

Cannon Insights

Planning Ideas—CLATS Couldn't be Better

With interest rates at historic lows, it may be an opportune time for your clients to take advantage of a Charitable Lead Annuity Trust.

How it Works

A CLAT is a charitable trust under which a public charity receives a fixed annuity interest for a period measured by a term of years or a life or lives. Following expiration of the charity's interest, the non-charitable beneficiaries, most often the donor's heirs, receive the trust property.

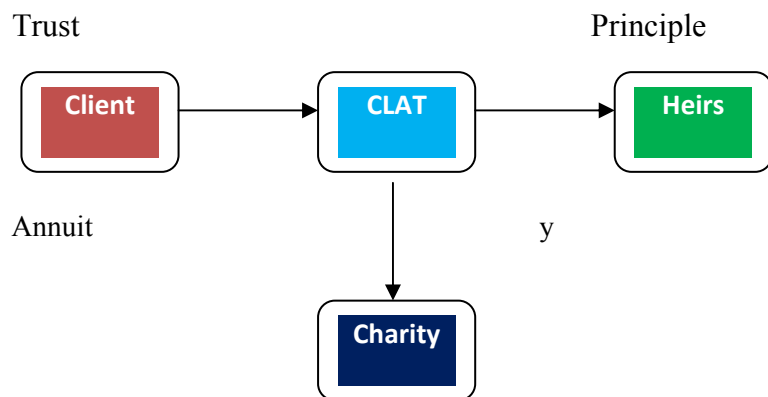
The mechanics of a CLAT are illustrated in the following example and diagram.

Example 1

Dave W. owns commercial property valued at \$10 million. The property generates \$1 million in rents annually. David has sufficient income from other sources to meet the needs of himself and his wife. He would like to transfer the commercial property to his two adult children outright, but is wary of gift and estate taxes. Furthermore, Dave wishes to benefit his favorite charity, a nationally known organization dedicated to the prevention and treatment of cancer. He'd prefer to donate to the charity during his lifetime, so that he can see the impact of his contribution.

Dave's financial advisor, Charlene, recommends a CLAT. Under the terms of the CLAT, the charity receives 10% of the initial value of the gift (\$10 million) semi-annually for 15 years. Assuming an Applicable Federal Rate of 7%, the value of the charitable interest is approximately \$9,265,000. The value of the remainder interest to children is only \$735,000. However, if the underlying property has appreciated to \$20,000,000 over the 15 year term of the trust, Dave will have passed over \$19 million outside of the transfer tax system to children.

Figure 1



The CLAT is an especially effective way for a donor to transfer appreciating property such as a closely-held business interest or commercial real estate, to his or her heirs at a discounted transfer tax cost. The value of the gift to heirs is the current value of the property less the value of the charity’s interest. Appreciation over and above the annuity payments made to charity pass to the family free of federal transfer tax.

Federal Income Tax Considerations

If the trust is structured as a grantor trust, the grantor is taxed on the income each year, but receives an income tax deduction in the year of the gift equal to the value of the charitable interest. If the trust is not structured as a grantor trust, the donor is not entitled to the income tax deduction.

Whether or not to structure the trust as a grantor trust depends on several factors:

- Limits on charitable contribution deduction limits—Charitable contributions to a CLAT are considered “for the use of charity” rather than “to” charity. Consequently, the deduction limit in the year of the gift is 30% (or 20% in the case of appreciated property), rather than the usual 50%. Although amounts not deductible in the year of the transfer may be carried over to future years, the amount of a donor’s income in the future may not sustain the deductions.
- Taxability on trust income—The donor is taxed on trust income for the duration of the trust, not just the first year when the charitable deduction is available to offset trust income.

Consequently, most practitioners agree, grantor CLATs are most appropriate for donors whose income in the year of the gift is expected to significantly exceed anticipated income in future years.

Federal Gift Tax Considerations

Regardless of whether the CLAT is a grantor trust for income tax purposes, the value of the charitable interest qualifies for the gift tax charitable deduction. Furthermore, the gift of the remainder interest is the value of the entire gift, less the charitable interest, rather than the entire value of the property. The gift of the remainder interest **does not** qualify for the gift tax annual exclusion, because it is a gift of future interest. However, any unused gift tax exclusion equivalent is available to shelter any gift tax payable. The amount of the gift tax exclusion equivalent in 2009 is \$1 million per donor.

Federal Estate Tax Considerations

No portion of the transferred property including future appreciation is included in the donor's estate for federal estate tax purposes.

Federal Generation Skipping Transfer Tax Considerations

In general, a CLAT is not recommended for transferring property to heirs beyond the donor's children's generation. This is because the GSTT exemption is allocated not against the initial value of the remainder interest at the time of the gift, but rather against the appreciated value of the trust property upon termination of the trust. The current (2009) GSTT is \$3.5 million per donor.

Financial Considerations

As the AFR declines, the value of the gift to charity increases and the value of the remainder interest decreases. This is because with a lower AFR it is assumed that a larger amount of property is required to generate the payout to the charity. However, if the income and appreciation on the transferred property exceeds the AFR, the non-charitable beneficiaries win. The income and appreciation over and above that necessary to make the required payout passes transfer tax free to the heirs.

Figure 2 illustrates the benefit of a lower AFR rate. The value of the transferred property is assumed to be \$1 million, the term 20 years, and the payout rate 5%.

Figure 2

AFR	Value of Remainder Interest	Value of Charitable Interest
11.2% \$606,990		\$393,010
3.6% \$296,770		\$703,230

Returning to the earlier example involving Dave W., if the current AFR (June 2009) of 2.8% were used, the value of Dave's current gift to his children is effectively reduced to zero. At a 7% AFR, the gift to heirs was \$735,000. Assuming a 45% gift tax rate, federal gift taxes saved, due to the lower AFR, equal \$330,750.

Bottom Line

The more services you provide to your clients, the more loyal they are to you and the more insulated they are from your competitors.

Cannon's Certified Wealth Strategist® (CWS) coursework contains ideas on how to gain insight on your clients' charitable goals. The CWS® coursework also contains extensive training on the use of charitable trusts to benefit your clients and the charities they value.

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