loss of the contributed assets.

Nevertheless, it may also be possible to obtain both a gift tax charitable deduction and an income tax charitable deduction with another technique known as a "Super CLAT." A Super CLAT is complex, with consequences and risks that must be individually assessed. Therefore, it is beyond the scope of this Client Alert, but we are available to discuss it.

Please feel free to contact us regarding any questions you may have about this or other wealth shifting techniques.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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