

The Charitable Lead Annuity Trust Revisited

The planets are in perfect alignment in 2012 for the creation of a lifetime Charitable Lead Annuity Trust, commonly known as a “CLAT.”

In simple terms, the CLAT is a split-interest trust created during the donor’s lifetime. The lead interest, which may be for a term of up to 20 years, pays a designated charity or charities a fixed annuity amount; after the lead interest expires, the trust principal passes to beneficiaries of the donor’s choosing, typically family members, either outright or in further trust. If the rate of return on the trust property exceeds the Section 7520 rate (1.4% for February, 2012), and if the payout to charity is properly structured, the excess passes to the remainder beneficiaries transfer tax free. In addition, depending upon whether the trust is configured as a grantor or non-grantor trust, the donor may be entitled to a federal income tax deduction equal to the present value of the payout to charity. What makes this device so attractive now is the increase in the lifetime gift tax exemption from \$1 million to \$5 million wrought by TRA 2010 (See accompanying article), coupled with the current historically low interest rate environment.

A simple example will illustrate the operation of the CLAT. Suppose Donor transfers \$5 million of assets to a 20 year CLAT that pays an annuity equal to 3% of the initial value of the trust corpus to charity (\$150,000). At the end of the 20 year term, the remaining trust principal will pass to donor’s children. Assuming the Section 7520 rate in the year of creation is 1.4%, and further assuming the annual rate of return is 7%, if the donor dies with a \$5 million taxable estate (exclusive of the assets used to fund the CLAT) in a year when the Applicable Exclusion Amount is \$5 million and the top tax rate is 35% and the donor has made no previous taxable gifts, there will be no estate tax due! If no trust had been created, the estate tax due would be approximately \$6.8 million; the tax savings resulting from employment of the CLAT is equal to that amount and the consequent increase in the amount payable to the donor’s children is approximately \$5.5 million. As well, the donor will have conferred a benefit of \$3 million upon a charity of his choosing.

There is a variation on this theme, referred to as a “shark-fin CLAT,” that is funded with a life insurance policy on the donor’s life. The annuity payments to charity in all but the final year of the trust are kept to a minimum, which permits long-term buildup of the trust property. Then, in the trust’s final year when the donor dies, the policy pays the death benefit to the trust, whereupon the charity receives its pre-determined annuity amount from the policy proceeds and the donor’s family receives the rest of the proceeds. This can be a potent technique, but many commentators feel that it is too aggressive, and that the IRS ultimately will disapprove of it.

For those with a significant charitable inclination and substantial resources, the CLAT is an extremely powerful tool, especially in 2012, which is the final year of TRA 2010 and, perhaps, of the \$5 million gift tax exemption.