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Memorandum

Reeling, Rolling and Reining In "Shark-Fin" CLATs

by Paul S. Lee, J.D., LL.M.
Bernstein Global Wealth Management
Turney P. Berry, J.D.
Wyatt, Tarrant & Combs, LLP
and Martin Hall, J.D.
Ropes & Gray LLP

THE "SHARK-FIN" CLAT

Introduction

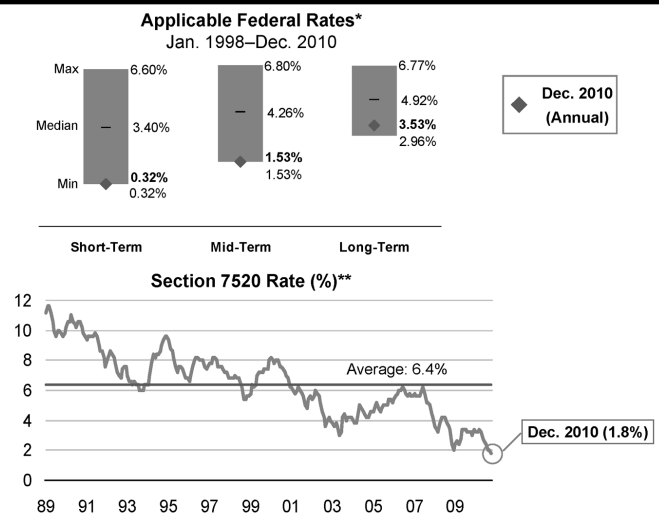
With §7520 [1] rates (and applicable federal rates [2] or "AFRs") at all-time lows, as illustrated in the display below (The AFR and Section 7520 Rates),[3] estate

[1] For purposes of this article, unless provided otherwise, all "§" references will refer to of the Internal Revenue Code of 1986, as amended (hereinafter, the "Code"), and the regulations promulgated thereunder.

[2] §1274.

[3] Rev. Rul. 2010-29, 2010-50 I.R.B. ___ (12/6/10). The §7520 rate for December 2010 is 1.8%, and the short-, mid- and long-term AFRs are 0.32%, 1.53% and 3.53% respectively (compounded annually). All of the calculations in this article were

The AFR and Section 7520 Rates



*Section 1274(d) of the Internal Revenue Code of 1986, as amended (Code)
**Code Section 7520. As of December 2010.
Source: Internal Revenue Service (IRS) and AllianceBernstein

planners should reconsider the benefits of the charitable lead annuity trust (hereinafter, ''CLAT'').[4]

Although a CLAT is generally appropriate only for a client with some charitable intent, there are significant wealth transfer benefits as well. A 2007 revenue procedure has inspired a CLAT structured in a new way, nicknamed the ''Shark-Fin'' CLAT. With interest rates likely to increase from this point forward,[5] based on the projections of Bernstein's Wealth Forecasting System indicated in the display below (CLATs: The Time Is Now), estate planners should seriously consider a CLAT for those clients who have a modicum of charitable intent and who would also like to transfer wealth to their children.[6] The 1.8% §7520 rate for December 2010 was announced just as this article was going to press. It will be available at least through February 2011 because of the three-month election for charitable trusts,[7] so there is a limited window of time to take advantage of a historic wealth transfer opportunity. All of the calculations in this article are based on the November 2010 interest rates (§7520 of 2.0%). The change in rates does not affect the conclusions in this article but actually make Shark-Fin CLATs even more advantageous.

Traditionally Structured CLATs

In the traditionally structured CLAT, there are two primary reasons a CLAT may fail to transfer wealth. First, as with a (GRAT), if the assets of a ''zeroed-out'' CLAT do not have a total return that exceeds the §7520 rate, then no assets will remain in the CLAT at the end of the term. On the other hand, if the assets in a GRAT underperform, the assets are returned to the grantor, who can redeploy them in another GRAT or other planning technique. Redeployment is not available with a CLAT, however, because the lead interest — and consequently all the underperforming assets — will have been paid to charity. Worse, if the CLAT is being used to meet a donor's charitable obligations, the obligation may not be discharged in full, depending on the degree of underperformance.

Second, even if the CLAT assets have a total return that exceeds the §7520 rate, the CLAT may fail because of the ''path of the returns.'' Consider a zeroed-out $10 million, 10-year CLAT, created when the effective §7520 rate is 6.0%. In order to zero-out the $10 million contribution, a fixed annual payment of $1.36 million for 10 years will be paid to charity. Ignoring the effect of income taxes, if the assets grow by a compound growth rate of 9.3% per year, then the remaining assets at the end of the 10-year period will be $3.4 million. Unfortunately, returns in the publicly traded capital markets are never straight-line. So, consider two different paths that a 9.3% growth rate could take:[8]

Year	Return Path 1	Return Path 2
1	10.1%	-22.1%
2	1.3%	-11.9%
3	37.6%	-9.1%
4	23.0%	21.0%
5	33.4%	28.6%
6	28.6%	33.4%
7	21.0%	23.0%
8	-9.1%	37.6%
9	-11.9%	1.3%
10	-22.1%	10.1%
Annual Growth Rate	**9.3%**	**9.3%**

If the assets of the aforementioned zeroed-out CLAT experience return path 1, the remainder interest

based on the rates for November 2010. The §7520 rate for November 2010 is 2.0%, and the short-, mid- and long-term AFRs are 0.35%, 1.59% and 3.35% respectively (compounded annually). Rev. Rul. 2010-26, 2010-44 I.R.B. 573.

[4] For purposes of this article, a CLAT will refer to a ''split-interest'' trust that generally provides for an annual (or more frequent) payment to a charitable organization that qualifies as a ''guaranteed annuity'' for income, gift and estate tax purposes under §§170(f)(2), 2055(e)(2)(B) and 2522(c)(2)(B), for a term of years (or the life or lives of a permissible individual or individuals) as defined under Regs. §§1.170A-6(c)(2), 20.2055-2(e)(2), 25.2522(c)-3(c)(2) with the remainder interest passing to or for the benefit of non-charitable beneficiaries (other than the grantor).

[5] Bernstein's Wealth Forecasting System forecasts that there is less than an 11% chance the §7520 rate remaining as low as 1.8% (December 2010) over the next 10 years.

[6] We will not discuss in detail the issues relating to the identity of non-charitable beneficiaries. In particular, we do not discuss the limitations regarding the application of any generation-skipping transfer (GST) tax exemption under §2642(e), which generally limits the ability to leverage the exemption by the §7520 rate. Although different strategies have been discussed and attempted to circumvent this limitation, the IRS continues to take the position that leveraging of the GST tax beyond the §7520 rate is impossible. *See, e.g.,* PLR 200107015 (The trustees of a zeroed-out CLAT proposed to amend the trust to allow a portion of the remainder interest to vest in the child of the grantor. The child of the grantor would then gift his vested remainder interest to his own children at a time when the interest was 2% of the trust property. The IRS ruled that the child would not be considered the transferor for GST purposes).

[7] If §7520 is being used to determine the value of a charitable income, gift or estate deduction (for example, for contributions to charitable lead trusts and charitable remainder trusts), the Code provides, ''the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls for purposes of paragraph (2).'' §7520(a). *See also* Regs. §§1.7520-2(b), 20.7520-2(b) and 25.7520-2(b).

[8] Return Path 1 represents the annual return of the S&P 500 from 1993–2002, and Return Path 2 is the reverse of those returns.

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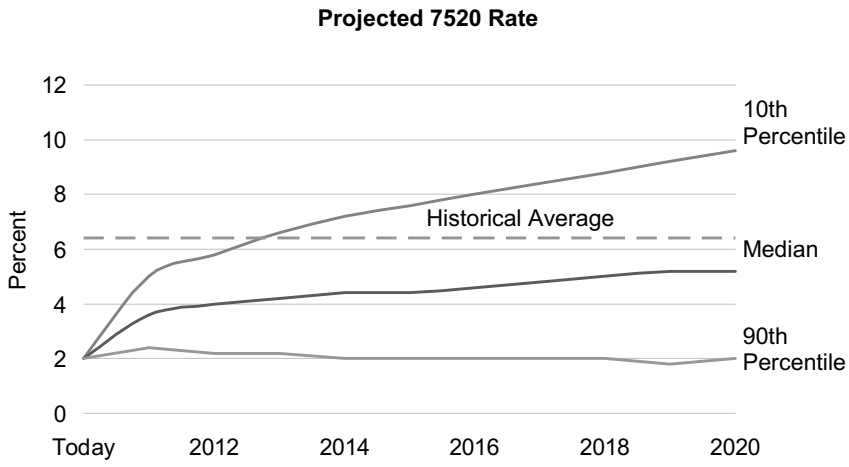

*Only 11.7% of forecasted trials resulted in a 7520 rate of 2.0% or less 10 years from now.
Based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed.
Source: AllianceBernstein

at the end of the term will be worth approximately $8.0 million. If, instead, return path 2 applies, the remainder interest will be worth zero, and there will be inadequate assets to pay out the year 9 and year 10 annuities. The actual path of returns (particularly the returns in the early years of the CLAT) is as important as the magnitude of the return. Because there is no way of knowing whether capital market returns will be positive or negative, traditional CLATs — those with equal annuity payouts beginning in year one — will quite often fail or perform poorly even when the compound annual returns exceed the §7520 rate.

Structuring a CLAT so that the annuity payments increase during the term can help manage the path-of-return problem by allowing the trustee to adjust the investments of the CLAT in preparation for the required CLAT payments. May a CLAT be back-loaded or must the annuity payments be equal throughout the term of the CLAT? Estate and charitable planners looked to two other types of trusts — the charitable remainder annuity trust [9] (hereinafter, ''CRAT'') and the grantor retained annuity trust [10] (hereinafter, ''GRAT'') — as precedents.

CRATs

Section 664(d)(1)(A) defines a CRAT as a trust from which *a sum certain* is to be paid, not less often than annually. In case there were any doubt whether ''a sum certain'' means that the CRAT may vary the annuity paid each year, the Treasury regulations provide clearly that a sum certain is ''a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period.'' [11] Thus, there is no ambiguity with a CRAT: the annuity payment may not increase during the term.

GRATs

Because both GRATs and CLATs calculate the resulting taxable gift upon contribution according to §7520, some estate planners believed that one could back-load CLAT annuity payments in a comparable manner as a ''qualified interest'' [12] under §2702. In pertinent part, the Treasury regulations provide:

- ''A qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.'' [13]
- ''A fixed amount means . . . [a] stated dollar amount payable periodically, but not less frequently than annually, but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or . . . [a] fixed fraction or percentage of the initial fair market value of the property transferred to the

[9] §664(d)(1).

[10] Trust that provides the grantor with a ''qualified annuity interest'' under Regs. §25.2702-3(b).

[11] Regs. §1.664-2(a)(1)(ii).

[12] §2702(b)(1).

[13] Regs. §25.2702-3(b)(1).

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trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year." [14]

If the GRAT rules applied to CLATs, then a CLAT could have back-loaded annuity payments, but only to the extent that each payment increased by no more than 120% of the previous year's payment. Even that minimal step results in more being paid to charity in aggregate over the term of the CLAT and more potential wealth transfer to the non-charitable beneficiary, because it provides a cushion in case there are negative returns in the first few years. With a sufficiently low §7520 rate, the fact that more is being paid to charity should be outweighed by the more forgiving annuity stream. Thus, the theory goes, even minimal back-loading should result in a higher probability of wealth transfer and a higher wealth transfer amount.

Revenue Procedure 2007-45

Happily for CLAT drafters, Treasury and the IRS are prepared to be more generous to CLATs than to CRATs or GRATs in defining what is an annuity. In 2007, the IRS issued sample trust forms for charitable lead trusts. Significantly, Rev. Proc. 2007-45,[15] in the annotations section, provides, in pertinent part:

- Guaranteed annuity. To qualify for the applicable estate and gift tax charitable deductions, a non-grantor CLAT must provide for the payment of a guaranteed annuity amount at least annually to a qualified charitable organization for each year during the annuity period. See §§2055(e)(2)(B) and 2522(c)(2)(B). A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term of years or for one or more measuring lives . . . An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer may be ascertained at the time of the transfer to the trust. Sections 20.2055-2(e)(2)(vi)(*a*) and 25.2055-2(e)(2)(vi)(*a*). A charitable interest expressed as the right to receive an annual payment from a trust equal to the lesser of a sum certain or a fixed percentage of the trust assets (determined annually) is not a guaranteed annuity interest. See §§20.2055-2(e)(2)(vi)(b) and 25.2055-2(e)(2)(vi)(b).[16]
- Payment requirements. CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The annuity payments may be made in cash or in kind.[17]

The foregoing is applicable to non-grantor CLATs, but Rev. Proc. 2007-45 provides substantially identical provisions for grantor CLATs.[18]

The rules for a CLAT are quite clear and quite different from those for CRATs or GRATs. The amount being distributed to charity must be ascertainable, but there is no maximum or minimum annual payment. Any one of the following annuity streams would seem to be permissible to zero-out a $10 million CLAT, assuming a §7520 rate of 2.0%:

[14] Regs. §25.2702-3(b)(1)(ii)(A) and (B).

[15] Rev. Proc. 2007-45, 2007-29 I.R.B. 89, specifically for inter-vivos CLATs. Rev. Proc. 2007-46, 2007-29 I.R.B. 102 for testamentary CLATs.

[16] Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(1) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4).

[17] Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4).

[18] Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraphs .02(1) and .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 7).

Year	Level	120%	150%	Shark-Fin
1	$ 611,567	$ 72,580	$ 2,146	$ 1,000
2	$ 611,567	$ 87,096	$ 3,219	$ 1,000
3	$ 611,567	$ 104,516	$ 4,828	$ 1,000
4	$ 611,567	$ 125,419	$ 7,242	$ 1,000
5	$ 611,567	$ 150,503	$ 10,864	$ 1,000
6	$ 611,567	$ 180,603	$ 16,296	$ 1,000

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7	$ 611,567	$ 216,724	$ 24,443	$ 1,000
8	$ 611,567	$ 260,068	$ 36,665	$ 1,000
9	$ 611,567	$ 312,082	$ 54,998	$ 1,000
10	$ 611,567	$ 374,499	$ 82,496	$ 1,000
11	$ 611,567	$ 449,398	$ 123,745	$ 1,000
12	$ 611,567	$ 539,278	$ 185,617	$ 1,000
13	$ 611,567	$ 647,134	$ 278,425	$ 1,000
14	$ 611,567	$ 776,560	$ 417,638	$ 1,000
15	$ 611,567	$ 931,872	$ 626,457	$ 1,000
16	$ 611,567	$ 1,118,247	$ 939,685	$ 1,000
17	$ 611,567	$ 1,341,896	$ 1,409,528	$ 1,000
18	$ 611,567	$ 1,610,275	$ 2,114,292	$ 1,000
19	$ 611,567	$ 1,932,330	$ 3,171,438	$ 1,000
20	$ 611,567	$ 2,318,797	$ 4,757,157	$ 14,836,177
Total	**$ 12,231,344**	**$ 13,549,878**	**$ 14,267,181**	**$ 14,855,177**

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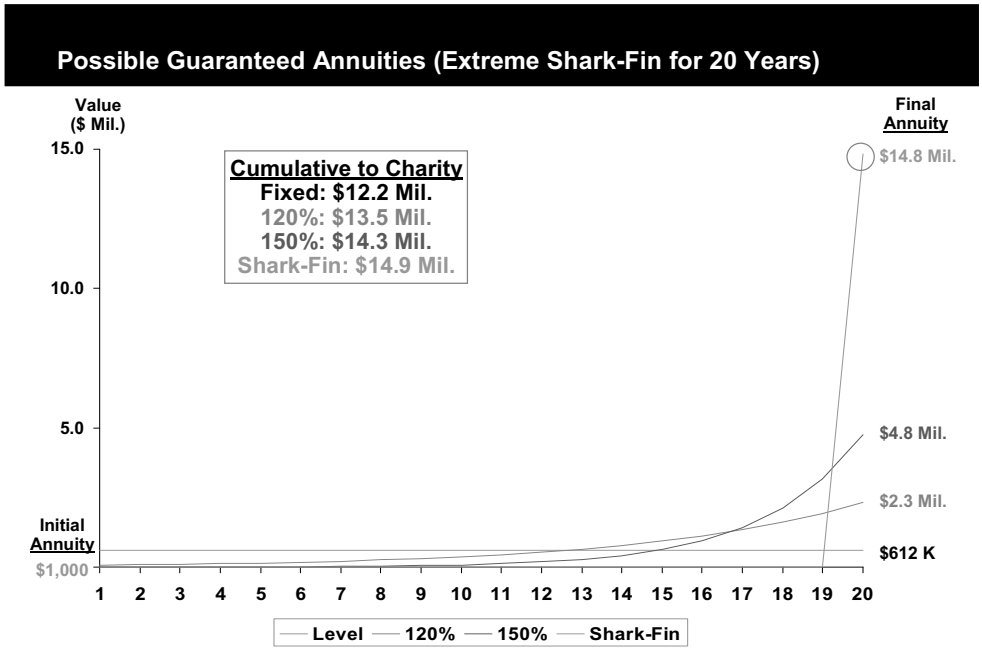
The last annuity stream in the above table has been nicknamed the Shark-Fin CLAT, for the shape the annuity pattern makes if arrayed horizontally, as illustrated in the display below (Possible Guaranteed Annuities (Extreme Shark-Fin for 20 Years)). It may also be thought of as a ''Balloon'' CLAT, with the rationale for back-loading the annuity payments similar to that of structuring an installment sale as interest-only with a balloon payment at the end of the term.



However, there are two critical differences between the Shark-Fin CLAT and an interest-only installment sale:

- The annual payment of $1,000 is smaller than the annual interest payment that would otherwise be payable on a 20-year installment note (the long-term applicable federal rate or ''AFR'').
- The internal rate of return or discount rate with the Shark-Fin CLAT is the §7520 rate, which is currently significantly lower than the long-term AFR (2.0% vs. 3.35%).[19]

As a result, the Shark-Fin CLAT should transfer more wealth than the other less severely back-loaded annuity patterns and, interesting to note, more than both an installment sale to an intentionally defective grantor trust (IDGT) and a GRAT over the same period of time, assuming that a donor's objective is to also transfer assets to charity.

Is a Shark-Fin CLAT Allowable?

Other than Rev. Proc. 2007-45, no other guidance has been issued regarding the ability to and the extent of the back-loading in structuring a CLAT. In PLR 9112009, the IRS did approve a CLAT where ''the 'minimum' annuity amount payable varies each year'' but the ''amount payable each year is specified in the instrument.'' However, no other information about how the annuity varied is contained in the ruling.

At least one article has expressed concern about the validity of Shark-Fin CLATs.[20] In it, the authors point to a number of rulings and regulations concerning charitable remainder trusts (CRTs)[21] and GRATs[22] that cast doubt on the clear language of Rev. Proc.

[19] November 2010. This differential is even larger for December 2010 (1.8% vs. 3.53%).

[20] Fox & Teitelbaum, ''Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance,'' 37 *Est. Plan. J.* 3 (Oct. 2010).

[21] The authors point to a number of rulings concerning CRTs that require an annuity or unitrust amount that is ''payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c).'' Regs. §§1.664-2(a)(3)(i) and -3(a)(3)(i). With respect to that, the authors cite a number of private letter rulings that state that the amount payable to non-charitable beneficiaries must be more than de minimis under the facts and circumstances. However, Rev. Proc. 2007-45 explicitly provides that ''CLATs are not subject to any minimum . . . payout requirements.'' Furthermore, it ignores the policy reason for the foregoing de minimis requirement with respect to CRTs. CRTs are afforded tax-exempt status. The de minimis requirement is meant to ensure that trusts that are not truly CRTs are not afforded tax-exempt status. CLATs are, of course, not tax exempt. Furthermore, in the context of Shark-Fin CLATs, a de minimis re-

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2007-45. Our belief is that the Treasury and the IRS know how to describe an annuity that may not vary, or may vary only in accordance with specified limits, and declined to do so with respect to CLATs. Our speculation is that there are policy differences that the government has considered, among them that the CRAT is a tax-exempt entity, and thus deferring annuity payments changes the income tax policy that underlies the general rule requiring mandatory payouts from charitable remainder trusts, and that the GRAT is a no-lose proposition for a donor unlike a CLAT, which divides benefits between charity and a donor's non-charitable beneficiaries.[23] Regardless, we see no reason to question such a clear and definitive pronouncement.

FORECASTED RESULTS AND PLANNING IMPLICATIONS

Forecasted Investment Results for Non-Grantor CLATs

The latest generation of financial planning tools moves beyond historical averages and takes into account the paths of return and the often random and unpredictable nature of the markets. Generically it is called stochastic or probabilistic modeling. The colloquial term is ''Monte Carlo'' modeling. For this article, a proprietary analytical tool was used that marries the benefits of stochastic modeling with Bernstein's structural model of the capital markets (the ''Wealth Forecasting Model'').[24] In each instance the model simulated 10,000 market scenarios or forecasts for the next 20 years, based initially upon the current state of the capital markets (for example, with very low Treasury interest rates, resulting in very low AFRs and §7520 rates). Unless otherwise noted, in each case, the model assumes 100% globally diversified equities and, for purposes of simplicity, a starting contribution of $10 million of cash.[25] With 10,000 different outcomes, the analytical outputs are probabilistic. In other words, instead of saying, for example, that the remainder value will be $10 million, the answer will be that there is a 50% chance of the remainder being at least $10 million or more.

quirement does not change the resulting charitable deduction, because §7520 specifically takes into account time-value concepts. In fact, as pointed out in this article, back-loading the annuity actually increases the probability that charity will receive the entire amount due to it.

[22] The authors state, ''[t]he policy concerns expressed by the IRS regarding a lump-sum balloon payment at the termination of a GRAT, a vehicle similar in purpose and operation to a CLAT, and the lack of any guidance from the IRS regarding the extent to which CLAT annuity payments may be increased, clearly raise a question as to the validity of the shark-fin CLAT. Indeed, it is possible that the IRS might view the shark-fin strategy as abusive and, accordingly, seek to limit the CLAT's charitable payments that may be deferred or, consistent with the GRAT regulations, seek to impose a percentage limitation on year-to-year increases in the annual payments to charity.'' The authors point to the preamble to the final Treasury regulations for GRATs that state that allowing a grantor to zero-out a GRAT while effectively transferring the appreciation on all of the property through a balloon payment at the end of the term is inconsistent with the principles of §2702. The preamble provides, ''[t]he proposed regulations prohibited increases (in the annual annuity payment) to prevent transferors from 'zeroing out' a gift while still effectively transferring the appreciation on all of the property during the term to the remainder beneficiary (e.g., by providing a balloon payment in the final year of the term). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of section 2702.'' T.D. 8395, 57 Fed. Reg. 4250 (2/4/92). Notwithstanding the dubious truth of Treasury's statement in the preamble, it should be noted that when the preamble was issued in 1992, the IRS's position was that grantors could not fully zero-out a contribution to a GRAT. *See Walton v. Comr.*, 115 T.C. 589 (2000) and TAM 200245053 (the National Office stated that the preamble to the final regulations under §2702 reflected that Congress did not intend to permit the value of the remainder to be very small, such as less than one percent of the fair market value of the property contributed to a GRAT). The authors do not point to any specific rulings, regulations, court cases or any other primary sources directly related to CLATs. Also, to state the obvious, the Code provisions for CLATs were enacted under the Tax Reform Act of 1969, P.L. 91-172 (1969), whereas GRATs were enacted under the Revenue Reconciliation Act of 1990. P.L. 101-508 (1990). To say that the Treasury regulations for GRATs have direct bearing on CLATs seems a stretch. Presumably the IRS could have adopted the GRAT position when it issued Rev. Proc. 2007-45 but pointedly did not.

[23] The authors also contend that the Shark-Fin CLAT structure, which provides for level payments with a single balloon payment at the end of the term, is not permissible because an increasing annuity (each year apparently) is required. A single large annuity payment at the end of the period would seem to meet the requirement of ''an annuity amount that is initially stated as a fixed dollar . . . amount but increases during the annuity period.'' If planners are concerned about not having annual increases, then theoretically one could increase the annuity by a small amount each year with a final large payment without altering the positive effects of back-loading (for instance, payments could be $1,000 in year one, $1,100 in year two, etc.). To say that the annuity must increase in some manner over the term seems overly picayune.

[24] Bernstein's proprietary capital markets engine and wealth forecasting model uses proprietary research and historical data to create a wide range of possible market returns for many asset classes over the coming decades, following many different paths of return. The model takes into account the linkages within and among different asset classes in the capital markets and incorporates an appropriate level of unpredictability or randomness for each asset class.

[25] The allocation to stocks is 35% U.S. value, 35% U.S. growth, 25% developed international, and 5% emerging markets. The source of the data is Bernstein, based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years. The data does not represent any past performance and is not a promise of actual future results.

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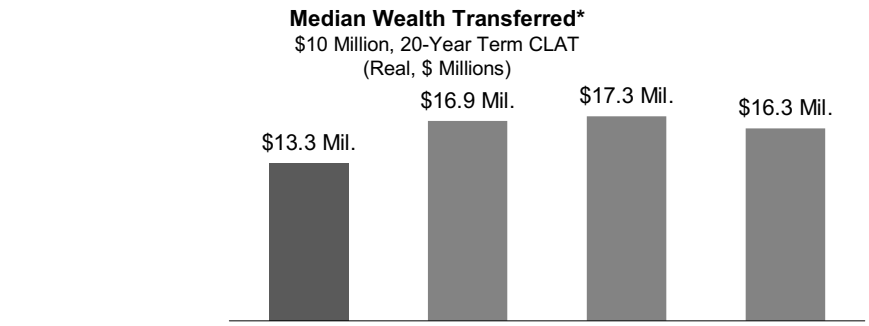
For 20-year ''zeroed-out'' CLATs with the aforementioned annuity patterns, the resulting median (50th percentile) inflation-adjusted remainder values, after all payments to charity and after the payment of income taxes, are illustrated in the display below (Back-Loading Increases Wealth Transfer . . . Only to a Point):

Back-Loading Increases Wealth Transfer...Only to a Point



Annuity Structure	Fixed	120%	150%	Shark-Fin
Probability of Success:	97%	>98%	>98%	97%

*Median inflation-adjusted non-grantor CLAT remainder assuming $10 million zeroed-out 20-year CLAT funded at the November 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >$0.

As one can see, the Shark-Fin structure actually results in a smaller remainder than both the 120% and 150% back-loaded CLATs over the same period of time. The highest probabilities of success (defined as the probability of a remainder greater than zero) and the highest remainder values peak with 150% back-loaded annuities. The Shark-Fin is only superior to the traditionally structured, fixed-level annuity CLAT. Despite a very low §7520 rate and the most extreme benefit of backloading, the Shark-Fin does not produce the types of results that one would expect.

This surprising result can be attributed to the income tax liabilities on the return experienced by the trust assets during the term. The traditional wealth-transfer CLAT (with the remainder passing to children, for example, rather than reverting to the grantor at the end of the term) is a taxable, complex trust. As such, the trust is entitled to a deduction under §642(c) in connection with the payment each year of the charitable annuity. Section 642(c) provides:

- In the case of an estate or trust (other than a trust meeting the specifications of subpart B), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by §170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in §170(c) (determined without regard to §170(c)(2)(A)). If a charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee or administrator may elect to treat such contribution as paid during such taxable year.

Although §642(c) does not limit a trust's income tax deduction, as §170 does with an individual (based on adjusted gross income), it effectively provides that the deduction in any given taxable year is the lesser of the taxable income of the trust and the payment to charity for that year. Furthermore, other than the election to treat payments in the following taxable year as having been paid in the previous taxable year, there is no mechanism to carry back or carry forward unused charitable deductions (in the instance where the charitable deduction/payment is greater than the taxable income for the year) and unused charitable deductions may not be carried out to the remainder beneficiaries in a terminating distribution. The Code specifically limits these ''terminating distribution'' tax benefits to unused carryover losses and unused deductions other

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than the charitable deduction and the personal exemption deduction.[26]

The practical result of the foregoing is that a Shark-Fin CLAT pays income taxes on almost all of its income every year until the last taxable year, when the large final payment is made. In addition, it is unlikely that the CLAT will have enough taxable income in that final year to use the charitable deduction effectively. As a consequence, the income tax benefits from the charitable payments during the term of the trust are minimal. As can be seen in the chart above, the model shows that the most efficient use of the §642(c) charitable deduction is a CLAT with 50% annually increasing annuities. It should be noted that the efficacy of the 150% backloaded annuity CLAT is specific to the investment strategy (global equities), the term of the CLAT (20 years) and the §7520 rate. A different asset allocation or a longer/shorter term for the non-grantor CLAT would likely result in a different back-loaded annuity pattern being the most efficient in terms of wealth transfer.

The efficient use of the §642(c) deduction is an important component of successfully administering a non-grantor CLAT. If a non-grantor CLAT realizes unrelated business taxable income (UBTI),[27] while it will not result in the imposition of an excise tax as it would for tax-exempt entities, a reduction of the otherwise allowable §642(c) charitable deduction will result. The Code provides, ''[i]n computing the deduction allowable under section 642(c) to a trust, no amount otherwise allowable under section 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year.'' [28] The Treasury regulations provide a methodology for reducing and allocating any remaining deduction between UBTI and other income.[29]

The most common instance when a CLAT will realize UBTI is if the CLAT has ''unrelated debt-financed income'' under §514. In particular, this arises when ''acquisition indebtedness'' [30] is deemed to exist. That being said, the Code provides, ''[w]here property subject to a mortgage is acquired by an organization by bequest or devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of the acquisition. If an organization acquires property by gift subject to a mortgage which was placed on the property more than five years before the gift, which property was held by the donor more than five years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift.''[31] In PLR 9716023, a non-grantor charitable lead trust took advantage of this provision. Significantly, the IRS ruled that since the trust had a charitable term of less than 10 years, the trust could retain mortgaged property received from the grantor without any loss of its §642(c) deduction.

The loss of the §642(c) charitable deduction in the context of back-loaded annuities (especially the Shark-Fin) may be of little consequence, because the disallowance is a reduction of the otherwise allowable deduction that year. In the Shark-Fin example above, the maximum allowable deduction for the first 19 years would only be $1,000. As a result, any reduction that might result due to the existence of UBTI for those years would be negligible. Furthermore, the existence of UBTI is of no consequence if the CLAT is considered a grantor trust.

Forecasted Investment Results for Grantor CLATs

If Shark-Fin CLAT benefits are limited by §642(c), might intentionally making the CLAT a grantor trust [32] create better results? When a grantor makes a contribution to a CLAT that is considered a grantor trust for income tax purposes, the grantor obtains a personal income tax deduction equal to the present value of the charitable contribution (determined under §7520) in return for taking on grantor trust income tax liability for the trust's assets.[33] Of course, there are wealth transfer benefits to the grantor paying the income tax liability, similar to the installment sale to an IDGT. There have been a number of rulings regarding this construct and planning technique.[34]

In the grantor CLAT form, the resulting median (50th percentile) inflation-adjusted remainder values, after all payments to charity (but ignoring income taxes) are illustrated in the display below (Grantor CLATs):

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[26] §642(h)(1) and (2).

[27] §512.

[28] §681(a).

[29] Regs. §1.681(a)-2(b).

[30] §514(c)(1).

[31] §514(c)(2)(B).

[32] §§671–679. Unless otherwise noted, a grantor CLAT for purposes of this article will refer to a CLAT that is a grantor trust for income tax purposes but that is not includible in the estate of the grantor for estate tax purposes. As such, it does not refer to a CLAT where the grantor has retained a power under §673 (a reversionary interest equal in value to at least 5% of the corpus as of the date of the transfer), because the CLAT corpus would generally be includible under §2038 for estate tax purposes.

[33] *See* §170(f)(2)(B) and Regs. §1.170A-6(c).

[34] PLRs 200011012, 200010036, 199936031, 199922007, 199908002, 9810019, 9224029.

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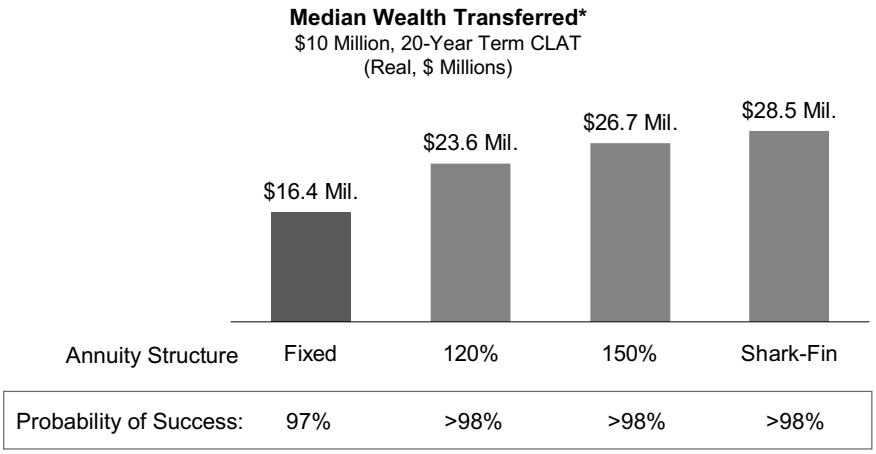
Grantor CLATs



*Median inflation-adjusted grantor CLAT remainder assuming $10 million zeroed-out 20-year CLAT funded at November 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >$0.

The grantor Shark-Fin CLAT, unburdened by the limitations of §642(c), now results in significantly more wealth transfer than all of the other annuity patterns. In fact, it provides more wealth transfer than an installment sale to an IDGT and a GRAT, as shown in the table below:[35]

INFLATION-ADJUSTED REMAINDER VALUES (MEDIANS) $10 MILLION INITIAL FUNDING YEAR 20		
Installment Sale to IDGT	GRAT	Grantor Shark-Fin CLAT
$21.9 Mil.	$23.6 Mil.	$28.5 Mil.

Significantly, even the more gently sloping annuity patterns, 20% and 50% annual increases, have wealth transfer figures comparable to or in excess of an installment sale to an IDGT or a GRAT.

The grantor Shark-Fin CLAT provides greater wealth transfer than both of the more popular estate planning techniques, but with a number of distinct advantages in its favor that are not reflected in the remainder values above:

- First, the installment sale to an IDGT remainder value, while it has the same initial funding amount of $10 million, requires a $1 million ''seed'' gift to the IDGT to support the payment of a $9 million installment sale. In other words, the installment sale figure created a $1 million taxable gift, requiring either the use of exemption equivalent or payment of gift tax. The grantor Shark-Fin CLAT, on the other hand, is a zeroed-out gift, and yet still results in more wealth transfer.
- Second, while the GRAT results are better than the installment sale, it assumes that the grantor survives the 20-year term. The grantor Shark-Fin CLAT, on the other hand, does not have any mortality risk, because if the grantor of a CLAT dies during the trust's term, the CLAT continues to its expiration (although grantor trust status is terminated).
- Third, none of the figures above takes into account the benefit passed to the grantor upon funding of the grantor CLAT in the form of the resulting $10 million charitable income tax deduction. Neither the installment sale nor the GRAT creates an income tax deduction, but the resulting grantor trust tax liability is the same in all of the foregoing strategies.

The income tax deduction created upon funding a grantor CLAT is limited to 30% of the grantor's contribution base (or 20% if capital gain tax property is

[35] All strategies were assumed to have been funded with $10 million. The 20-year GRAT is assumed to be funded at the Nov. 2010 §7520 rate with 20% increasing annuities. For the installment sale to the IDGT, the numbers assume a $1 million ''seed'' gift with a $9 million installment sale to IDGT with a promissory note paying interest only at the appropriate applicable federal rate for Nov. 2010 and a balloon payment at the end of the term. All forecasted figures are based on Bernstein estimates of the range of returns for the applicable capital markets over the periods analyzed. Please see the Notes on Wealth Forecasting at the end of this article for further details. All strategies are modeled assuming 100% global diversified equities (35% U.S. value, 35% U.S. growth, 25% developed international and 5% emerging markets).

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contributed), because the transfer is treated as a transfer ''for the use of'' charity.[36] As such, the higher 50% limitation is unavailable to the grantor. In one private letter ruling, the IRS concluded that the five-year carry forward for unused current year deductions was unavailable for contributions to grantor CLATs.[37] However, subsequent rulings have concluded otherwise, and it seems that the 1988 ruling has been superseded.[38]

TERM OF THE CHARITABLE ANNUITY

Term Certain

Charitable remainder trusts are limited to terms of no more than 20 years.[39] On the other hand, CLATs do not have any statutory limitations on the length of a term. The Treasury regulations simply require that a CLAT have a ''specified term'' of years.[40]

If the grantor intends to zero-out the gift to the grantor's non-charitable beneficiaries, the longer the term the smaller the charitable annuity payments need to be each year and potentially more wealth will be transferred to the non-charitable beneficiaries. For example, in order to zero-out a $10 million contribution with a fixed-level annuity payment at a 2.0% §7520 rate, a 10-year term would require an annual payment of approximately $1.1 million, but a 20-year term would require approximately $612,000. The results in the display below (Longer Terms Increase Wealth Transfer and Probabilities of Success) are inflation-adjusted for 10-, 20- and 30-year non-grantor CLATs that are zeroed-out and that have fixed-level annuities.

[36] §170(b)(1)(B); Regs. §1.170A-8(a)(2).

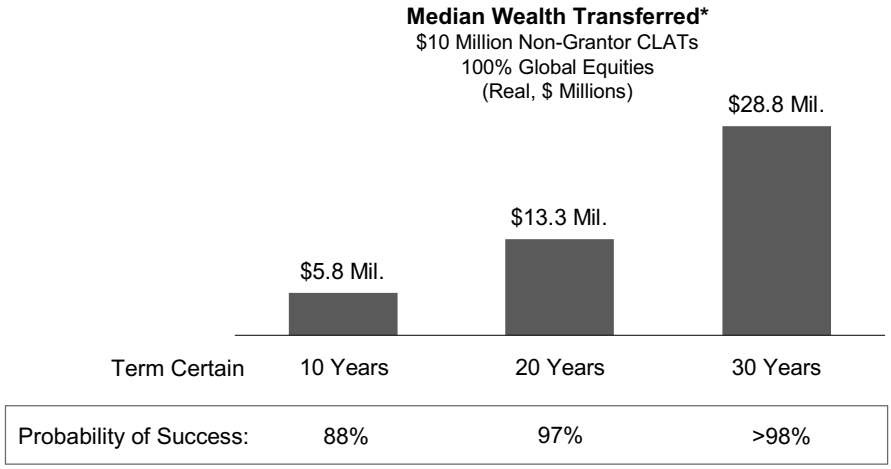
[37] PLR 8824039.

[38] *See, e.g.,* PLR 200010036.

[39] §677(d)(1)(A) (pertaining to charitable remainder annuity trusts, with a similar rule for charitable unitrust interests in §677(d)(2)(A)).

[40] Regs. §§1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a).

Longer Terms Increase Wealth Transfer and Probabilities of Success



*Median inflation-adjusted non-grantor CLAT remainder assuming $10 million zeroed-out 20-year CLAT funded at the November 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >$0. Equities defined as 35% US Value, 35% US Growth, 25% Developed International and 5% emerging markets. Bonds are intermediate term taxable bonds

From a wealth transfer standpoint, CLATs do not have the same ''mortality risk'' as GRATs,[41] because if the grantor dies prior to the end of a term certain CLAT, generally no portion of the assets will be includible in the estate of the grantor. The CLAT will continue to be administered according to the terms of the trust for the remaining years, and the only difference moving forward would be the conversion from grantor to non-grantor trust status if the CLAT were a grantor trust at the time of grantor's death (as discussed below in more detail). Despite the wealth transfer benefit of longer CLAT terms, because it defers both the non-charitable remainder beneficiaries and, potentially, the charity's enjoyment of the trust assets, grantors need to balance the timing of enjoyment with the potential wealth transfer benefits.

[41] *See* Regs. §20.2036-1(c)(1).

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Benefit of Inter-Vivos versus Testamentary CLATs

Many charitable gifts, including those made through CLATs, are testamentary. In a low interest rate environment like today, there is an opportunity for grantors to fund these gifts now. The benefits would seem clear: (i) lock in a §7520 rate of 2.0%, with all of its potential wealth transfer; (ii) if the CLAT is a grantor trust, create a personal income tax deduction that otherwise would have been lost if the charitable contribution had been made at death; and (iii) if the grantor survives the term, allow the grantor to see both charity and the remainder beneficiary enjoy the trust assets.

Lifetime Term

In addition to a term certain, the Code provides that a CLAT may provide for annual charitable payments ''for the life or lives of an individual or individuals, each of whom must be living at the date of transfer and can be ascertained at such date.'' [42] In order to preclude certain abusive transactions where grantors were inflating the charitable deduction by using the measuring lives of unrelated individuals who were seriously ill,[43] the Treasury regulations now limit the allowable measuring lives to the donor, the donor's spouse, a lineal ancestor of the remainder beneficiaries, and an individual who, with respect to all noncharitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.[44]

Assuming, for purposes of this article, the measuring life in question is the donor of the CLAT, the calculation of the charitable deduction is determined by multiplying the amount of the annuity by the appropriate annuity factor found in Table S (for a single life annuity) in IRS Publication 1457, Actuarial Valuations Version 3A (5-2009) (for valuation dates after April 30, 2009) (hereinafter, ''Publication 1457''),[45] supplemented by Notice 2009-18 [46] with factors for §7520 rates below 2.2%. The annuity factors in Table S of Publication 1457, however, assume a fixed-level payment. With any back-loaded annuity, the annuity factors cannot be used. That being said, the remainder factors (which are the factors used to determine the present value of the right to receive an amount in the future) from Table S can be utilized.

For example, the Shark-Fin CLAT described above provided for a $1,000 annual payment and a $14.8 million payment at the end of year 20, zeroing-out the $10 million gift. The calculation of a lifetime CLAT for a 62-year-old donor (who has a 20-year life expectancy based on the 2000 mortality tables) that is patterned in the same manner can be calculated by using the appropriate annuity factor from Table S for the $1,000 annuity for life, and using the appropriate remainder factor from Table S for the last payment, as follows:

PV of Annuity for Lifetime		
Annuity Factor from Table S		15.7528
× Annuity Amount	$	1,000
Present Value	**$**	**15,753**
PV of Final Payment at Death		
Remainder Factor from Table S		0.6849
× Final Payment	$	14,576,820
Present Value	**$**	**9,984,247**
TOTAL CHARITABLE VALUE	**$**	**10,000,000**

Keep in mind that both the $1,000 annuity amount, as prorated to the date of death, and the final payment of $14,576,820 must be paid. The final payment at death (ignoring any prorated portion of the $1,000 annuity) is $259,356 *less* than the final payment that would be paid in the 20-year term certain ($14,836,177), despite the fact that a 62-year-old grantor has a 20-year life expectancy. This can be seen as the present value of the unusual ''mortality risk'' associated with lifetime CLATs. However, the mortality risk is different, depending on whether the CLAT is a fixed-level annuity or a Shark-Fin. For example, in order to zero-out a $10 million contribution to a CLAT for the lifetime of a 62-year-old grantor, the charity will receive a fixed-level payment of $634,808,[47] which is $23,241 per year *more* than the 20-year term annuity of $611,567. Over 20 years, the CLAT would cumulatively pay $464,812 more to charity.

This difference reflects the inverse relationship that fixed level annuity lifetime CLATs have when compared to lifetime Shark-Fin CLATs. If the grantor of a fixed level annuity CLAT dies significantly before life

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[42] Regs. §1.170A-6(c)(2)(i)(A), with similar language in Regs. §§20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

[43] Individuals who were seriously ill but who were not terminally ill (greater than 50% chance of surviving one year from the date of transfer). *See* Regs §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

[44] Regs. §§1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a). *See* T.D. 8923, 66 Fed. Reg. 1040 (1/5/01).

[45] If IRS Publication 1457 is not directly on point, an annuity factor may be calculated from Table S in Regs. §20.2031-7T(d)(7) by subtracting the applicable Table S remainder factor from 1.0 and dividing the result by the applicable §7520 rate.

[46] 2009-10 I.R.B. 64.

[47] Table S annuity factor for 62-year-old (2.0% §7520 rate) of 15.7528 multiplied by the annuity equals $10 million.

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expectancy, the charity receives less than it anticipated and the remainder beneficiaries reap the benefit of more wealth transfer. Of course, if the grantor dies long after his or her life expectancy, the charity receives more than it anticipated. By contrast, if the grantor of a Shark-Fin CLAT dies significantly before life expectancy, the charity receives its share earlier than it anticipated and the remainder beneficiaries do not realize as much wealth transfer. In fact, if the grantor of a Shark-Fin CLAT dies at the very beginning of a lifetime CLAT, there is a high probability that the CLAT will not have sufficient assets to pay the $14.6 million due to the charity (with the remainder beneficiaries obviously receiving no assets).[48] As mentioned above, a term-of-years Shark-Fin CLAT actually provides a higher probability of the charity receiving its entire share, whereas with a lifetime Shark-Fin CLAT, the charity's share could be at risk if the grantor dies before his or her life expectancy. This mortality risk may be hedged by the CLAT purchasing insurance on the life of the measuring life, although there are a number of issues regarding the use of life insurance in CLATs, as discussed later in this article.

It is not readily evident, based upon the examples provided in Publication 1457, how to calculate the charitable interest and, thus, zero-out a contribution to an annually increasing back-loaded CLAT (as opposed to the Shark-Fin CLAT, which is essentially a fixed annuity and a fixed payment at death). That being said, there seem to be at least a few different methodologies for calculating the charitable interests by using a combination of mortality-adjusted annuity factors (subtracting smaller annuity amounts from larger annuity amounts) and remainder factors under Table S with the commutation factors under Table H. For the less actuarially inclined, the IRS has a procedure for requesting special actuarial factors.[49] The preamble to the §7520 Treasury regulations provides that unusual situations may be ''computed by the taxpayer or, upon request, by the IRS for the taxpayer, by using actuarial methods consistent with those used to compute the standard §7520 actuarial factors.'' [50]

Purchasing the Charitable Lead Interest

If a Shark-Fin CLAT is created with a very long term, the remainder beneficiaries may want to consider purchasing the lead charitable interest from the charity. The rationale is based on the reasonable assumption that charity would prefer to receive a smaller amount today, rather than having to wait a considerable amount of time for the bulk of the trust assets, particularly if the charity estimates it can invest those assets at a higher rate of return than the prevailing §7520 rate. Under these circumstances, the remainder beneficiaries could conceivably purchase the charitable lead interest at a significant discount to the actual assets held in the CLAT at the time of purchase. Thus, assuming the state law applicable to the trust provides for the merger doctrine, the remainder beneficiaries could purchase the interest, which would collapse the trust and accelerate transfer of the assets.

To illustrate, consider the following, perhaps extreme, example. In a month when the §7520 rate is 2.0%, if a grantor contributes $10 million to a 100-year Shark-Fin CLAT that provides for a $1,000 annual payment for 99 years, then a fixed payment of $72,135,229 would be required at the end of the 100th year in order to zero-out the gift. The charity's right to receive the $72.1 million in 100 years may be worth considerably less than the $10 million contributed. For instance, if the charity invested its assets at a 5% compound annual return, the present value of that last payment is worth only $548,552. As a result, the remainder beneficiaries might negotiate the purchase of the charity's lead interest for, say, $600,000. The remainder beneficiaries would thus net $9.4 million (assuming exactly $10 million of assets in the trust at the time of purchase).

The self-dealing rules applicable to private foundations (discussed in more detail below) would, in most cases, prohibit the purchase of the charitable lead interest by the remainder beneficiaries if the charity selling the lead interest is a private foundation. The private foundation rules would not apply if: (i) the charity in question is a public charity; and (ii) the CLAT trustee is an unrelated, independent trustee not involved in the negotiation of the transaction and is not a party to the transaction.

Commutation clauses are generally prohibited in CLATs. Rev. Proc. 2007-45 provides, ''a charitable lead annuity interest is not a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the annuity period.'' [51] At least in form, if the CLAT trustee is not a party to the transaction and the

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[48] See Regs. §25.7520-3(b)(2)(i), which provides that the standard §7520 annuity factor may not be used if the trust will exhaust itself.

[49] *See* Regs. §§20.2031-7T(d)(4) and 25.2512-5T(d)(4).

[50] Preamble to the Treasury regulations applicable to §7520.

[51] Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(1) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in §4), citing Rev. Rul. 88-27, 1988-1 C.B. 331. See PLR 9844027, where the IRS allowed for prepayment of the charitable lead interest where the payment was an undiscounted amount of all distributions and where the trust was prepaying the charitable lead interest to avoid the imposition of an excise tax

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collapsing of the trust under the merger doctrine is forced upon the trustee by the remainder beneficiaries, this transaction would not seem to be a commutation. A CLAT with a term so long that a reasonable grantor would not have created the CLAT but for the expectation that the charitable interest would be purchased may be more subject to attack than a CLAT of shorter term.

GRANTOR CLATS

If much of the wealth transfer benefit afforded to the Shark-Fin CLAT is predicated on the trust having grantor trust status over the entire trust, but not also having the trust assets be includible in the estate of the grantor for estate tax purposes, it is crucial that tax planners carefully consider which grantor trust power to use with a CLAT.

What Grantor Trust Power?

The typical power used to achieve grantor trust status for a CLAT is one described under §675(4)(C), namely giving the grantor, or a person other than the grantor, the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[52] In Rev. Proc. 2007-45, the promulgated CLAT forms suggest giving someone other than the grantor the power of substitution. Specifically, the revenue procedure provides, ''[d]uring the Donor's life, [individual other than the donor, the trustee, or a disqualified person as defined in §4946(a)(1)] shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value.'' [53]

In PLR 9224029, a person who was neither a trustee nor a §672(a) adverse party had the substitution power exercisable in a non-fiduciary capacity, without the approval or consent of fiduciary. The IRS determined that the CLAT was a grantor trust under §675(4) without discussing any possible self-dealing issue. The IRS also ruled that the grantor was entitled to a §2522(a) charitable gift tax deduction equal to the present value of the charitable interest and that no part of the trust property would be includible in the grantor's estate for estate tax purposes. More recently, however, the IRS has declined to affirmatively rule on the grantor trust status of trusts under §675(4)(C), saying that such a determination is dependent on all the facts and circumstances.[54]

Giving the grantor the retained power of substitution is not, in and of itself, a violation of the private foundation rules (discussed below). However, given the steep penalties for engaging in a self-dealing transaction (as the exercise would be), the IRS could argue that this power is not a bona fide power, and as such, should be ignored for grantor trust purposes. Thus, giving someone other than the grantor the power would seem to be an important safeguard. Some practitioners will want to go further and include additional bases for establishing grantor trust status.[55]

The IRS has ruled favorably on the grantor trust status of a CLAT involving the application of §674.[56] The grantor's children were the remainder beneficiaries of the trust, but the trustees had the power to add one or more charities as remainder beneficiaries, eligible to receive trust corpus upon termination of the term. The grantor had a power to remove the trustees and to appoint successor trustees who were not related or subordinate to the grantor or to any person having a trustee removal power. Neither the grantor nor the grantor's spouse could serve as trustee. The trustees were non-adverse parties under §672(b). The IRS ruled that the grantor was the owner of the trust under §674(a).

Using Appreciated Property to Pay Charity

With respect to non-grantor CLATs, the IRS takes the position that the satisfaction of the annuity payment with appreciated property is a taxable event, thereby triggering capital gain. Citing Rev. Rul. 83-75,[57] the IRS forms provide, ''[i]f the trustee distributes appreciated property in satisfaction of the re-

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under the excess business holdings rules.

[52] §675(4).

[53] Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Section 7, Paragraph 11).

[54] *See, e.g.,* PLR 199908002.

[55] Additional powers, not otherwise discussed in this article, that potentially achieve grantor trust status without causing includibility for estate tax purposes include: (i) permitting the income of the trust, without the approval or consent of an adverse party, to be ''applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.'' §677(a)(3); and (ii) using a foreign-situs CLAT, because a foreign trust created by a U.S. grantor with one or more U.S. beneficiaries is a grantor trust under §679. In each case, the facts and circumstances of the client situation should be carefully evaluated. For example, with respect to the payment of premiums on life insurance on the life of the grantor or the grantor's spouse, it should be noted that the CLAT needs to have an insurable interest for state law purposes. *See, e.g.,* PLR 9110016.

[56] PLR 199936031. The IRS did point out that the exception to §674(a) under §674(c) does not include a power held by non-adverse parties to add to the beneficiaries who are entitled to receive trust corpus.

[57] 1983-1 C.B. 114.

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quired annuity payment, the trust will realize capital gain on the assets distributed to satisfy part or all of the annuity payment and the trust will be allowed a §642(c)(1) deduction for the realized capital gains.'' [58]

Surprisingly, with respect to grantor CLATs, the IRS takes the same position, notwithstanding that if the grantor ''owned'' the appreciated property and gave the same property to the charity (whether in satisfaction of an enforceable pledge or not), no capital gain would be triggered and the grantor would be entitled to a charitable income tax deduction.[59]

In PLR 200920031, the IRS ruled that the annual payment to a private foundation by a CLAT each year for 20 years would result in the recognition of gain by the grantor, because the trustees of the CLAT intended to satisfy the annual payment requirement with appreciated securities rather than income. The CLAT was a grantor CLAT because the grantor had the ''right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value.'' [60] The IRS cited as support for its position *Kenan v. Comr.*,[61] which dealt with the satisfaction of a noncharitable beneficiary's interest in trust assets, and two rulings,[62] one that discussed a non-grantor CLAT and the other the IRS's own inter-vivos CLAT form.

The IRS distinguished Rev. Rul. 55-410,[63] which concluded that ''satisfaction of a mere pledge to charity with property that has either appreciated or depreciated in value does not give rise to a taxable gain or deductible loss,'' on the grounds that a pledge to the charity is not a debt, whereas in a CLAT, the charity has a claim against the CLAT assets. Finally, the IRS pointed out that the grantor received a charitable deduction when the CLAT was created and before any annuity payments were made to the charity, but an individual would not be entitled to a charitable deduction upon making a pledge to a charity. As a result, the IRS ruled that grantor would recognize gain on the distribution of appreciated securities in satisfaction of the annuity amount.

The supporting authority the IRS cited could be distinguished because it deals with non-charitable beneficiaries and non-grantor trusts. Enforceable pledges are bona fide claims that can be enforced against the donor, and that the grantor received a charitable deduction upon contribution would not seem to be significant, because the grantor was not claiming an additional charitable deduction for the payment to charity. Furthermore, the perceived abuse of receiving an initial income tax deduction upon contribution and not realizing sufficient taxable gain during the term of the CLAT is covered by the recapture rules of §170(f)(2)(B), as discussed in more detail later in this article. Nonetheless, the IRS position is clear: the satisfaction of a charitable annuity in a grantor CLAT with appreciated assets triggers capital gain.

Grantor to Non-Grantor Trust Status

When a grantor either relinquishes the power that affords him or her grantor trust status or dies during the term of the CLAT, the trust becomes a non-grantor trust. Under those circumstances, three significant consequences must be considered:

- Income tax consequences resulting from the change in status;
- Recapture of the original income tax deduction; and
- The ongoing §642(c) deduction from that point forward.

Income Tax Consequences

The termination of grantor trust status during the lifetime of the grantor is treated as the transfer by the grantor of the trust assets to a non-grantor trust (separate taxpayer) in exchange for any consideration given to the grantor for the transfer.[64] Typically the simple relinquishment of grantor trust powers does not involve any consideration. Thus, unless the trust holds property encumbered with debt in excess of the adjusted tax basis (which will cause the grantor to realize gain on the constructive transfer),[65] there should be no income tax consequence upon a change in tax status. Assuming no debt, the constructive transfer will result in a gratuitous transfer for income tax purposes, with the trust receiving assets with a carryover basis under §1015.

The income tax treatment of the termination of grantor trust status as a result of the grantor's death is less clear, because there is no court case, Treasury regulation or ruling that directly addresses this issue.

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[58] Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Paragraph .02(2) of the annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in §4).

[59] *See generally* §§170(a) and (e).

[60] Substitution power of administration under §674(5).

[61] 114 F.2d 217 (2d Cir. 1940).

[62] Rev. Rul. 83-75, 1983-1 C.B. 114, and Rev. Proc. 2007-45, 2007-29, I.R.B. 89.

[63] Rev. Rul. 55-410, 1955-1 C.B. 297.

[64] *See* Regs. §1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222; and *Madorin v. Comr.*, 84 T.C. 667 (1985).

[65] Regs. §1.1001-2.

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In all likelihood, a change in grantor trust status will not be considered a taxable event.[66] Notwithstanding the foregoing, the IRS may take the position that the termination should be the treated as a constructive transfer (like a change in status during lifetime, as discussed above). As mentioned above, generally, this will not be an issue under most circumstances and, even if debt existed on the property, the basis adjustment rules of §1014 would seemingly apply.

In the unusual circumstance where a non-grantor CLAT is converted to a grantor CLAT,[67] the conversion will not be considered a transfer for income tax purposes.[68]

Recapture

The Code provides, in pertinent part, that ''[i]f the donor ceases to be treated as the owner of such an interest for purposes of applying §671, at the time the donor ceases to be so treated, the donor shall for purposes of this chapter be considered as having received an amount of income equal to the amount of any deduction he received under this section for the contribution reduced by the discounted value of all amounts of income earned by the trust and taxable to him before the time at which he ceases to be treated as the owner of the interest. Such amounts of income shall be discounted to the date of the contribution.'' [69]

Effectively, this Code provision provides, at the time of relinquishment or death, that an amount of income may be included on the grantor's income tax return to ''recapture'' the benefit of the original income tax deduction if the grantor has not effectively given back that benefit in terms of realized income over the time that the trust was a grantor trust. Interestingly, while the Code calculates the recapture amount in terms of ''income earned by the trust and taxable to the'' grantor, the Treasury regulations calculate the recapture amount in terms of amounts paid to charity. The Treasury regulations provide, ''[i]f for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be treated as the owner of such interest for purposes of applying §671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under §170 for the contribution of such interest reduced by (ii) the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest.'' [70] As such, there remains the possibility that as long as amounts that are ''required to be, and actually were, paid'' to charity in a grantor CLAT, no recapture of the income tax deduction will occur, even if little or no income becomes taxable to the grantor.

In either case, whether the recapture amount is calculated against trust income taxable to the grantor or payments made to charity, the maximum amount includible in gross income is the original deduction amount, even if the recapture event occurs many years after the original contribution. In other words, even if the entire recapture amount is recognized, the grantor had the time benefit of the income tax deduction (assuming the donor is able to use the deduction, given the lower threshold limits applicable to charitable contribution deductions generated through CLATs).

The Remaining §642(c) Deduction

The Treasury regulations point out that upon termination of grantor trust status, after recapture has been calculated and recognized, the trust becomes a non-grantor trust, entitled to any then allowable §642(c) deduction.[71]

As such, recapture of the deduction under §170(f)(2)(B) is not a loss of the deduction. Rather, the deduction is converted to a charitable deduction under §642(c). In the case of a CLAT it may often produce a larger aggregate deduction than the original deduction. To illustrate, in the extreme Shark-Fin example above, if the trust becomes a non-grantor trust in year 19, even if the entire $10 million original deduction is recaptured (assuming no taxable income and nominal distributions to charity), the trust would still be entitled to over $14.8 million in deduction in the last year of the trust, when it is a non-grantor trust.

Interestingly, it is theoretically possible to get both deductions. If, as the Code provides, recapture is cal-

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[66] *See Crane v. Comr.*, 331 U.S. 1 (1947); Rev. Rul. 73-183, 1973-1 C.B. 364; Blattmachr, Gans & Jacobson, ''Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,'' 96 *J. Tax'n* 149 (Sept. 2002); and Manning & Hesch, ''Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements,'' 24 *Tax Mgmt. Estates, Gifts & Tr. J.* 3 (1999).

[67] This would occur if there is an appointment of related or subordinate trustee to replace an independent trustee under §674. There are other circumstances where this would occur, but they would likely be considered self-dealing transactions, under the private foundation rules.

[68] PLR 200923024.

[69] §170(f)(2)(B).

[70] Regs. §1.170A-6(c)(4). *See* Regs. §1.170A-6(c)(5), Ex. 3.

[71] Regs. §1.170A-6(c)(5), Ex. 3, provides that after the grantor ceases to be the owner for grantor trust purposes the amounts paid to charity are determined under §642(c)(1) and the regulations thereunder.

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culated by determining the discounted value of the income taxable to the grantor, then, from a planning standpoint, grantor trust status can be relinquished at the point that just enough taxable income is realized by the grantor so that there would be no recapture. From that point forward, the trust would be entitled to offset taxable income with the §642(c) deduction, with all of the limitations noted above but, just as importantly, without any AGI threshold limitations. This can be particularly useful where the trust holds appreciated assets that otherwise would be used to pay a charity in-kind and trigger capital gain tax liability to the grantor, as discussed above. Under these circumstances, grantor trust status can be relinquished and the capital gain realized can be offset fully by the §642(c) deduction, which is equal in value to the payment to a charity.

PRIVATE FOUNDATION RULES

CLATs are split interest-trusts for which §508(e) sets forth various governing instrument requirements. In pertinent part the Code provides, ''[i]n the case of a trust which is not exempt from tax under §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.'' [72]

If, however, the present value (as determined under §7520) of the charitable interest does not exceed 60% of the trust assets, the governing instrument of a CLAT is not required to prohibit acquisition and retention of §4943 excess business holdings and §4944 jeopardy investments.[73] Most CLATs are designed to generate a charitable deduction, at least for gift tax purposes, well in excess of 60%. If the private foundation rules are violated income, estate or gift tax charitable deductions may be disallowed[74] and excise taxes may be imposed.[75]

Section 508(e) provides that the governing instrument of a private foundation must require the foundation to distribute income in such a way to avoid the excise tax imposed on undistributed income under §4942. In addition, the governing instrument must prohibit the trust from:

- Engaging in self-dealing under §4941(d);
- Retaining excess business holdings under §4943(c);
- Making jeopardy investments under §4944; and
- Making taxable expenditures under §4945(d).[76]

The most common private foundation rules issues arise with CLATs in conjunction with the sale, exchange or leasing of property between the CLAT and a disqualified person, and the retention of excess business holdings.

A ''disqualified person,'' in the context of CLATs, includes:

- A ''substantial contributor,'' [77] which includes the grantor and any persons ''who contributed or bequeathed an aggregate amount of more than $5,000 to a private foundation, if such amount is more than 2% of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person'';[78]
- A ''foundation manager,'' [79] which includes a trustee or any individual having similar powers or responsibilities;[80]
- A ''family member'' [81] of any of the foregoing, which includes an individual's ''spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren'';[82] and

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[72] §4947(a)(2).

[73] §4947(b)(3)(A); Regs. §§1.170A-6(c)(2)(i)(D), 20.2055-2(e)(2)(vi)(*e*), 25.2522(c)-3(c)(2)(vi)(*e*); Rev. Rul. 88-82, 1988-2 C.B. 336.

[74] §508(d)(2).

[75] §§4941-4945.

[76] It would be a rare circumstance that a termination tax would apply to a CLAT, so this provision of the private foundation rules is not further discussed in this article.

[77] §4946(a)(1)(A).

[78] §507(d)(2)(A).

[79] §4946(a)(1)(B).

[80] §4946(b)(1).

[81] §4946(a)(1)(D).

[82] §4946(d).

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- Trusts in which persons described above own more than 35% of the total beneficial interests.[83]

Fortunately, an exception to the self-dealing prohibitions allows reasonable and necessary compensation to be paid to a disqualified person, thereby permitting a trustee — including the grantor acting as such — to be compensated. In addition, the IRS has ruled that it is not an act of self-dealing for the payment of fees to an investment management company owned by the grantor's descendants.[84]

The Treasury regulations do provide an exception for transactions with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death).[85] This has been relied upon to allow an estate's sale of real property to a disqualified person so that the CLATs could be funded with a promissory note instead of the real property.[86]

Section 4943 imposes an excise tax on the value of the ''excess business holdings'' of a private foundation.

A private foundation is deemed to have excess business holdings to the extent that it, together with all disqualified persons, owns in the aggregate more than 20% of the voting stock of an incorporated business enterprise.[87] For unincorporated entities like partnerships and limited liability companies, the percentage ownership requirement is replaced with profits, capital and beneficial interest concepts.[88]

A ''business enterprise'' includes the active conduct of a trade or business and any activity that is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under §513.[89] A business that derives more than 95% of its gross income from ''passive sources'' will not constitute a ''business enterprise'' within the meaning of §4943, and a foundation's investment in such an entity will not constitute a ''business holding.'' [90] Gross income from passive sources includes dividends, interest, payments with respect to securities loans and annuities, royalties, whether measured by production or by gross or taxable income from the property in question, rents, and gain from the sale or exchange of property (other than inventory or stock in trade).[91] Generally, where a private foundation acquires excess business holdings, it has five years from the date of acquisition to dispose of them in order to avoid the imposition of the excise tax.

INVESTMENT IMPLICATIONS

Section 4944 imposes an excise tax on a private foundation for investing any amount in such a manner as to jeopardize the carrying out of its exempt purposes. The Treasury regulations provide, ''an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return).'' [92] In evaluating whether an investment is jeopardizing, the IRS has generally followed this ''prudent trustee'' standard, looking to where and how such investment fits in the overall portfolio.[93] The Treasury regulations provide that no investment is per se considered a jeopardy investment; however, ''trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts' and 'calls' and 'straddles,' the purchase of warrants and selling short'' all require close scrutiny.[94]

Importantly, the Treasury regulations provide, ''[s]ection 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1)) in the amount of such consideration.'' [95] In other words, it is permissible to contribute a speculative investment

[83] §4946(a)(1)(G). Beneficial interest is determined in accordance with the attribution rules under §267(d). *See* §4946(a)(4).

[84] PLR 200018062.

[85] Regs. §53.4941(d)-1(b)(3).

[86] PLR 200124029 and PLR 200024052.

[87] §4943(c)(2)(A).

[88] Regs. §53.4943-3(c).

[89] Regs. §53.4943-10(a)(1).

[90] §4943(d)(3)(b).

[91] §4943(d)(3) and §512(b)(1), (2), (3) and (5) with certain modifications.

[92] Regs. §53.4944-1(a)(2)(i).

[93] *See, e.g.,* TAMs 9205001 and 9627001 and PLR 9451067.

[94] Regs. §53.4944-1(a)(2)(i).

[95] Regs. §53.4944-1(a)(2)(ii)(a).

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to a CLAT, but it would be a jeopardizing investment if the cash to purchase that same investment was first contributed and then the trustee of the CLAT made the investment.

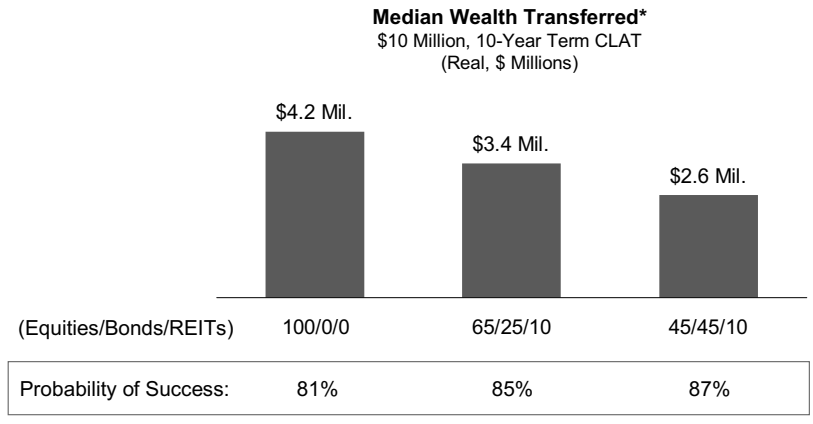
CLATs do not have the same restrictions on investments as CRTs. Under the Treasury regulations, ''[a] trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.'' [96] This restriction is not applicable to CLATs. That being said, the Treasury regulations do provide that if the facts and circumstances suggest that charity will not receive some or all of the annuity payments, then any resulting tax deduction will be limited to the minimum amount charity will receive. The Treasury regulations provide, ''[i]f by reason of all the conditions and circumstances surrounding a transfer of an income interest in property in trust it appears that the charity may not receive the beneficial enjoyment of the interest, a deduction will be allowed . . . only for the minimum amount it is evident the charity will receive.'' [97] The examples in the Treasury regulations focus on circumstances where either by the terms of the trust document or by virtue of state law, the tax deduction should be limited to a lesser amount than would be calculated under §7520. The examples do not focus on situations involving the investments of the trust. Notwithstanding that fact, because this test is based on ''all the conditions and circumstances,'' it could conceivably be used to limit or disallow a charitable income or transfer tax deduction. For example, if the trust required the trustee to invest only in deferred annuities that had a return less than the §7520 rate, then it is quite possible the tax deduction would be reduced, using the lower discount rate of return of the deferred annuities.

From an investment standpoint, the ability to backload the annuity payments in a CLAT allows the trustee to invest in higher volatility (and, theoretically, higher returning) asset classes and strategies. Because failure with a CLAT is unforgiving, in a traditionally structured CLAT the trustee has to balance the competing interests of lower-volatility portfolios with higher probabilities of success but lower return potential against higher-volatility portfolios with lower probabilities of success but higher return potential. As the following display shows (Higher Probabilities of Success at the Cost of Potential Wealth Transfer), as a CLAT's asset allocation moves from 100% globally diversified equities toward a more diversified, less volatile portfolio, probabilities of success rise but often at the cost of potential wealth transfer.

[96] Regs. §1.664-1(a)(3). See PLR 7802037, where a charitable income tax deduction was denied because the trust document required the trustee to invest in tax-exempt securities.

[97] Regs. §§1.170A-6(c)(3)(iii), 20.2055-2(f)(2)(iv), 25.2522(c)-3(d)(2)(iv).

Higher Probabilities of Success at the Cost of Potential Wealth Transfer



*Median inflation-adjusted non-grantor CLAT remainder assuming $10 million zeroed-out 10-year CLAT funded at the November 2010 Section 7520 rate, invested 100% global equity. Probability of success defined as remainder interest >$0. Equities defined as 35% US Value, 35% US Growth, 25% Developed International and 5% emerging markets. Bonds are intermediate term taxable bonds

The foregoing examples assume a 10-year, zeroed-out non-grantor CLAT with level annuity payments. The differences between probabilities of success and the projected wealth transfer can be muted by extending the term and making the CLAT a grantor trust. However, as pointed out above, higher probabilities of

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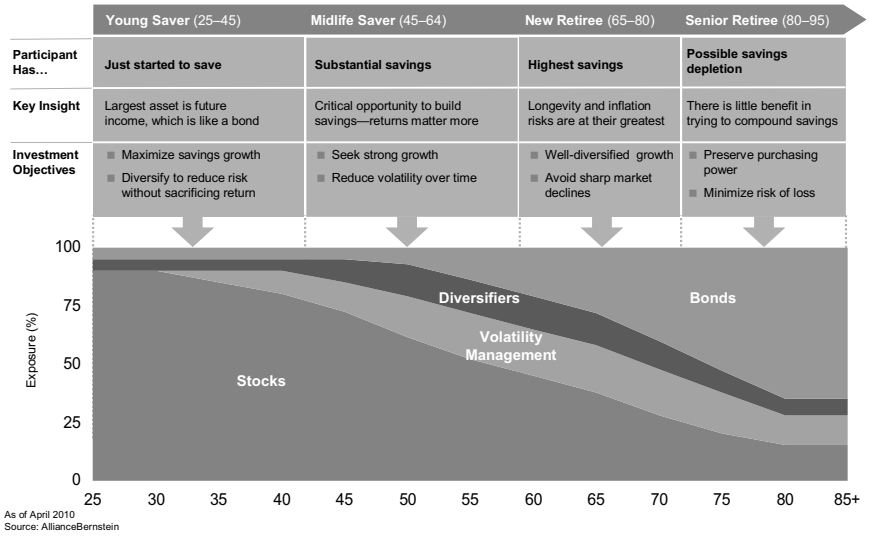
success and higher potential wealth transfer can best be achieved by back-loading the annuity payments in some manner. A trustee need not be as concerned with volatility during the initial years in a CLAT with a sufficiently long term if the bulk of the charitable payments are deferred to the end of the term.

One logical investment implication with back-loaded payments is a concept called ''glide path'' investing that is common in retirement and educational funding planning (§529 Plans). Glide path investing involves a gradual adjustment of an investor's asset allocation as the investor gets closer to the point (retirement, matriculation, etc.) at which the portfolio will have significant outlays (living expenses, tuition, etc.). As the theory goes, the more time a portfolio has to be invested without any drawdown, the more volatile the portfolio can be. Thus, over time, as one gets closer to the point at which drawdowns begin, the portfolio should reflect a lower risk profile, as the following display on retirement glide path investing shows (Glide Path Design).

Glide Path Design: Determined by Life Stage Circumstances and Objectives



As of April 2010
Source: AllianceBernstein

In addition to the foregoing, the flexibility to back-load the annuity payments in a CLAT provides a new window of opportunity for planners to contribute certain types of assets and do certain types of planning that historically were not practical. This was because the nature of the assets was such that requiring a mandatory payment each year put the asset at risk to either having to be sold to generate funds to make the annuity distribution, or transferred in-kind to charity at a time when the asset either had no liquidity or very little value.

The planning in this arena is complicated by the application of the private foundation rules, discussed above. However, for careful planners who are willing to take on this additional set of considerations, the benefits to donors and charities can be substantial.

INVESTMENT EXAMPLES

FLP Interests Holding Commercial Real Property

Interests in family limited partnerships and LLCs (collectively, ''FLPs'') owning commercial real property have been thought poor candidates to contribute to CLATs because of the danger that cash flows from the property might fall, leaving insufficient cash to make the annuity payment. The choices at that point were dire: sell or mortgage the underlying property to generate the cash required for the distribution; distribute FLP interests in-kind and have the charity become a partner of the FLP; or have the trustee borrow from

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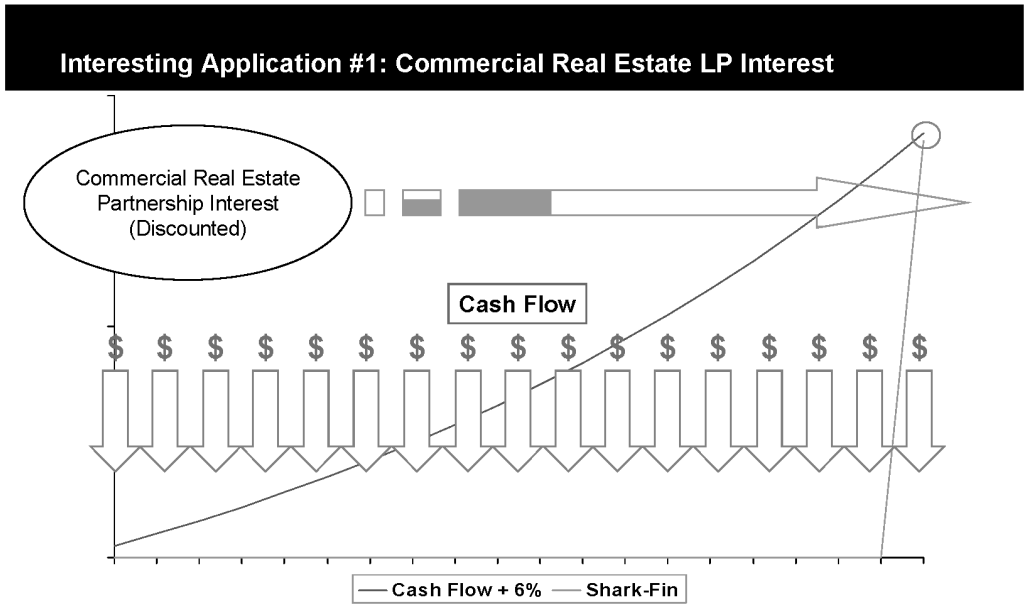
a third party in order to make all or a portion of the annual payment.[98]

On the other hand, in a back-loaded CLAT, early cash flows from the real property may accumulate and be invested in the CLAT, providing a significant cushion for the larger payments to a charity toward the end of the term, as illustrated in the display below (Interesting Application #1: Commercial Real Estate LP Interest). The term of the CLAT may be adjusted to ensure a high likelihood that there will be sufficient cash or liquid securities to satisfy the large charitable payments toward the end of the term.

[98] The latter might be considered acquisition indebtedness and thus debt-financed income if the borrowing is seen as ''reasonably foreseeable'' at the time the property is acquired by the trust. Regs. §1.514(c)-1(a)(1)(iii).



One feature common to commercial real property is the existence of debt. In general, a grantor can transfer mortgaged property to a CLAT. If, however, the mortgage was acquired immediately prior to the transfer, UBTI problems may arise.

PLR 7808067 is instructive. In the ruling, real property subject to a mortgage was transferred to a CLAT. The IRS ruled that there was no acquisition indebtedness for purposes of determining whether the trust had debt-financed income under the UBTI rules because the mortgage had been placed on the property more than 10 years prior to the transfer. Interest on the mortgage, depreciation, amortization of leasehold, commissions, management, expenses, and legal and accounting fees, as well as the annuity paid to the charity, were all deductible by the trust and not deemed paid for a private purpose. The ruling concluded that the excess business holdings provision was inapplicable, because conducting the real estate business was found not to constitute a business enterprise on the grounds that over 95% of the gross income was derived from passive sources (i.e., rents). The IRS also ruled that the jeopardy investment provisions were not violated by holding the real estate.

As discussed previously, the existence of UBTI in a grantor CLAT is of no consequence. If the grantor dies during the term of the CLAT, however, the trust will become a non-grantor trust, and at that point UBTI will impose an impediment to the trust's investment performance because of limitations on the deductibility of the charitable distributions. To facilitate the disposal of the investment under these circumstances, planners should consider contributing the interests in the FLP subject to a purchase option at fair market value. The Treasury regulations provide that, under the right terms, such a purchase from the CLAT by a disqualified person (for instance, the estate of the grantor) will not be considered an act of self-dealing.[99] Also, it is worth reiterating that if property is encumbered by debt which exceeds the grantor's

[99] Regs. §53.4941(d)-1(b)(1) provides, ''The term indirect self-dealing shall not include any transaction described in §53.4941(d)-2 between a disqualified person and an organization controlled by a private foundation (within the meaning of sub-

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basis in the property, there will be recognition of gain when the trust's income tax status changes.[100]

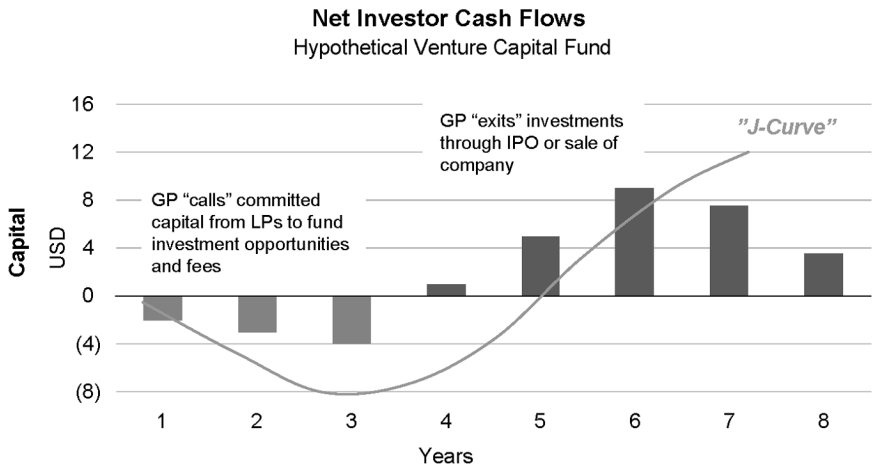
Private Equity Interests

Private equity investments, in particular venture capital investments, commonly have no liquidity or readily ascertainable value at the outset of the investment. Where the investment is made through a fund, these features are compounded, because the fund likely will carry with it significant capital call obligations and restrictions on the ability to transfer, assign or liquidate the investments (generally the lock-up is 10 years). As such, private equity investments are said to follow the ''J curve'' of investment return, where the value of the investment falls in value before, hopefully, appreciating far above the original investment (through sale of the company, IPO or other liquidity event), as suggested in the display below (Interesting Application #2: Private Equity Investments).

paragraph (5) of this paragraph) if: [t]he transaction results from a business relationship which was established before such transaction constituted an act of self-dealing (without regard to this paragraph), [t]he transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person, and [e]ither: [t]he organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at a severe economic hardship to such organization, or [b]ecause of the unique nature of the product or services provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship.''

[100] Regs. §1.1001-2.

Interesting Application #2: Private Equity Investments



■ Remember gifts of speculative property are NOT jeopardy investments (Regs. § 53.4944-1(a)(2)(ii)(a)).

Private equity investments, which in years past were not strong candidates for a CLAT, may now be contributed to a Shark-Fin or other back-loaded annuity CLAT so that v the charitable payments can be matched to when the private equity investment is expected to have liquidity and value.

Theoretically, one could create 20 different Shark-Fin CLATs with 20 separate private equity investments (similar to asset-splitting zeroed-out ''rolling'' GRATs) with the understanding that many of the investments will fail, which is common to this particular type of investment. Assuming the CLAT is not being used to satisfy enforceable charitable pledges of the grantor, the failure of the CLATs should not have adverse consequences to the grantor. By separating these investments, the spectacular returns of a few of them will not be watered down by the failure of most of them, thereby generating more wealth transfer than if they had been combined into one CLAT. Quite obviously, the transaction costs of this type of planning make it impractical in many settings.

Under any circumstance where private equity investments are the sole asset of the CLAT, one must be concerned with the jeopardy investment rules, as dis-

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cussed above. As mentioned above, the gratuitous transfer of a speculative investment to a CLAT is not considered a jeopardizing investment.[101]

Preferred Investment FLP Interests

The contribution of preferred interests in an FLP holding investment securities is a prime candidate for contribution to a back-loaded CLAT. Anytime, however, a preferred interest in an FLP is created or transferred, §2701 must be considered. There are myriad of ways that §2701 can be implicated, and a full discussion is beyond the scope of this article, but assume an FLP is funded with $20,000,000 in cash and marketable securities and receives, among other interests, a class that has a liquidation preference of the following: (1) $10,000,000;[102] (2) an appraiser determines that the fair annual yield on the interest is 8% per year (against the liquidation preference) until maturity.[103]

When the grantor gifts the entire 8% $10 million preferred interest to a Shark-Fin or other back-loaded CLAT, the transfer will likely be entitled to a valuation discount which we will assume to be 20%.[104] The gift of the 8% $10 million preferred interest, which was worth $10 million before the discount, now has a gift tax value of $8 million. This increases the effective yield on the preferred interest from 8% to 10%.

The grantor has made an $8 million gift that has an effective guaranteed return of 10%, which is being contributed to a CLAT that has an internal rate of return equal to the §7520 rate of 2.0%. It guarantees an arbitrage of 8.0% each year for the term of the CLAT. In addition, because the annuity payments are back-loaded, the preferred payment (which can be distributed in cash or in-kind) will continue to stay in the CLAT, further compounding for the remainder of the term, as illustrated in the display below (Interesting Application #3: Preferred Investment FLP or LLC Interests).

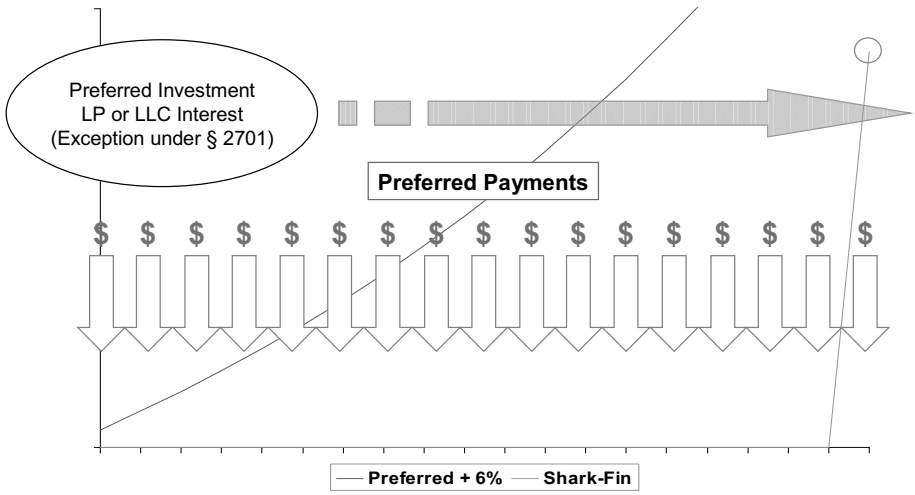
[101] Regs. §53.4944-1(a)(2)(ii)(a).

[102] This should qualify for the ''vertical slice exception'' to §2701. Regs. §25.2701-1(c)(4).

[103] According to the factors set out in Rev. Rul. 83-120, 1983-2 C.B. 170. *See, e.g.,* Hatcher and Manigault, ''Warming Up to the Freeze Partnership,'' *Estate & Personal Financial Planning* (June 2000).

[104] This should qualify for the ''junior equity interest exception'' to §2701. §2701(c)(2)(B)(i); Regs. §25.2701-2(b)(3)(i).

Interesting Application #3: Preferred Investment FLP or LLC Interests



- What about excess business holdings under § 4943?

Based on Bernstein's Wealth Forecasting Model, a grantor Shark-Fin CLAT providing for a $1,000 annual payment for 19 years and a $12.8 million payment in the 20th year, the median value[105] of cash and securities (in nominal terms) that the remainder beneficiaries will receive at the end of the term (after

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charity is fully paid) is $21.8 million, plus the remainder beneficiaries will receive a preferred interest in the FLP with $10 million of liquidation preference and an 8% yield.

Single-Stock or Concentrated Stock Positions

Many wealthy individuals have highly appreciated but concentrated positions in one or a few companies. For those individuals, emotional ties to the company that created their wealth, the cost of diversifying (capital gain taxes) and the disbelief that a diversified portfolio will outperform their stock have prevented them from selling the position. Highly appreciated, publicly traded stocks are great candidates to contribute to charity, because they result in an income tax deduction at fair market value, rather than an adjusted tax basis.[106] However, the only economic benefit to the grantor (and the grantor's family) is the tax savings resulting from the charitable income tax deduction.

From an investment standpoint, concentrated or single stock positions have higher volatilities than diversified stock portfolios, and as a result, they exhibit what is commonly referred to as ''risk drag.'' Stated another way, the more volatile the investment, the lower the compound annual return that investment is likely to have over time. However, notwithstanding risk drag and notwithstanding the risk of concentrating one's wealth in one company (consider Bear Stearns, Lehman Brothers, Enron, WorldCom, TWA, etc.), for a certain cohort of individuals, diversifying is out of the question. Indeed, concentrated stock positions can create enormous wealth. The issue is how to effectively transfer the concentrated stock position to the next generation (and, perhaps, also to charity).

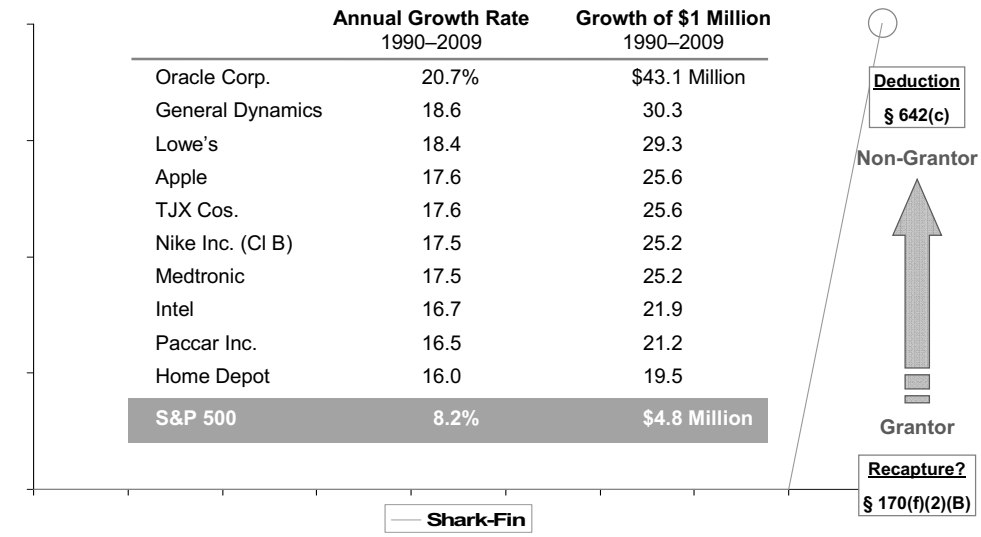
A back-loaded or Shark-Fin CLAT, as illustrated in the display below (Interesting Application #4: Single Stock Positions), may be one solution for transferring a concentrated stock position to charity and to children. Concentrated stock positions will not suffer as badly in a back-loaded or Shark-Fin CLAT structure, because the fixed payments to charity will not lock in the losses of the stock when it has negative volatility. Also, with a low §7520 rate, a grantor may be able to contribute a stock whose dividend alone already exceeds the §7520 rate. By way of example, the S&P 500 is currently yielding 2.1%, and the companies in the S&P 500 Dividend Aristocrats Index (large-cap, blue chip companies within the S&P 500 that have followed a policy of increasing dividends every year for at least 25 consecutive years) are yielding significantly more. As a result, all or significantly all of the §7520 rate of return theoretically may be covered by the dividend yield alone.

[105] As with all of the figures in this article, we assumed globally diversified equities.

[106] §170(e)(5).

Interesting Application #4: Single Stock Positions

	Annual Growth Rate 1990–2009	Growth of $1 Million 1990–2009
Oracle Corp.	20.7%	$43.1 Million
General Dynamics	18.6	30.3
Lowe's	18.4	29.3
Apple	17.6	25.6
TJX Cos.	17.6	25.6
Nike Inc. (Cl B)	17.5	25.2
Medtronic	17.5	25.2
Intel	16.7	21.9
Paccar Inc.	16.5	21.2
Home Depot	16.0	19.5
S&P 500	8.2%	$4.8 Million



Source: Center for Research in Security Prices (CRSP) and AllianceBernstein

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An important question is whether a non-grantor CLAT or a grantor CLAT will create better results. A grantor CLAT has the obvious benefit of giving the grantor an individual income tax deduction upon contribution. That benefit is offset by the ongoing grantor trust liability. With a concentrated stock position that is not going to be sold, the income tax liability will come from the dividends paid over the term of the CLAT and any capital gains realized by the CLAT to make the charitable payments to charity. As mentioned above, the IRS's current position is that in-kind payments in satisfaction of the charitable annuity will trigger capital gain. Thus, assuming one used a 20-year Shark-Fin CLAT, long-term capital gain would be triggered in the 20th year equal to the $14.8 million minus the total dividends paid on the stock (originally $10 million) and any compounded earnings on those dividends. The $10 million up-front income tax deduction versus the deferred tax liability (most of which is recognized in the 20th year) at qualified dividend or long-term capital gain rates may be a reasonable trade-off, especially considering the amount of wealth that could potentially be transferred to the remainder beneficiaries at the end of the CLAT term. While it is theoretically possible to swap cash for the low-basis appreciated stock prior to the payment in-kind to charity under the grantor trust rules and avoid recognizing capital gain, given the dire penalties for self-dealing (sale or exchange between a private foundation and a disqualified person),[107] that is an impractical planning idea.

A non-grantor CLAT will not create an income tax deduction for the grantor, but because the §642(c) charitable deduction is not limited by a percentage of contribution base (adjusted gross income), it provides a highly tax-efficient way of offsetting any resulting capital gain tax. With a concentrated stock position, annual payments to charity could be set to approximate the annual dividends, with the anticipation that the larger, deferred payments to charity would be satisfied with appreciated shares of stock. The dividends and the resulting capital gain would be fully sheltered by the §642(c) deduction.

One interesting planning option is to initially start as a grantor CLAT and then relinquish grantor trust status just prior to the last payment to charity. As mentioned above, the conversion from grantor to non-grantor trust status is not a taxable event unless there is debt in excess of basis. As such, the grantor could retain grantor trust status (as long as the grantor is alive, of course) until the bulk of the payments are payable to charity (in the 20th year, for example). Upon conversion to non-grantor trust status, there would be recapture of the income tax deduction under §170(f)(2)(B) equal to the original deduction amount minus the discounted value of the dividends declared on the stock and the tax on the reinvestment of the dividends, but as discussed above, recapture is not as detrimental as it might appear at first glance. More importantly, once the CLAT is a non-grantor trust, any resulting gain from the payment in-kind to charity in the last year or years will be fully sheltered by the charitable deduction ($14.8 million in the 20th year in the Shark-Fin example).

Life Insurance

Because a grantor CLAT provides an income tax deduction to the grantor at the cost of having the grantor be taxed on the CLAT's income, an investment inside the grantor CLAT that would not create any income tax liability may be desirable. Life insurance is such an investment, as illustrated in the display below (Interesting Application #5: Life Insurance). Proponents of the use of life insurance inside a grantor CLAT hope it will provide an income tax deduction under §170(a) to the grantor upon funding of the CLAT, but because all or a portion of the contributed assets will grow tax-free inside the policy, there will be little or no income tax liability to the grantor over the term of the CLAT.

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[107] §4941(d)(1).

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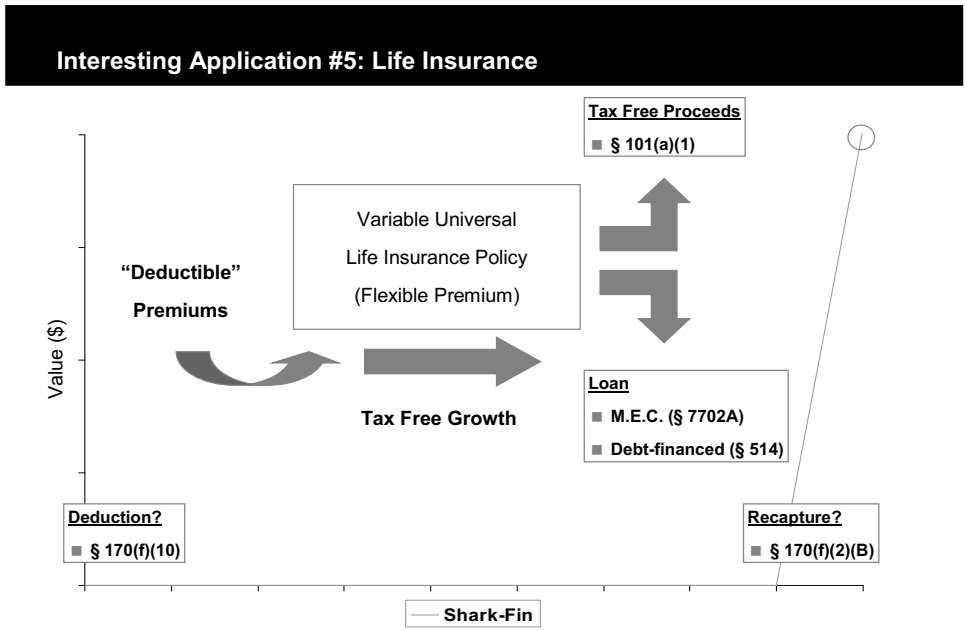

However, planners must be wary of a number of technical issues, including the modified endowment contract rules under §7702A, the charitable split-dollar rules under §170(f)(10), the recapture rules and the private foundation rules (as discussed in more detail above).

Basics of the Plan

In the most extreme but simplified, version of the plan, the grantor makes a $10 million cash contribution to a 20-year grantor Shark-Fin CLAT, which generates a $10 million income tax deduction under §170(a).

The trustee of the CLAT uses the cash to purchase a variable, universal or whole life insurance policy, paying premiums over three to seven years (however long it takes to create a paid-up policy without causing the policy to be a modified endowment contract under §7702A). While the cash is waiting to be paid into the policy in premiums, the trustee invests the assets in something that generates very little or no taxable income to the grantor, such as municipal bonds. For purposes of this example, let's assume the premiums purchase $60 million in death benefit.

The trustee then lets the assets grow inside the policy for the remainder of the 20-year term. Effectively, what you have created is $10 million of personal income tax deduction, which is equal to the premiums paid, and no grantor trust liability.

At the end of the 20-year period, only one of two things has occurred. The grantor, as the insured, is either alive or dead. In the less likely event the grantor dies during the 20-year period, let's say in year 15, the following occurs:

1. $60 million of death benefit is paid to the CLAT, tax free under §101(a)(1), which is more than enough to pay charity the $14.8 million it is owed in year 20, leaving a sizable amount of wealth transfer to the remainder beneficiaries at the end of the term.
2. There will be recapture of the original income tax deduction under §170(f)(2)(B) in an amount equal to the deduction on the decedent's last income tax return. However, as noted above, the maximum amount included in income is the original deduction, and the grantor has had the time-value benefit of that deduction. Furthermore, the tax liability will be deductible for estate tax purposes under §2053.

In most circumstances, from an economic standpoint, the family is better off if the grantor dies during the term.

In the more likely event that the grantor is still alive at the end of the 20-year term, the following is likely to occur:

1. So that charity can receive its $14.8 million, the trustee takes $14.8 million out of the life insurance policy, stripping $10 million of basis out of the policy and then borrowing against the cash value for an additional $4.8 million. Both of these are non-taxable from an income tax standpoint because the policy is not a modified endowment contract. Trustee pays charity $14.8 million.
2. It is highly likely that even after withdrawing $14.8 million of funds from the policy, there will still be significant net cash value in the policy.

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The assets have been growing tax free, and if those assets are invested in globally diversified equities, the median amount after all payments to charity and after inflation will be $28.5 million. Of course, that figure does not take into account the reduction in value due to mortality charges, administrative charges, commissions on the policy and other expenses. For purposes of this illustration, let's assume that after all payments to charity, expenses and charges against the funds, this policy still has $20 million nominally in net cash value (after debt).

This policy now passes to the remainder beneficiaries, who can:

1. Cancel the policy and take the $20 million of net cash value, but this will be a taxable event. However, the tax may be borne by the grantor if the remainder is held in a grantor trust;
2. Continue to maintain the $60 million death benefit policy for the remainder of the grantor's lifetime, although this would likely require additional premiums to be paid into the policy; or
3. Reduce the death benefit to, say, $40 million and have a fully paid-up policy on which no additional premiums will be paid.

It is likely that upon termination there is no recapture of the income tax deduction under §170(f)(2)(B). First, there is the argument that recapture under these circumstances only occurs when the ''donor ceases to be treated as the owner of such an interest for purposes of applying section 671.'' If the grantor CLAT ceases and then passes to another grantor trust, grantor trust status never ceases. More to the point, however, as mentioned above, the Treasury regulations provide that as long as charity is paid, recapture has been satisfied.

In all, at least in theory, what this plan has created is $10 million of deduction, no grantor trust liability, no recapture of the deduction, and a life insurance policy that is out of the estate of the grantor and for which no taxable gifts and annual exclusions were needed.

Different variations of this basic plan might include changing the term to a lifetime term to match up the termination of the CLAT to the economic event under the policy (mortality). Under this construction, the CLAT might purchase (or the insured grantor who is also the measuring life might purchase and then transfer to the CLAT) a single premium guaranteed universal life insurance policy. Any death benefit payable at death (presumably guaranteed) above the final charitable payment would pass to the remainder beneficiaries free of estate taxes. If, taking the lifetime term example from earlier in this article, a $10 million single premium can purchase $30 million of death benefit for a 62-year-old insured, anything above $14,572,820 that is payable to charity at death will pass to the remainder beneficiary (ignoring the $1,000 payment each year).

It is important to note that the IRS is clearly aware of the use of life insurance in the grantor trust context, although perhaps not specifically with ''intentionally defective'' grantor CLATs. It bears remembering that pursuant to Rev. Proc. 2010-3,[108] the IRS has stated it will not rule on whether ''the grantor will be considered the owner of any portion of a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.'' [109] The IRS has also ruled that under certain circumstances an investment in life insurance will be considered a jeopardy investment under the private foundation rules.[110]

Charitable Split-Dollar Rules

In our opinion, one of the primary sticking points is to what extent the ''charitable split-dollar rules'' of §170(f)(10) are deemed to apply under these circumstances. The ''charitable split-dollar'' rules provide ''no deduction shall be allowed, for any transfer to or for the use of an organization described in subsection (c) if in connection with such transfer:'' [111]

- ''The organization directly or indirectly pays, or has previously paid, any premium on any personal benefit contract with respect to the transferor, or'' [112]
- ''There is an understanding or expectation that any person will directly or indirectly pay any pre-

[108] 2010-1 I.R.B. 110.

[109] *Id.* at §3.01(54).

[110] Rev. Rul. 80-133, 1980–1 C.B. 258. But see PLR 8134114, where the IRS held that insurance policies are not jeopardy investments where there is no outstanding loan on the policy, the donor surrenders all incidents of ownership, and the donor pays the premiums. Presumably this would not be applicable to this technique, because the grantor would not be paying any of the premiums, the CLAT would be paying them.

[111] §170(f)(10)(A).

[112] §170(f)(10)(A)(i).

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mium on any personal benefit contract with respect to the transferor.'' [113]

A ''personal benefit contract'' is ''with respect to the transferor, any life insurance, annuity, or endowment contract if any direct or indirect beneficiary under such contract is the transferor, any member of the transferor's family, or any other person (other than an organization described in subsection (c)) designated by the transferor.'' [114] An individual's family is deemed to include ''the individual's grandparents, the grandparents of such individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.'' [115]

There is an exception for certain life insurance contracts held by charitable remainder trusts but not for CLATs.[116] A CLAT is not an organization described in §170(c), so §170(f)(10)(A)(i) is not applicable. On the other hand, we believe §170(f)(10)(A)(ii) is more problematic.

The IRS could argue that in the example outlined above, there is an ''understanding or expectation'' that some ''person'' (the CLAT) ''will directly or indirectly pay'' premiums on a personal benefit contract. There are credible arguments to say that this provision does not apply to the example outlined above. For example, it can be argued that the life insurance here is not a ''personal benefit contract'' as defined above because the beneficiary is the CLAT and the person designating the beneficiary of the contract is the CLAT trustee. Furthermore, it can be argued that, assuming the contract has an internal rate of return equal to the §7520 (an assumption inherent within the calculation of the income tax deduction), no personal benefit is expected to pass to the grantor's family, because the contract would only benefit charity. Finally, it seems clear that the charitable split-dollar rules were not intended to apply to this situation. Indeed, the legislative history to §170(f)(10) indicates that such section was designed to stop charitable split-dollar arrangements that provide little benefit to charity.[117]

What is unusual about this provision is that if a grantor had an existing policy that is paid up (at least by the terms of the current in-force ledger and illustration), the grantor could contribute that existing policy, get an income tax deduction for the value of that contribution, and §170(f)(10)(A)(ii) would not be applicable. This is because there would be no ''understanding or expectation'' that the CLAT ''will'' (prospectively) pay any premiums. If an existing life insurance policy is transferred, however, the proceeds of the life insurance will continue to be includible in the estate of the transferor for three years following the transfer.[118]

Importantly, planners should keep in mind that if the charitable split-dollar rules do apply, not only will the original income tax deduction be disallowed, but the CLAT itself will be subject to an excise tax equal to the premiums paid.[119] The excise tax is imposed on a §170(c) organization, but the Code also provides, for purposes of the excise tax that ''payments made by any other person pursuant to an understanding or expectation referred to in subparagraph (A) shall be treated as made by the organization.'' [120] In any case, before planners jump into the deep end on this type of plan, they should carefully consider the charitable split-dollar rules and whether they might or might not apply to their facts and circumstances.

CONCLUSION

The Internal Revenue Code assumes that any asset contributed to a CLAT will have a total return equal to the §7520 rate. A zeroed-out CLAT is designed to distribute to charity what the government assumes the CLAT will earn and accumulate the excess — which the government assumes will be zero — for eventual distribution to the grantor's non-charitable beneficiaries, usually the grantor's children. Because the government assumes the excess accumulation is zero, the grantor makes no gift to the children.

The central insight of the Shark-Fin or back-loaded CLAT is that the longer an asset remains in the CLAT, the longer it may produce excess earnings for eventual distribution to the children (or other non-charitable beneficiaries). The Internal Revenue Code, Treasury regulations, and IRS pronouncements have prohibited back-loaded annuities for charitable remainder annuity trusts, limited them for grantor retained annuity trusts, and allowed them for charitable lead annuity trusts; presumably this is because of policy differences that apply to the different types of trusts.

One of the most significant developments that has arisen from the Shark-Fin or back-loaded CLAT is that it opens the door to contributions of certain types of assets that in years past were not good candidates for CLATs. These types of assets are characterized by a lack of liquidity and often very low value at the time of contribution (for example, private equity invest-

[113] §170(f)(10)(A)(ii).
[114] §170(f)(10)(B).
[115] §170(f)(10)(H).
[116] §170(f)(10)(C) and (E).
[117] S. Rep. No. 120, 106th Cong., 1st Sess. 206–207.
[118] §2035(a)(2).
[119] §170(f)(10)(F).
[120] §170(f)(10)(F)(ii).

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ments or interests in FLPs holding commercial real property). Shark-Fin CLATs (or other back-loaded annuity CLATs) can provide significant cushion so that the charitable payments are matched to when liquidity (and higher value) is expected to occur. Equally as important, from an investment standpoint, the deferred charitable payments allow trustees of CLATs to more easily manage volatility in the portfolio, which hopefully will result in higher overall returns over the term of the CLAT.

Concerns about back-loaded CLATs on policy grounds are misplaced. If the §7520 rate accurately predicted the total return on investments, then a CLAT — regardless of the term — with a zero remainder would in fact produce zero for the non-charitable beneficiaries. To the extent that §7520 underestimates the actual total return on the CLAT investments, a remainder is created for those beneficiaries. The government could have imposed a floor on the §7520 rate or otherwise prohibited the use of extremely low rates such as those in effect now, and for the last several years. The government has chosen not to do so and, indeed, mandates use of the low rate. Why some ''remainders'' should be thought ''permissible'' and others ''abusive'' is unclear. Further, even a rate return of 1.8% may not be achieved in certain investment environments even over a long period of time.

Many grantors are troubled by a gift to charity that does not produce an income tax deduction as well as wealth transfer tax benefits. A non-grantor CLAT removes its earnings from the grantor's income tax return — in effect a 100% deduction for the grantor — and to the extent those earnings are paid to charity, the trust will receive an income tax deduction. A non-grantor Shark-Fin CLAT will not allow a full income tax deduction in the trust, because the trust will likely not have sufficient income in the year in which the large charitable payment is made. In order to achieve a full income tax deduction, a grantor CLAT may be used, but at the risk of a mismatch between the income tax rates in effect when the trust is created and those in effect when the annuity payments to charity are made, whether by selling assets or by using appreciated assets directly.

Because the value of the grantor's gift is determined using the §7520 rate in effect when the CLAT is created, doing so when the rate is low is more efficient than when it is high. As of this writing, the lowest the rate has ever been is 1.8% (Dec. 2010) 2.0% (Nov. 2010) which is also the current rate. Thus, creating CLATs now rather than waiting until the grantor dies is desirable.

From the point of view of a charity, a stream of payments from a CLAT, or a single payment in the future, has a present value that may be determined by reference to the expected earnings of the charity's endowment. Conceptually, to the charity, a dollar in a CLAT is worth only the dollar increased by the §7520 rate until the date the charity receives the payment but a dollar in the charity's endowment is worth the actual earnings of the endowment. If those actual earnings are likely to exceed the §7520 rate, the charity may be amenable to selling its future payment or stream of payments for a lump-sum. Such a transaction may be beneficial for the purchasers as well.

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APPENDIX

NOTES ON THE WEALTH FORECASTING SYSTEM

Capital Market Projections

	Median 30-Year Growth Rate	Mean Annual Return	Mean Annual Income	One-Year Volatility	30-Year Annual Equivalent Volatility
Short-Term Taxables	4.5%	4.8%	5.1%	1.0%	9.6%
Int.-Term Diversified Municipals	3.5	3.8	3.6	4.5	7.5
Int.-Term Taxables	4.5	4.8	5.7	4.8	8.7
US Value	9.5	11.0	3.8	21.8	14.7
US Growth	9.1	11.1	2.3	24.8	15.7
Developed International	9.8	12.1	3.6	26.3	16.9
Emerging Markets	7.9	11.9	3.0	35.9	25.6
Inflation	2.6	2.9	n/a	1.3	9.4

Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns.
Based on 10,000 simulated trials each consisting of 30-year periods.
Reflects Bernstein's estimates, and the capital market conditions of June 30, 2010.

1. Purpose and Description of Wealth Forecasting Analysis: Bernstein's Wealth Forecasting Analysis is designed to assist investors in making long-term investment decisions regarding their allocation of investments among categories of financial assets. Our new planning tool consists of a four-step process: (1) Client Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: Our proprietary model, which uses our research and historical data to create a vast range of market returns, takes into account the linkages within and among the capital markets, as well as their unpredictability; and finally (4) A Probability Distribution of Outcomes: Based on the assets invested pursuant to the stated asset allocation, 90% of the estimated ranges of returns and asset values the client could expect to experience are represented within the range established by the 5th and 95th percentiles on ''box and whiskers'' graphs. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Expected market returns on bonds are derived by taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results or the actual probability that these results will be realized.

2. Rebalancing: Another important planning assumption is how the asset allocation varies over time. Bernstein attempts to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, stocks, REITs and hedge funds over the period of the analysis. Where this is not sufficient, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio allocation will be maintained reasonably close to its target. In addition, in later years, there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his/her personal portfolio and entirely of stocks in his/her retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. Bernstein puts primary weight on maintaining the overall allocation near target, which may

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result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value

3. Modeled Asset Classes: The following assets or indexes were used in this analysis to represent the various model classes: U.S. value (S&P/Barra Value Index, 15% annual turnover), U.S. growth (S&P/Barra Growth Index, 15% annual turnover), developed international (MSCI EAFE Unhedged Index, 15% annual turnover) and emerging markets (MSCI Emerging Markets Index, 20% annual turnover).

4. Volatility: Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed on the Capital Markets Projections page at the beginning of this Appendix. In general, two-thirds of the returns will be within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will be between (8.9)% and 28.8%. With intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. Bernstein's forecast of volatility is based on historical data and incorporates Bernstein's judgment that the volatility of fixed income assets is different for different time periods.

5. Technical Assumptions: Bernstein's Wealth Forecasting System is based on a number of technical assumptions regarding the future behavior of financial markets. Bernstein's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs that summarize the current condition of the capital markets as of June 30, 2010. Therefore, the first 12-month period of simulated returns represents the period from June 30, 2010, through June 30, 2011, and not necessarily the calendar year of 2010. A description of these technical assumptions is available on request.

6. Tax Rates: The federal income tax rate represents Bernstein's estimate of either the top marginal tax bracket or an ''average'' rate calculated based upon the marginal-rate schedule. The federal capital gains tax rate is represented by the lesser of the top marginal income tax bracket or the current cap on capital gains for an individual or corporation, as applicable. Federal tax rates are blended with applicable state tax rates by including, among other things, federal deductions for state income and capital gains taxes. The state tax rate generally represents Bernstein's estimate of the top marginal rate, if applicable. The Wealth Forecasting System uses the following top marginal tax rates unless otherwise stated: In 2010, a federal income tax rate of 35% and a federal capital gains tax rate of 15%. For 2011 and beyond, the federal income tax rate becomes 39.6% and the federal capital gains tax rate becomes 20%.

7. Intentionally Defective Grantor Trusts (IDGTs): The intentionally defective grantor trust (IDGT) is modeled as an irrevocable trust whose assets are treated as the grantor's for income tax purposes, but not for gift or estate tax purposes. Some income- and transfer-tax consequences associated with transfers to and the operation of an IDGT remain uncertain, and the strategy may be subject to challenge by the IRS. Hence, this technique requires substantial guidance from tax and legal advisors. The grantor may give assets to the trust, which will require using gift tax exemptions or exclusions, or paying gift taxes. The IDGT is modeled with one or more current beneficiaries, and one or more remainder beneficiaries. Distributions to the current beneficiaries are not required, but the system permits the user to structure annual distributions in a number of different ways, including (1) an amount or a percentage of fiduciary accounting income (FAI) (which may be defined to include some or all realized capital gains); (2) FAI plus some principal, expressed either as a percentage of trust assets or as a dollar amount; (3) An annuity, or fixed dollar amount, which may be increased annually by inflation, or by a fixed percentage; (4) A unitrust, or annual payment of a percentage of trust assets, based on the trust's value at the beginning of the year, or average over multiple years; or (5) any combination of the above four payout methods. Because the IDGT is modeled as a grantor trust, the system calculates all taxes on income and realized capital gains that occur in the IDGT portfolio each year, based on the grantor's tax rates and other income, and pays them from the grantor's personal portfolio. The IDGT may continue for the duration of the analysis, or the trust assets may be distributed in cash or in kind at a specific point in time or periodically to (1) a nonmodeled recipient, (2) a taxable trust or (3) a taxable portfolio for someone other than the grantor. If applicable, an installment sale to an IDGT may be modeled as a user-entered initial seed gift followed by a sale of additional assets to the trust. The system will use one of two methods to repay the value of the sale assets plus interest (less any user-specified discount to the grantor): (1) user-defined payback schedule, or (2) annual interest-only payments at the applicable federal rate (AFR) appropriate for the month of sale and the term of the installment note, with a balloon payment of principal plus any unpaid interest at the end of the specified term.

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8. Grantor Retained Annuity Trusts: The grantor retained annuity trust (GRAT) is a wealth transfer vehicle which receives its initial funding from the grantor and transfers annuity payments to the grantor's personal portfolio each year. The annuity amounts, which are determined in advance, may be fixed (the same amount each year) or increasing (growing each year by no more than 20% of the previous year's amount). The annuity payment is made first from available cash, and then from other portfolio assets in kind. Because the GRAT is modeled as a grantor trust, the system calculates all taxes on income and realized capital gains that occur in the GRAT portfolio each year, based on the grantor's tax rates and other income, and pays them from the grantor's personal portfolio. When the GRAT term ends, the remainder, if any, may be transferred in cash or in kind (as the user specifies) to (1) a non-modeled recipient, (2) a continuing grantor trust or (3) a taxable trust. If the remainder is transferred in kind, the assets will have carryover basis.

9. Non-Grantor Charitable Lead Trusts: The charitable lead trust (CLT) is modeled as a portfolio which receives its initial funding from the grantor and transfers payments to one or more charitable recipients each year for a specified number of years. The annual payments may be a fixed-dollar amount (charitable lead annuity trust or CLAT) or a percentage of the trust's assets (charitable lead unitrust or CLUT). In the case of a CLAT, annuities may be fixed (the same amount each year), or variable (so long as the present value of the annuity is ascertainable at the time the trust is funded). The annual payment is made first from available cash and then from other trust assets in kind. The trust will pay income taxes on retained income and will receive a charitable income tax deduction for income paid to the charitable recipient(s). Realized capital gains may be treated in one of two ways, as directed: (1) taxed entirely to the trust, or (2) included in the payment to charity and, therefore, deducted from the trust's income, to the extent the payment exceeds traditional income. When the CLT term ends, the remainder, if any, may be transferred in kind to (1) a non-modeled recipient, (2) a taxable trust or (3) a beneficiary's portfolio. The transferred assets will have carryover basis.

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