The Optimized CLAT: A Compelling Income Tax Deduction Vehicle Hiding In Plain Sight

In a year in which charities fear donations will be down, charitable lead annuity trusts (CLATs) encourage gifting to charities and provide generous wealth transfer benefits.

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What if tax advisors and investment professionals had a charitable income tax deduction vehicle that was created and funded to eliminate up to 30% of a client's taxable income? Many planners would be surprised to know that such a tool has actually been available since 1969 when the charitable lead annuity trust ("CLAT") was added to the Code.[1]

The CLAT is a notoriously underutilized vehicle. The IRS reports that only 5% of IRS Form 5227 charitable split-interest returns are filed by CLATs (versus 85-90% for charitable remainder trusts, or CRTs).[2] This should come as no surprise to planners – the CLAT has historically been implemented by the ultra-wealthy as an *estate and gift tax* tool. However, in this article, the authors will demonstrate that it is the CLAT's *income tax benefits* (which have largely gone overlooked by advisors) that can make the CLAT attractive to both the "working rich" and ultra-wealthy, alike.

First, the authors will unpack the key components of what they deem to be the "optimized" version of the CLAT (an irrevocable inter vivos grantor trust "super-CLAT" that includes features designed to minimize the income tax in the year of funding, leverage estate and gift tax exclusions, and maximize other economic benefits to the grantor's family, and possibly the grantor). Second, the authors will show how a high-income client might fund an Optimized CLAT (which possesses many attributes that are surprisingly similar to a qualified retirement plan) to reduce their taxable income by up to 30%. Of course, the Optimized CLAT can also be used to address a one-time income "spike" event (such as in the year of a business sale, stock option exercise, Roth conversion, or bonus payment). Finally, the authors will present a case study and financial projections demonstrating that the grantor's family wealth actually *increases* by more than three times by funding the Optimized CLAT (versus no CLAT, all assumptions equal) – a true "win-win" for family and philanthropy.

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Key Components of the Optimized CLAT

The primary benefits of an Optimized CLAT can be summarized as follows:

1. The grantor enjoys a potentially significant (and, in many cases, dollar-for-dollar) income tax deduction in the year of funding (limited to

30% of AGI without phase-outs);
2. The grantor can project 1-4x of the contribution amount to be returned to the grantor's family after a term of years (assuming reasonable 5-7% investment rates of return);
3. The CLAT assets should be immediately exempt from the federal estate tax (with zero use of the grantor's lifetime gift exclusion); and
4. The CLAT assets are protected from the grantor's creditors.[3]

To generate these benefits, the Optimized CLAT draws on a number of IRS-approved attributes combined to maximize the benefit to the grantor and the grantor's family to the greatest extent permitted by law. Specifically, the key features that make up the Optimized CLAT (versus a "plain vanilla" inter vivos CLAT) are that the Optimized CLAT (i) is intentionally designed as a grantor trust (to enjoy the upfront income tax deduction); (ii) is "zeroed-out" (to avoid using the grantor's gift tax exclusion, as well as minimize the funds committed to the CLAT to generate the desired deduction); and (iii) utilizes maximum IRS-approved deferral of charitable annuity payments over a 20-30 year charitable annuity term (to maximize the growth of the CLAT assets returned to the grantor or the grantor's family at the end of the charitable annuity term). Additionally, the Optimized CLAT should also be funded in a low interest rate environment (the applicable Section 7520 rate for August 2020 is 0.4%). Finally, given the potential for changed circumstances over the 20-30 year term, the Optimized CLAT should also include extensive Trust Protector limited power of appointment provisions (most importantly, the ability to change charities and appoint the remainder assets to members of the grantor's family, including perhaps the grantor).[4] Each of these individual attributes and features are described in more detail below.

Locking in all-time low interest rates to maximize benefits to grantor and family. A CLAT pays an initial annuity to charity and the remainder is paid to the grantor (or the grantor's family). Thus, in many ways, a GRAT and a CLAT are structurally similar. An annuity is paid to the grantor (in the case of a GRAT) or charity (in the case of a CLAT), and the remainder is paid to, or held for the benefit of, the grantor's family (or to, or held for the benefit of, either the grantor *or* the grantor's family, in the case of a CLAT).

The CLAT's income tax benefits (which have largely gone overlooked by advisors) can make the CLAT attractive to both the "working rich" and ultra-wealthy, alike.

With a grantor-style CLAT, the grantor enjoys an upfront income tax deduction equal to the present value of all charitable payments "pledged" from the CLAT during the lead interest, using the monthly interest rate under Section 7520 (the "7520 rate") (which is 120% of the mid-term AFR under Section 1274) as the discount rate (just as with the computation for a GRAT annuity stream).[5] The grantor may apply the 7520 rate in effect for (i) the month of the transfer, or (ii) for either of the two months preceding the transfer.

The 7520 rate for August 2020 is 0.4%, and has been in this range for several months. This current all-time low 7520 rate makes CLAT planning attractive because it reduces the aggregate amount of charitable annuity payments that must be made from the CLAT to charity during the annuity term (which are fixed at the outset, and not subject to interest rate changes). Thus, with the near-zero 7520 rate, the grantor of a CLAT can receive a near dollar-for-dollar deduction based on the promised annuity payments from the CLAT.

To put this in perspective, a zeroed-out 30-year Optimized CLAT funded in May 2020 (when the 7520 rate was 0.8%) with $1,000,000 requires only $1,230,000 to be paid to charity over the 30-year term. If the same Optimized CLAT had been funded in December 2018 (when the 7520 rate was 3.6%), charity would have had to receive $2,400,000 (leaving far less in the CLAT to be available for the grantor's family).

Importantly, the 7520 rate has been declining steadily and is expected to remain low in the near-future, particularly since the Federal Reserve Board dropped the overnight lending rate for banks to 0% on March 16, 2020 (this 0% rate has not been imposed since 2015). As interest rates rise (eventually), the CLAT may be less and less attractive (because a larger portion of the CLAT assets would be paid to charity, leaving less for the grantor). Because rates are currently low and can be locked in at the outset, clients are urged to act quickly, especially if asset values remain relatively depressed.

Deferring charitable annuity payments over 20-30 year term (without "shark fin risk"). The charitable payment schedule selected by the grantor will depend on the grantor's charitable intentions and desired timing of giving. However, considering the all-time low 7520 rate, a grantor seeking maximum economic return from a CLAT is incentivized to defer the charitable payments made from the CLAT as long as possible in order to maximize the growth of the CLAT assets (which could ultimately be available to the grantor or the grantor's family). Fortunately, the applicable safe harbor IRS Revenue Procedure[6] allows for near-absolute flexibility in structuring the term and charitable payments, with minimal restrictions.

First, there is no minimum or maximum limit on the length of a CLAT's charitable annuity term. In fact, the IRS has privately approved a CLAT that could last as long as 118 years.[7] Moreover, because the 7520 rate is fixed as of the month of funding the CLAT (or one of the two preceding months) *and* the Optimized CLAT should not result in estate inclusion if the grantor dies (unlike a GRAT), an extremely long CLAT charitable annuity term can, from an estate tax perspective, safely be used. (Note that the difficulty of overcoming the generation skipping transfer tax ("GSTT") challenges associated with the CLAT is explained below.)

Second, the timing of payments is flexible. The annuity simply must be (i) payable to one or more qualifying charities (including, potentially, a donor-advised fund created by the grantor); (ii) paid no less often than annually; and (iii) guaranteed in a determinable amount.[8]

Third, the amount of the payments is flexible. CLATs are not subject to any minimum or maximum payout requirements. The governing instrument must simply 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* (emphasis added).[9]

An Optimized CLAT backloads the charitable annuity payments over a long annuity period for two primary reasons:

- First, backloading allows the CLAT assets to grow and accumulate to a large amount before the charitable payments become substantial. Given that the 7520 rate is only 0.4% in August 2020, electing to backload is tantamount to deferring the payment of a low-interest loan; i.e., the longer that assets can be retained and invested in excess of the historically low 0.4% August 2020 7520 rate, the greater the value of the assets at term.
- Second, backloading allows for CLAT asset performance to make up for underperformance of assets in earlier years (due to an unexpected pullback in markets, for example). Stochastic Monte Carlo models generally indicate that, so long as a 20-plus year charitable annuity term is used, fixed and variable models tend to produce similar results (as a result of the smaller charitable payments in earlier years, which allow for assets to "bounce back" from negative asset performance in the earlier years).

In determining the extent of backloading, some commentators advocate for a "shark-fin" payment schedule (with nominal annual payments and a balloon payment at the end of the term). Despite apparent authorization in the safe harbor IRS Revenue Procedures, there is some question regarding whether the shark-fin CLAT would be respected by the IRS. To date, there has not yet been an approved shark-fin payment structure. On the other hand, the IRS has privately approved a CLAT having a very small initial charitable payment which increased in its amount by 20% per year (like a GRAT).[10] Thus, the Optimized CLAT is typically structured using a 20-30 year term with "maximum IRS-approved backloading" (i.e., a 20% step increase each year). Although not a true shark-fin, a 20-30 year charitable annuity term with IRS-approved backloading still results in extremely low charitable payments (such that approximately 60% of the total charitable payments are deferred until the last five years of the charitable annuity term).

Zeroing out the CLAT for gift tax purposes. The Optimized CLAT's charitable payment schedule is also structured so that the present value of all charitable payments equals approximately 100% of the contribution amount to "zero out" the

1 See Section 170(f)(2)(B).

2 https://www.irs.gov/statistics/soi-tax-stats-split-interest-trust-statistics.

3 The creditor protection element of the CLAT is determined by the state law under which the trust, trustee, beneficiary, and trust assets are located, among other factors. Important analysis must be conducted with legal counsel to determine the veracity of creditor protection elements.

4 The appointment back to the grantor may produce vulnerability to the grantor's creditors and in turn possible gift and estate tax issues. Locating the trust in a state with a domestic asset protection statute can be more protective. Fifteen states have adopted such statutes. Legal counsel should provide guidance on these issues and which states and statutes would be most protective and appropriate.

5 Reg. 1.170A-6(c)(3)(i).

6 Rev. Proc. 2007-45, 2007-29 IRB 89; Rev. Proc. 2007-46, 2007-29 IRB 102.

7 Ltr. Rul. 9801013 (Sept. 29, 1997).

8 Regs. 1.170A-6(c)(2)(i), 20.2055-2(e)(2)(vi), and 25.2522(c)-3(c)(2)(vi).

9 Rev. Proc. 2007-45, 2007-29 IRB 89.

CLAT (just like a GRAT). This offers two key advantages:

- First, the grantor of the Optimized CLAT enjoys a substantial (in many cases, a near dollar-for-dollar) income tax deduction,[11] thereby reducing the assets that the grantor must irrevocably commit to the CLAT's annuity term (during which time the funds cannot be accessed by the grantor).
- Second, a zeroed out CLAT should produce no gift tax consequences on the date of funding (similar to a GRAT). Since the charitable gift tax deduction equals 100% of the contribution amount, the value of the remainder for gift tax purposes is zero. Thus, regardless of whether the grantor retains a reversion or not (or initially retains a reversion interest that may be removed by an independent Trust Protector), there should be no taxable gift on the date of funding of the Optimized CLAT.[12]

Exemption from estate tax. For clients with large estates, the Optimized CLAT offers two primary estate tax benefits.

First, the grantor's payment of tax on "phantom income" earned by the CLAT during the charitable annuity period results in wealth transfer benefits. These benefits are identical to those associated with an irrevocable grantor trust, i.e. "income tax burn." (Virtually all of the CLAT articles that have been published in major journals over the years consider this feature as a drawback of the grantor CLAT. However, curiously, in the context of irrevocable grantor trusts, this feature is widely praised as a major benefit for achieving gift-tax-free wealth transfer.)

Second, the Optimized CLAT can be designed so that the contributed assets are *immediately* exempt from federal estate taxes. Unlike a GRAT, if the grantor dies at any time during the charitable annuity period (including *immediately* after funding the CLAT), the CLAT assets escape estate tax in the grantor's estate.[13] Moreover, the CLAT account can grow to an unlimited amount. When the assets are transferred to trusts for children or other family members at the end of the charitable annuity period, there are no gift or estate taxes paid on the transfer. Combined with the income tax benefits, the estate tax benefits of the CLAT greatly enhance the total economic benefits of the Optimized CLAT (as demonstrated in the case study below).

Changing remainder beneficiaries. Given the long-term nature of the Optimized CLAT, an independent Trust Protector (a person who is not "related or subordinate" to the grantor under Section 672(c)) should be conferred a lifetime limited power of appointment to redirect the distribution of the remainder interest among (i) a defined class of family members,[14] and (ii) qualified charities.[15] In the event that the grantor desires the CLAT assets to be removed from his gross estate, these powers may not be retained by the grantor,[16] but they may be retained by someone other than the grantor (including apparently the grantor's spouse).[17]

Given the long term of the Optimized CLAT, the Trust Protector's power to alter the distribution of the remainder interest through a limited power of appointment is important because it allows the Trust Protector to address changes in family circumstances that occur during the charitable annuity period, such as the death of a remainder beneficiary, a "home run" CLAT (which would result in "too much" wealth passing to, or in trust for the benefit of, children), or changes in the grantor's testamentary or charitable intentions.

In addition, the Trust Protector might also be conferred the ability to appoint the remainder assets back to the grantor.[18] For example, a grantor who does not have a gross estate that is expected to give rise to the payment of estate tax might be included in the class of appointees (along with the grantor's descendants and charities) to whom a non-adverse, independent Trust Protector could appoint the remainder interest through a well-crafted limited power

10 Ltr. Rul. 201216045 (April 20, 2012). See also Reg. 25.2702-3(b)(1) (20% step-increase permitted for GRAT).

11 The charitable deduction does not reduce AGI. Thus, the taxpayer may still incur more taxes as a result of AGI-linked phase-outs and limits. In most cases, the taxpayer's AGI will exceed the limitations, in which case the marginal effect is limited. Under the Tax Cut and Jobs Act, the Pease limitation after December 31, 2025 could limit the charitable deduction. State income taxes could further limit or eliminate the charitable deduction. Contrast this with retirement accounts (to which the CLAT is later compared), contributions to which are deductible above-the-line and recognized by all states.

12 See Note 5, *supra*.

13 At the point of the grantor's death, the trust becomes a non-grantor CLAT and is subject to recapture of the excess charitable deduction in the grantor's final tax return (Form 1040).

14 See Ltr. Rul. 9224029 (Mar. 13, 1992).

15 See Ltr. Rul. 199936031 (Sept. 10, 1999).

16 Sections 2036 and 2038.

17 See Ltr. Rul. 9224029 (Mar. 13, 1992).

18 See Note 5, *supra*.

19 See Sections 2036(a)(2) and 2038(a)(1).

20 See Reg. 25.2511-2(c).

21 See Ltr. Rul. 9532007 (May 4, 1995) (referring to Rev. Rul. 78-101); Ltr. Rul. 200043029 (July 26, 2000); Ltr. Rul. 9331015 (May 6, 1993).

22 Ltr. Rul. 199936031 (Sept. 10, 1999).

23 See Note 10, *supra*.

24 See Reg. 1.170A-6((c)(2)(i)(F); Section 4941. Additionally, because the Optimized CLAT is zeroed out, the additional Private Foundation rules related to excise taxes for excess business holdings and jeopardizing investments will apply. See Sections 4943, 4944. The trust document must prohibit the trustee from investing so as to become subject to these excise taxes.

25 This is the grantor trust power used in the safe harbor trust provisions issued by the IRS for CLTs. Rev. Proc. 2008-45, section 7 paragraph 11, 2008-30 IRB 224. Rev. Proc. 2007-45, section 7 paragraph 11, 2007-29 IRB 89.

of appointment. This way, the grantor retains the possibility of receiving back the transferred assets, subject to the Trust Protector's independent decision to appoint the remainder assets to the grantor, if deemed appropriate by the Trust Protector. Alternatively, if the taxable estate of the grantor is in excess of exclusions, the Trust Protector may decide that it is in the best interests of the family to instead appoint the remainder to the grantor's children (potentially free of gift and estate taxes) and/or charity.

Changing charitable beneficiaries. While the grantor of a Grantor CLAT may reserve the power to change the initial charity named in the Optimized CLAT without affecting the charitable income tax deduction under Section 170(a), the assets are included in the grantor's gross estate if the grantor dies during the charitable annuity terms and retains this power.[19] Moreover, this power to change the beneficiary also makes the gift to the CLAT incomplete under applicable gift tax statutes.[20]

Grantors who wish to retain some measure of control over the manner in which assets are invested after they are distributed out of the CLAT typically name, as the annuitant, a donor advised fund created by the grantor.

In addition, as discussed above, an independent Trust Protector could also be given a limited power of appointment to change the trust's charitable (and individual remainder) beneficiaries. This should not result in inclusion of the CLAT's assets in the grantor's estate[21] and reinforces the grantor trust status of the CLAT.[22]

The Optimized CLAT as a Synthetic Retirement Account

Up to this point, the authors have examined the structure and components of the Optimized CLAT. In this section, they demonstrate that the Optimized CLAT is, in many ways, quite similar to a qualified retirement account. Critically, an Optimized CLAT can be funded with a far greater amount (30% of the grantor's AGI, without phase-outs). This makes an Optimized CLAT the equivalent of a "super-charged" retirement account. A separate CLAT could be funded annually by high-income clients with charitable intent.

Similarities between a CLAT and a qualified retirement account. In many ways, the Optimized CLAT shares many of the same attributes as an IRA, 401(k) account, or profit-sharing plan. Consider the following:

- First, similar to a traditional IRA, immediately upon contributing funds into the CLAT account, the grantor enjoys a substantial (in many cases, a near dollar-for-dollar) charitable income tax deduction in that tax year.[23] Building on similar investment compounding principles that apply in the context of qualified retirement accounts, the upfront income tax deduction allows the grantor to enjoy immediate tax savings, which can be compounded over a long investment time horizon, in the year of contribution.
- Second, like most retirement vehicles, the assets are "locked up" for an extended period of time. (For this reason, the authors colloquially refer to the charitable annuity lead interest term as the CLAT's "Lock-Up Period" when discussing with clients.)

During the charitable annuity term, the CLAT is subject to many of the same prohibitions that apply to a private foundation – most importantly, the

Backloading allows the CLAT assets to grow and accumulate to a large amount before the charitable payments become substantial.

prohibition against self-dealing prevents the grantor (and the grantor's family) from engaging in certain activities during the charitable annuity term.[24] These restrictions are much like the restrictions applicable to a self-directed IRA, specifically: (i) the grantor may not withdraw or borrow from the CLAT; (ii) CLAT assets may not be used to purchase personal assets; and (iii) the grantor may not purchase assets from (or sell assets to) the CLAT, including swaps using a substitution power held by the grantor (although a swap power held by a non-disqualified person is apparently permitted).[25] Also, like a retirement account, when the charitable annuity term ends, the grantor can project to receive back one-to-four times the amount of the initial contribution, assuming 5-7% rates of investment return (although these returns are subsidized by income taxes borne by the grantor during the charitable annuity term as discussed below).[26]

- Third, through a properly-designed trust, the grantor may retain full control of investing the contributed assets. A grantor may serve as Trustee of a CLAT without adverse estate tax consequences so long as the grantor does not possess the power to change charities or allocate payments between more than one charity. Moreover, subject to certain limitations discussed below, the CLAT's governing document can be drafted to allow for a wide latitude of investment discretion, including (i) a waiver of the duty to diversify assets; (ii) waiver of the prudent investment rules; and (iii) authorization to hold concentrated positions. As alluded to, there are some investment limitations due to the private foundation rules that apply to CLATs; however, these investment restrictions are quite similar to a self-directed IRA. Most notably, (i) the excess business holdings rules prevent the grantor from investing CLAT funds in an active operating business in which the grantor and the grantor's family hold more than a 20% interest (or, in some cases, a 35% interest); (ii) the jeopardizing investment rules penalize grossly imprudent investment activity;[27] and (iii) as discussed above, the self-dealing rules prohibit transactions between the CLAT and the grantor and the grantor's family members.
- Fourth, akin to an ERISA plan (but without the commensurate regulations), the CLAT assets are protected from the claims of a grantor's creditors, bankruptcy, and lawsuits (and divorce, if single when the account is funded) as a result of the CLAT's spendthrift clause. This should be the case so long as the grantor does not retain a reversion interest (and perhaps even if the grantor is named in the class of appointees to whom a Trust Protector may appoint the remainder assets since the grantor is nothing more than a potential appointee and not a beneficiary).[28]

Key differences between a CLAT and qualified retirement account. Despite the similarities to a qualified retirement account described above, there are some critical advantages and some drawbacks:

- First, the CLAT is a charitable vehicle and must pay a qualified annuity to charitable organizations (typically, a donor advised fund created by the grantor).
- Second, the grantor may fund the CLAT with up to 30% of AGI (without phaseout) and fully enjoy the income tax deduction in the year of funding (so long as the CLAT's charitable beneficiaries are restricted to public charities).[29] Any excess contributions may carried over as for a period of up to five (5) years after the initial date of contribution.[30] This feature is the CLAT's most attractive benefit compared to traditional retirement savings vehicles: the CLAT can be funded with 30% of AGI, regardless of the amount of the grantor's taxable income. As discussed further below, this allows clients with a very large income realization to eliminate a significant amount of their taxable income on an annual basis.
- Third, the ongoing income tax treatment of the CLAT is the opposite of a traditional IRA, 401(k) account, or qualified profit-sharing plan. To enjoy a tax deduction when funded, the CLAT is required to be a grantor trust under Sections 671-677.[31] Thus, during the charitable annuity terms, the grantor must pay taxes on the CLAT's income using funds outside of the CLAT. On one hand, this is a perceived drawback of the CLAT compared to a qualified retirement account (where investments grow tax-free). On the other hand, the "tax burn" reduces the grantor's eventual estate tax liability. Note that if the grantor determines that pay-

26 Investment returns are not guaranteed and the recent market volatility is an example. The long-term recovery of the capital markets supports the likely appreciation of the CLAT's assets under the Optimized CLAT features of its long-term and back-loaded annuity payments.

27 See Section 4944.

28 Note that the protections offered by the CLAT must be evaluated under the state law governing the trust's administration and substantive interpretation.

29 The gift to the CLAT is a gift "for the use of" charity which limits the deduction to 30% of the taxpayer's AGI. See Section 170(b)(1)(B); Reg. 1.170A-8(a)(2). However, the deduction will be limited to 20% of fair market value if long-term capital gain property (other than qualified appreciated stock, although there are "securities" that do not qualify for this exception, such as bonds) is contributed to the CLAT and the charitable beneficiary is not limited to a public charity. See Section 170(b)(1)(D); Reg. 1.170A-8(c); Ltr. Rul. 20010036.

30 See Sections 170(d)(1)(b) and 170(d)(1)(D)(ii).

31 See Section 170(f)(2)(B).

32 Of course, the sale of any assets inside the grantor trust CLAT will cause the grantor to realize taxable ordinary income or capital gain.

33 See Section 170(f)(10).

34 See Ltr. Rul. 8034093 (additional contributions make it impossible for the guaranteed annuity interest to be determinable when the trust is created). Moreover, the safe harbor trust provisions for both inter vivos and testamentary CLATs prohibit additional contributions. See also, Rev. Proc. 2007-45, 2007-29 IRB 89; Rev. Proc. 2007-46, 2007-29 IRB 102.

ment of the income tax for the trust is no longer advantageous, the status of the trust as a grantor trust can be changed by the Trust Protector. Conversion to a non-grantor trust would immediately alter the income taxation of the CLAT (resulting in taxation as a complex trust subject to tax under Subchapter J of the Code). Keep in mind that converting to a non-grantor trust during the charitable annuity term may result in recapture income to the grantor (as further discussed below). Moreover, unlike a qualified retirement account (where withdrawals result in recognition of ordinary income), the grantor does not recognize taxable income when the assets remaining at the end of the CLAT term are distributed in-kind to, or held in further trust for the benefit of, the grantor or his or her family.[32] Income taxes can be minimized during the charitable annuity term by thoughtful investment in growth and non-dividend paying securities, REITs, and other tax-advantaged investments. In addition, the CLAT assets can be "wrapped" inside life insurance to avoid the generation of taxes owed by the grantor on phantom income (although life insurance held within a CLAT subjects the trust to additional requirements that generally necessitate the policy's being fully "paid-up" before transferring the policy to the CLAT).[33]

- Fourth, if the grantor dies during the charitable annuity term there is partial recapture of the income tax deduction taken by the grantor in the year of the CLAT's funding (discussed further below).

Year-to-year funding of optimized CLATs: "racking, stacking and rolling." As explained above, assuming the CLAT agreement restricts charitable payments to public charities (including a donor advised fund), the upfront income tax charitable deduction for the grantor is limited to 30% of the grantor's AGI for the tax year.

> **Assuming the CLAT agreement restricts charitable payments to public charities (including a donor advised fund), the upfront income tax charitable deduction for the grantor is limited to 30% of the grantor's AGI for the tax year.**

Although grantor CLATs have historically been utilized by clients on a "one-off" basis to generate a tax deduction in a spike year (e.g., a large bonus payment, stock option exercise, the sale of a business, or lottery winner), the ability to duplicate ("rack, stack and roll") the Optimized CLAT can amplify the tax benefits considerably. Although additional contributions to a CLAT are prohibited,[34] the initial Optimized CLAT agreement can easily be duplicated (and updated for the new 7520 rate) at any time to allow clients to enjoy ongoing income tax deductions.

Particularly, clients with large ordinary income (including executives, professionals, and athletes, as well as high-net-worth families with taxable portfolio income) may fund multiple Optimized CLATs on an ongoing, year-to-year basis (as a de facto retirement account) to eliminate up to 30% of their taxable income in each and every tax year. The CLAT is particularly attractive since the tax deduction effectively applies first to ordinary income (before capital gains income), so clients that have ordinary income and significant capital gains income (such as in the year of a business sale) can fund the CLAT to entirely eliminate their ordinary income. For clients with taxable estates, the CLAT's estate tax-exempt nature further amplify the benefits.

Moreover, if a client has a consistent annual income (such as an athlete with a guaranteed contract), an Optimized CLAT can be "super-funded" with an amount in excess of the 30% AGI limitation, with the excess deduction carried forward for up to five years. This way, the grantor can lock in the current low 7520 rate while enjoying tax deductions for the next five years.

Optimized CLAT as supplement to estate tax planning strategies. Finally, the Optimized CLAT is a supplement to (not a replacement for) all of the client's other estate tax minimization vehicles. While GRATs, GSTT-exempt trusts, qualified personal residence trusts (QPRTs), and the like are excellent for their wealth transfer benefits, those vehicles are usually grantor trusts that result in the generation of phantom income the taxes on which are due from the grantor. By funding the Optimized CLAT each year, the grantor can offset the taxes on phantom income using the income tax deduction generated by the Optimized CLAT. Also, like the other vehicles, the Optimized CLAT assets are also immediately exempted from estate taxes.

A Case Study Illustrating the Optimized CLAT

Joe is a 45-year-old attorney making $3,000,000 of ordinary income. His spouse, Sheila, is also a professional, and she earns $500,000. Joe and Sheila file a joint income tax return. Joe and Sheila give moderate amounts to charities from the donor advised fund they created in the past, but they plan to increase their charitable giving as they get older. Joe would like to (i) minimize income taxes; (ii) protect his assets from creditors; (iii) minimize U.S. estate taxes at his death; and (iv) create a vehicle for charitable giving during his lifetime.

To meet all of his objectives, Joe decides to fund a CLAT with $1,000,000 (approximately 30% of Joe and Sheila's current year AGI) before December 31. By funding the Optimized CLAT, Joe will enjoy a $1,000,000 income tax deduction when he files his Form 1040 next year. Joe's CPA estimates that the $1,000,000 deduction will provide Joe with a tax benefit of $370,000 (37% top income tax bracket). Thus, Joe feels that it only "costs" him $630,000 to fund the CLAT (he was going to pay another $370,000 in taxes if he did not fund the CLAT).

To claim the $1,000,000 deduction, the Code requires Joe to transfer assets valued at $1,000,000 into the trust. In light of the restrictions on withdrawals during the charitable annuity term, Joe really does not want to tie up his cash inside the irrevocable trust. Fortunately, Joe has a non-qualified brokerage account valued at $5,000,000 (which he considers "retirement funds" and "does not plan to touch for many years"). Joe transfers $1,000,000 of securities from the brokerage account into the newly-established CLAT. Just like the brokerage account, Joe retains title to the Optimized CLAT (as Investment Trustee of a well-drafted agreement).

As a result, Joe feels that he generated a $1,000,000 tax deduction by simply "moving funds from one account to another." Joe appreciates this will reduce his expected income tax bill due in April by $370,000. Plus, as an attorney with potential high personal liability, Joe is pleased that all of the CLAT assets will be immediately and permanently removed from the reach of his and his family's creditors (and potential divorcing spouse).[35]

In structuring the terms of the Optimized CLAT, Joe considers a number of factors.

- First, Joe wants to maximize what his family (and possibly he) will receive as a remainder from the CLAT. Therefore, he selects a 30-year charitable annuity term with "maximum IRS-approved back-loaded" payments in later years. Applying the low IRS-set 0.8% May 2020 7520 rate required just $1,229,155 to be paid to charities; moreover, approximately 65% of those payments will not occur until the last six years of the 30-year charitable annuity term. By delaying payments to charity for a very long time, Joe can maximize the amount of time that he can invest the CLAT assets in earlier years (since the remainder will ultimately be payable to his family at year 30). If there is a market correction or bear market in the earlier years (such as was experienced in March 2020), the relatively small charitable payments in the early years should allow enough time for the remaining CLAT assets to recover.
- Second, Joe is uncertain that he wants all of the charitable payments to go to the charity that he initial selects. He also wants to retain the ability to invest the charitable payments that are required to be paid out of the Optimized CLAT each year. To give him maximum flexibility, Joe names a donor advised fund he has previously created as the charitable recipient from the Optimized CLAT.
- Third, Joe also finds it difficult to decide where the CLAT assets should go when the 30-year charitable annuity term ends. Joe is just on the verge of having an estate on which estate taxes would be due and he is not quite sure what will happen with the estate tax exclusion given political uncertainties. Joe's attorney advises him that the balance in the Optimized CLAT remaining at the end of the charitable annuity term (the "remainder") could be transferred to (or in further trust for the benefit of) his children or other family members, free of gift and estate taxes. However, to address a worst-case scenario that Joe may need the funds back in 30 years, Joe's attorney also counsels him to include himself (and Sheila) in the class of appointees to whom the Trust Protector may appoint the remainder assets (Joe happens to reside in a state with a self-settled trust statute). Accordingly, to give his family flexibility over the CLAT, Joe names a friend (who is not a related or subordinate party under Section 672(c)) as Trust Protector and gives his friend a limited

35 See Note 3, *supra*.

36 Note that these are projections and cannot be relied upon as any assured result. Investment results will vary.

power of appointment to direct the remainder amount among Joe's children (either outright or in trust), Joe and Sheila, and qualified charities. Joe appreciates the Trust Protector feature because it gives him flexibility to either (i) receive back the assets (if the Trust Protector decides to appoint the assets to Joe), or (ii) appoint the assets to charity and/or a trust for Joe's children (including the possibility that Joe could be named as Trustee to allow for continued control, so long as Joe is limited to making distributions subject to an ascertainable standard to avoid estate inclusion under Section 2036(a)(1)).

These exhibits assume a minimum adjusted gross income for the grantor that would allow the full deduction to be claimed currently. Economic benefit assumes deduction is taken against income taxed at the top ordinary rate.

Exhibit 1 illustrates the value of the Optimized CLAT and charitable payments on a year-by-year basis (based on JPMorgan Private Bank long-term aggressive growth assumptions, including volatility, which results in 6.3% total rate of return).[36] By year 30, the charitable beneficiary (donor advised fund) will have received $1,229,155 in total payments; however, approximately $1,000,000 of the $1,229,155 is not paid until the final seven years of the charitable annuity term (due to maximum IRS-approved back-loading). This back-loading allows the Optimized CLAT to grow materially in the earlier years with minimal cash outlay to the donor advised fund. The total charitable payments of $1,229,155 are greater than the $1,000,000 deduction that Joe received this year. The present value of these payments is approx-

EXHIBIT 1
Value of the Optimized CLAT and Charitable Payments on a Year-by-Year Basis

Year	CLAT Net Asset Return	Annuity Payment to Charity (%)	Annuity Payment to Charity ($)	CLAT Value
0				$1,000,000
1	$57,132	0.104%	($1,040)	$1,056,092
2	$60,337	0.118%	($1,248)	$1,115,181
3	$63,713	0.134%	($1,498)	$1,177,396
4	$67,267	0.153%	($1,797)	$1,242,866
5	$71,008	0.174%	($2,157)	$1,311,717
6	$74,941	0.197%	($2,588)	$1,384,070
7	$79,074	0.224%	($3,105)	$1,460,039
8	$83,416	0.255%	($3,727)	$1,539,728
9	$87,968	0.290%	($4,472)	$1,623,224
10	$92,738	0.331%	($5,366)	$1,710,596
11	$97,729	0.376%	($6,439)	$1,801,886
12	$102,945	0.429%	($7,727)	$1,897,104
13	$108,386	0.489%	($9,273)	$1,996,217
14	$114,048	0.557%	($11,127)	$2,099,138
15	$119,928	0.636%	($13,353)	$2,205,713
16	$126,017	0.726%	($16,023)	$2,315,707
17	$132,301	0.830%	($19,228)	$2,428,780
18	$138,761	0.950%	($23,074)	$2,544,467
19	$145,371	1.088%	($27,688)	$2,662,150
20	$152,094	1.248%	($33,226)	$2,781,018
21	$158,885	1.434%	($39,871)	$2,900,032
22	$165,685	1.650%	($47,845)	$3,017,872
23	$172,416	1.902%	($57,414)	$3,132,874
24	$178,988	2.199%	($68,897)	$3,242,965
25	$185,277	2.549%	($82,677)	$3,345,565
26	$191,139	2.965%	($99,212)	$3,437,492
27	$196,391	3.463%	($119,054)	$3,514,829
28	$200,809	4.065%	($142,865)	$3,572,773
29	$204,119	4.798%	($171,438)	$3,605,454
30	$205,987	5.706%	($205,726)	$3,605,715
Total to charity (nominal)			**$1,229,155**	
Net to beneficiaries				**$3,605,715**

EXHIBIT 2
Scenarios 1 and 2: Holding the Assets vs. Using a CLAT

Scenario 1: Hold Assets	
	Grantor
Value of assets	$ 1,000,000
Ordinary income tax	(370,000)
Gift tax	-
Value at end of Year 30	2,386,055
Estate tax	(954,422)
Cost of trust income taxes**	-
Capital gains tax due on sale	-
Net wealth to family	1,431,633
Wealth to charity	-

Scenario 2: Use a CLAT			
	CLAT	Grantor	Charity
Value of assets	$ 1,000,000	$ -	$ -
Ordinary income tax	-	-	-
Gift tax	-	-	-
Value at end of Year 30	3,605,715[1]	-	1,689,403
Estate tax	-	-	-
Cost of trust income taxes**	-	(839,418)	-
Capital gains tax due on sale	-	-	-
Net wealth to family	3,605,715	(839,418)	-
Wealth to charity	-	-	1,689,403
[1] Assets held in trust do not receive a step-up in basis at death.			
Total wealth to beneficiaries	$4,455,700		
Value added by CLAT	$3,024,067		

** Opportunity cost to the grantor of paying trust income taxes; shown net of estate taxes because assets are not in the grantor's estate.

imately equal to the $1,000,000 funding amount (since the Optimized CLAT is zeroed out).

In year 30, Joe's family receives more than 3.5x his contribution amount ($3,605,715) as the remainder (however, Joe has paid $803,684 of income tax on the CLAT's realized income and therefore the net benefit must be reduced by the income taxes paid, as considered below). The continuing trust may be structured so that Joe is the Trustee, allowing Joe to continue to manage the remainder assets until his death (with due regard to Sections 2036(a)(1) and 2041). If Joe needs access to the funds inside his children's trust, Joe (as grantor) could borrow from the trust assets (so long as Joe pays adequate interest). This way, Joe can indirectly enjoy access to the remainder during his lifetime, without causing inclusion of the trust assets in his taxable estate at his death.

Exhibit 2 provides a comparison of the results at Year 30 if Joe (i) does not fund the CLAT (i.e. pays the $370,000 of income tax on $1,000,000 ordinary income and invests the after-tax proceeds for 30 years), or (ii) funds the CLAT with $1,000,000 (and claims a $1,000,000 charitable income tax deduction) and gives the remainder to his children (assuming 6.3% total rate of return).[37]

As illustrated in Exhibit 2, Joe's heirs receive approximately $1,334,664 more (after giving $1,689,403 to charity) than if Joe had given nothing to charity. Thus, Joe's heirs receive nearly double ($1,431,633 vs. $2,766,297) by funding the CLAT, net of income taxes and charitable gifts.

37 Cost of trust income taxes to grantor is affected for 40% estate tax savings. Moreover, all values indicated represent the future value at Year 30.

38 Reg. 1.170A-6(c)(4).

39 See Section 691(c).

However, Scenario 1 in Exhibit 2 does not consider the charitable giving that Joe intends to otherwise make over the next 30 years. Let's assume that Joe is planning on making the same charitable gifts that would occur with the CLAT (*assuming this would occur in the same amount and on the same schedule for comparison sake*) regardless of whether Joe funds the CLAT or not. In such case, Joe's heirs would only receive $859,799 in year 30 if Joe does not fund the CLAT, as shown in Exhibit 3. As demonstrated in the exhibits, the amount transferring to Joe's heirs is more than triple what they would receive if Joe does not fund the CLAT, all things equal ($859,799 vs. $2,766,297).

EXHIBIT 3
Scenario 3: Invest Assets & Make Annual Gifts to Charity

Scenario 3: Invest Assets & Make Annual Gifts to Charity		
	Grantor	Charity
Value of assets	$ 1,000,000	$ -
Ordinary Income tax	(370,000)	-
Value at end of Year 30	1,432,998	1,689,403
Estate tax	(573,199)	-
Net wealth to family	859,799	-
Wealth to charity	-	1,689,403

Prior to Joe's implementation of the Optimized CLAT strategy, Joe's advisor cautions him that (i) he and his family cannot access the CLAT assets until the charitable annuity term ends in year 30, and (ii) between now and year 30, Joe will be responsible annually for paying taxes on the CLAT's income. Joe accepts paying the trust's income taxes because (i) Joe would have paid the ordinary and capital gains income taxes anyway (albeit less income taxes) had he retained the $1,000,000 that he contributed to the Optimized CLAT (and not enjoyed the $1,000,000 reduction in his taxable income); (ii) Joe intends to invest in high yielding investments such as REITs (which pass through depreciation deductions) and growth equities that pay no dividends (thus reducing his "phantom income" tax bill); and (iii) to the extent that he does pay tax, Joe's income tax payments ultimately reduce his U.S. estate tax liability at his death.

Joe may duplicate this strategy each successive tax year (so long as Joe is willing to continue pledging an additional $1,000,000 each year). If his annual income is steady, he can choose to "superfund" this year's CLAT with more than $1,000,000 to lock in the low 7520 rate, while carrying forward the deduction amount exceeding 30% AGI for up to five years.

Considerations and Drawbacks

Partial income tax recapture if grantor dies within charitable annuity term. If the grantor dies before the end of the charitable annuity term, the grantor's estate is required to recognize recapture income equal to a fraction of the upfront income tax deduction. Curiously, there is uncertainty regarding the calculation of the recapture income. On one hand, Section 170(f)(2)(B) provides that the grantor shall be considered as having received an amount of income equal to (i) the tax deduction that the grantor received when the CLAT was funded, reduced by (ii) the discounted value (determined as of the date of creation of the CLAT using the 7520 rate in effect at that time) of all amounts of income earned by the CLAT and taxable to the grantor before death. On the other hand, the Regulations provide that the amount of reduction shall be the discounted value of all charitable annuity amounts that were paid before death.[38]

Obviously, the two approaches lead to vastly different calculations of the recapture amount. With respect to the Optimized CLAT

By funding the Optimized CLAT each year, the grantor can offset the taxes on phantom income using the income tax deduction generated by the Optimized CLAT. And, like the other vehicles, the Optimized CLAT assets are also immediately exempted from estate taxes.

(where charitable payments are backloaded), the Internal Revenue Code approach should generally produce a far more attractive recapture result (because phantom income would be recognized much earlier in the charitable annuity term – and in a larger amount – compared to the charitable annuity payments paid from the CLAT, which would be minimal until the second half of the charitable annuity term).

Regardless of the calculated amount, it is important to understand that the recapture risk is mitigated by a number of offsetting factors:

- First, this risk can easily be hedged by purchasing inexpensive term life insurance (or retaining other liquid assets) owned outside the CLAT.
- Second, even with recapture, the grantor will have enjoyed the compounding on the upfront tax savings from the date of funding to the date of death.
- Third, recapture income is included in the estate of the grantor; however, it is income in respect of a decedent and therefore deductible against the grantor's estate's income tax under Subchapter J of the Code.[39]
- Fourth, the assets should be exempt from estate taxes and result in transfer-tax-free wealth transfer of the trust assets to heirs. On the other hand, if the grantor retained the assets, they will be included in the grantor's taxable estate under Section 2033 and receive a stepped-up income tax basis under Section 1014(a).
- Fifth, after the grantor's death, the CLAT converts to a "non-grantor CLAT" and will thereby be entitled to claim charitable income tax deductions against its annual income under Section 642(c) (although the non-grantor CLAT would become subject to the unrelated business taxable income rules).[40]

[40] See Section 512(b). UBTI does not generally apply investment income such as dividends, rents, interest, annuities, royalties, and other amounts received in consideration of loans.

[41] See Section 2642(e).

[42] See Reg. 26.2642-3. With an Optimized CLAT, the GST considerations are deemphasized. If GSTT exemption is allocated to the CLAT, other planning techniques are available such as distributions to non-skip persons to avoid taxable distributions, and qualified severance of the trust into exempt and non-exempt trusts. See Reg. 26.2642-6; see also Reg. 26.2612-1(b) (to avoid taxable terminations).

[43] See Ltr. Rul. 200107015 (Feb. 16, 2001).

[44] Ltr. Rul. 201633021 (Aug. 12, 2016) described the sale of a non-grantor to a grantor trust that it formed. Self-dealing issues should also be considered in any such sale.

CLAT not ideal for the use of the GSTT exclusion. Some clients have wealth transfer objectives that extend to future generations. However, CLATs are rarely used for GSTT planning because, as explained below, (i) the GSTT exclusion cannot be leveraged, and (ii) even if GSTT exclusion is allocated to the CLAT, it is virtually certain that the grantor will either over-allocate or under-allocate GSTT exclusion at the time of creation. The reason is that the mechanics of applying GSTT exclusion to a CLAT involves great complexity. Briefly, to the extent that GSTT exclusion is allocated at the time of transfer to the CLAT, the coverage of that exclusion will "grow" at the rate of the 7520 rate in effect at the time of the CLAT funding.[41] In other words, the inclusion ratio of the CLAT is determined based on the value of the GSTT exclusion allocated, increased by the 7520 rate, compounded annually, through the end of the charitable annuity term. Because the August 2020 7520 rate is a low 0.4% (and virtually all grantors are funding the CLAT with the belief that the trust's total return will be higher than that rate), the allocation of GSTT exclusion to a CLAT would almost certainly be a waste.

Assuming no GSTT exclusion is allocated to the CLAT at the outset, it is recommended that (i) an independent Trust Protector possess a limited power of appointment to redirect the remainder interest to address the tax consequences caused by a remainder beneficiary's death during the extended charitable annuity term (which could otherwise result in a GSTT taxable event at the end of the charitable annuity term), and (ii) remainder beneficiaries also possess a testamentary general power of appointment in favor of creditors of their estate with respect to their remainder interest (although the Trust Protector's power to divest each remainder beneficiary's interest should negate the value of a predeceasing remainder beneficiary's interest for estate tax calculation purposes). Finally, the grantor may also delay allocation of GSTT exemption until the end of the lead term.[42]

Another potential planning technique is that the CLAT's remainder interest might be sold to a *different* GSTT-exempt irrevocable grantor trust created by the grantor for the benefit of grandchildren and more remote descendants. Due to of the advantage of a zeroed-out Optimized CLAT, the remainder to be sold could be valued at zero or near zero. The appreciation in the remainder (to the extent that the growth in the Optimized CLAT exceeds the 7520 rate) would then benefit the new GSTT-exempt grantor trust beneficiaries (i.e. the grantor's grandchildren). Thus, assuming the second trust was allocated GSTT exemption, the CLAT's remainder could itself be part of a family intergenerational legacy. However, it is possible that the IRS could successfully challenge this transaction on the basis of a step transaction.[43] Another solution may be that assets of the CLAT could be sold by the Trustee of the CLAT to a different GSTT-exempt grantor trust.[44]

Certainly, the long-term element of the Optimized CLAT necessitates a view toward GSTT planning. A discussion of the technical issues and risks associated with these transactions is beyond the scope of this article, but should be undertaken with legal counsel.

Conclusion

CLATs offer clients the chance to maximize the benefits of their charitable giving, enjoy the opportunity to make a difference to their community, and at the same time reap considerable financial rewards accruing to the benefit of themselves, or to beneficiaries of their legacy. By leveraging the current all-time low 7520 rate and using the Optimized CLAT, charitably-inclined clients now have a unique opportunity to eliminate annual income taxes, provide for charity, and transfer enormous wealth, free of gift and estate taxes (and without any use of their lifetime exclusions). When the tax and economic benefits are considered together, the

Optimized CLAT has the power to outperform nearly all other traditional investment vehicles.

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