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The Super Charitable Lead Annuity Trust
Double Your Client's Tax Savings

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For many years, the Charitable Lead Trust, and, more specifically, the Charitable Lead Annuity Trust (CLAT) has been an essential tool in both charitable and wealth-transfer planning for the affluent. In the traditional sense, a CLAT has been set up either during the donor's lifetime (inter vivos CLAT) or by bequest at the donor's death (testamentary CLAT).

Because the ultimate remainder beneficiary does not have to be a qualified charity, CLATs, unlike Charitable Remainder Trusts (CRTs), are not income tax exempt trusts. In any given year, any of a CLAT's realized income that is not distributed to a qualified charity will be taxable income to the trust. Unlike individuals, however, a CLAT can deduct 100% of charitable contributions each year. For a trustmaker to receive an up-front *income* tax deduction for creating a CLAT, it must be considered a grantor trust.

While it may sound nice to receive an income tax deduction for creating a grantor CLAT, the trust's income would be subsequently taxed to the trustmaker for the duration of the CLAT. Further, because the income tax deduction was taken up-front, no annual deduction would be granted for the ongoing charitable annuity payments. Also, a typical grantor CLAT would revert back into the trustmaker's taxable estate if the trustmaker died during the term of such a CLAT. Last, CLATs are subject to private foundation Excise Tax rules. With the above complications, most trustmakers opt to establish non-grantor, non-reversionary CLATs. This type of CLAT only generates up-front gift or estate tax deductions but once created the trustmaker is no longer liable for the trust's income or excise tax liabilities.

Regardless of the income tax consequences, CLATs are powerful estate and charitable planning tools. However, what if your client could create a CLAT that would generate both gift tax deductions *and* income tax deductions? What if your client could accomplish this without risking reversion of trust principal if he or she died during the CLAT's term? What if this client didn't have to pay income taxes on the trust's ongoing, charitable disbursements? While it's not faster than a speeding bullet, the Super CLAT achieves *all* the above benefits!

Simply put, a Super CLAT generates an up-front income tax deduction[i]. It also generates an up-front gift tax deduction. It's annual charitable annuity payments are carefully constructed so that no cash flow is considered taxable income back to the trustmaker. It does not revert back into the trustmaker's taxable estate if the trustmaker dies during the Super CLAT's term. It distributes trust principal income, gift, and estate tax-free to trust beneficiaries upon its termination. Here's how it works:

Step One

Depending on state laws, the client creates either a Family Limited Partnership (FLP) or a Limited Liability Company (LLC) to maintain the efficient central management of investments even if many parties may eventually hold an interest in the FLP or LLC. For this article, assume the client uses an LLC with 1% voting shares (A shares) and 99% non-voting shares (B shares). The B shares are hindered with significant constraints that may reduce their marketability. The client funds this LLC with liquid investment assets with a high income tax basis. The manager of the LLC, the A shareholder, invests the LLC's assets in a municipal bond portfolio. Also, the manager acquires a Private Placement Life Insurance (PPLI) policy on the client (or the client and his or her spouse) by selling municipal bonds and/or using municipal bond yields. These premiums should continue for at least five years. The Private Placement Life Insurance policy's investment fund should go into a diversified, blue chip stock portfolio.

Step Two

To achieve the "double tax bonus," the trust is established with an intentional defect, such as the right for a "non adverse party" to substitute trust principal for assets of equal value. Such a defect renders the trust "invisible" for income tax purposes; meaning that the trustmaker is taxed on the Super CLAT's cash flows as if the trust did not exist.[ii] As long as the trustmaker does not retain any rights that would otherwise cause the gift to be considered incomplete for transfer tax purposes, the taxable gift to the trust beneficiaries becomes complete when the trust is established and funded. Further, assuming the trustmaker does not retain any estate tax interests or control, the trust principal is not included in the trustmaker's estate regardless of the time of death.

Step Three

After obtaining a detailed, independent appraisal of the LLC A & B share fair market values, the LLC A shareholder agrees to contribute all LLC B shares (99% of the LLC's shares) to the Super CLAT[iii]. The annuity payment and the length of the Super CLAT's term can be structured so that the charitable income benefit is valued at virtually 100% of the trust's principal. This structure will leave virtually no remainder value for transfer tax purposes and therefore eliminate gift taxes. At this point, the trustmaker would receive both an income tax deduction[i] and a gift tax deduction equal to the charitable income benefit.

Step Four

To meet the annual charitable annuity payment obligations necessitated by the Super CLAT, the A shareholder would distribute a combination of municipal bond income and proceeds from the sale of high basis municipal bonds over the first half of the Super CLAT's term (i.e. first 5 years of a 10 year Super CLAT). With proper management, all of these distributions could be exempt from Federal income taxes. At the midpoint of the Super CLAT term, the municipal bond portfolio will be exhausted leaving only the Private Placement Life Insurance contract as the sole asset of the LLC. To continue to meet charitable annuity obligations over the remainder of the Super CLAT term, the A shareholder will take annual policy loans out from the Private Placement Life Insurance policy's investment account. Since these distributions are considered loans and not income for federal income tax purposes, these too should avoid taxation.

Step Five

At the end of the Super CLAT's term, the LLC B shares would be distributed to the trust beneficiaries. Again, at this time the LLC's only asset would be the PPLI policy. As long as interest on the cumulative policy loans is paid annually, no income taxes would be recognized on these prior withdrawals. As a life insurance contract, the annual returns earned by the policy's investment fund would not be taxable to the LLC or its shareholders as long as these returns remained inside the contract. The A shareholder would continue to control all LLC investment decisions including distributions, loans, policy termination, additional premium payments, etc. even though 99% of the LLC's assets have been transferred to the trust beneficiaries. Viola! That's the essence of the Super CLAT!

The Secret of "Super"

While more complicated, the use of a grantor trust structure to receive an income tax deduction in addition to a gift tax deduction certainly is not new. As mentioned earlier, one drawback to this type of CLAT is that the trustmaker's death during the CLAT term would cause the trust principal to revert back into the trustmaker's taxable estate. To keep the trust principal from reverting back into the trustmaker's estate, the popular "defective" technique has now been successfully applied.[iv] Another shortcoming to the traditional approach is the annual income tax liability the trustmaker would have to bear after he or she received the up-front income tax deduction. The most obvious solution to the income tax dilemma has traditionally been to invest the CLAT exclusively in municipal bonds. Municipal bonds, however, produce very low yields. The term of a CLAT invested solely in municipals would have to be very, very long in order to achieve a virtual 100% income and gift tax deduction.

While the Super CLAT includes municipal bonds as a key ingredient to its strategy, it gets its true leverage from two other techniques. First, because the Super CLAT only receives severely restricted B shares, the fair market value of these shares might be reduced. For example, a 30% reduction in value would make a transfer of $1,000,000 in municipal bonds to a Super CLAT worth only $700,000 in B shares. The bonds would still pay out the same amount of interest (say 5% or $50,000 of the full bond value) per year. Based on the April, 2001 Section 7520 federal discount rate of 6.0%, a grantor CLAT valued at $1,000,000 paying out $50,000 annually would generate a 68.8% charitable income and gift tax deduction over 30 years. A grantor CLAT worth $700,000 with the same $50,000 annual payout would generate a 98.3% charitable income and gift tax deduction over this same time period!

If the Super CLAT's B shares have depressed fair market values due to their restraints then the trustmaker enjoys added leverage to maximize the percentage of the charitable deductions!

The second leveraging technique employed in the Super CLAT involves the use of the Private Placement Life Insurance. As indicated earlier, the Super CLAT strategy works best if the charitable distributions are not considered taxable income to the client. Municipal bonds are one way to achieve income tax-free distributions but their yields are very low. Conversely, blue chip equity funds have historically produced much higher annual rates of return when compared to municipals but these distributions would generally be taxable. However, using Private Placement Life Insurance allows the LLC (and subsequently, the Super CLAT) to invest in a potentially higher yielding equity portfolio and still pull out the needed charitable annuity distributions on an income tax-free basis when these distributions are taken in the form of policy loans. Plus, the equity portfolio inside the PPLI will grow income tax-deferred, further leveraging the yield.

Icing on the Cake

While the benefits of a Super CLAT described above should seem powerful enough, a recent Private Letter Ruling (PLR) opens the possibility of yet another powerful bonus to this technique. In PLR 9952093, an inter vivos CLAT was created in 1993 by the trustmaker solely benefiting a private foundation, funded with shares of stock in a closely held, private bank holding company. The CLAT was to continue in existence for 20 years and pay the private foundation at the end of each year a guaranteed 5% annuity payment. If the bank holding company stock was worth $1,000,000, for example, the CLAT would have owed the private foundation a total of $1,000,000 over 20 years. Following this example, seven years into the CLAT term would have left an outstanding obligation to the private foundation of $650,000. At the end of the 20-year term, the CLAT was to distribute the remainder interest to the trustmaker's four children. However, the bank holding company was acquired by a larger publicly traded company. The CLAT's stock soared leaving the trustee with excess dividends and surplus principal. The trustmaker of the CLAT, the CLAT trustee, the private foundation, and the remainder beneficiaries all wanted to pay the remaining charitable annuity obligation (again, following the above example, $650,000) immediately and subsequently terminate the CLAT. All parties were willing to make this payment without applying present value discounts. The IRS held that the CLAT could make such a payment and then distribute the remaining principal to the trustmaker's beneficiaries without penalties!

In the Super CLAT scenario, what if the trustmaker, as the person insured by the Private Placement Life Insurance policy, died while the Super CLAT was in mid term? The trustee would receive the Super CLAT's share of the PPLI death benefit. Typically, this benefit could far exceed the original contribution to the trust. Applied to this scenario, PLR 995203 could serve as the blueprint for all involved to argue to the IRS that their Super CLAT should also be allowed to accelerate the annuity payments and therefore pass the remainder to the trust beneficiaries immediately with cash from the death benefits! If the executor of the trustmaker's estate, the trustee of the Super CLAT, the benefiting charity or charities, and the trust remainder beneficiaries all agreed, they could structure a petition to the IRS for a Private Letter Ruling just as the parties in PLR 995203 did. While PLRs are issued on a case-by-case basis and certainly cannot be applied to outside parties, with PLR 995203 on the books the IRS could be hard pressed not to issue a similar ruling in this example!

Summary

When combined, the defective terms of the trust, the depressed values of the trust's LLC B shares, and the high-yielding, tax-free, charitable distributions from Private Placement Life Insurance make an ordinary CLAT a Super CLAT! For the client who uses this trust, the Super CLAT generates an up-front income tax deduction, and up-front gift tax deduction, funds a qualified charity that the trustmaker may choose, and ultimately passes assets to the trustmaker's beneficiaries virtually gift-tax free. During this entire process, the client, if he or she is the A shareholder, maintains control over all investment decisions before, during, and *after* the Super CLAT's term. The remainder beneficiaries inherit an asset that, while the insured is alive, provides a tax-sheltered investment fund available to them at the A shareholder's discretion. At the insured's death, these beneficiaries receive, via the LLC, death benefits with a 100% income tax basis.

Case Example:

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Let's assume that a fictional client, John Dough, is a healthy, non-smoking, 55-year-old executive who is considering exercising nonqualified stock options this tax year. The fair market value of the stock he may purchase is $15,000,000 and his options allow him to purchase this stock for $5,000,000. He really doesn't need the assets to support his lifestyle and he doesn't want to pay the income taxes on the $10,000,000 difference between his price and the stock's fair market value (he's paying around 40% in income taxes). He has to exercise the options this year or they will expire, and he has more options set to expire next year and the year after.

John's a charitable guy. He currently has a Donor Advised Fund at his community's foundation. His Alma Matter is asking him to step forth and pledge a significant gift to be paid over the next decade. He's very interested in making this pledge because he wants to offset his huge income tax spikes he'll have to recognize each time he exercises his options over the coming years. He believes that if he invested his net proceeds after exercising his options he could have a reasonable shot at earning an average annual rate of return of 10%. His net worth already puts him in the 55% estate tax bracket.

First, let's examine the hypothetical cash flows if John simply exercised the options, paid the income tax, invested the net proceeds, and contributed a large, consistent amount to charity each year.

Current Situation

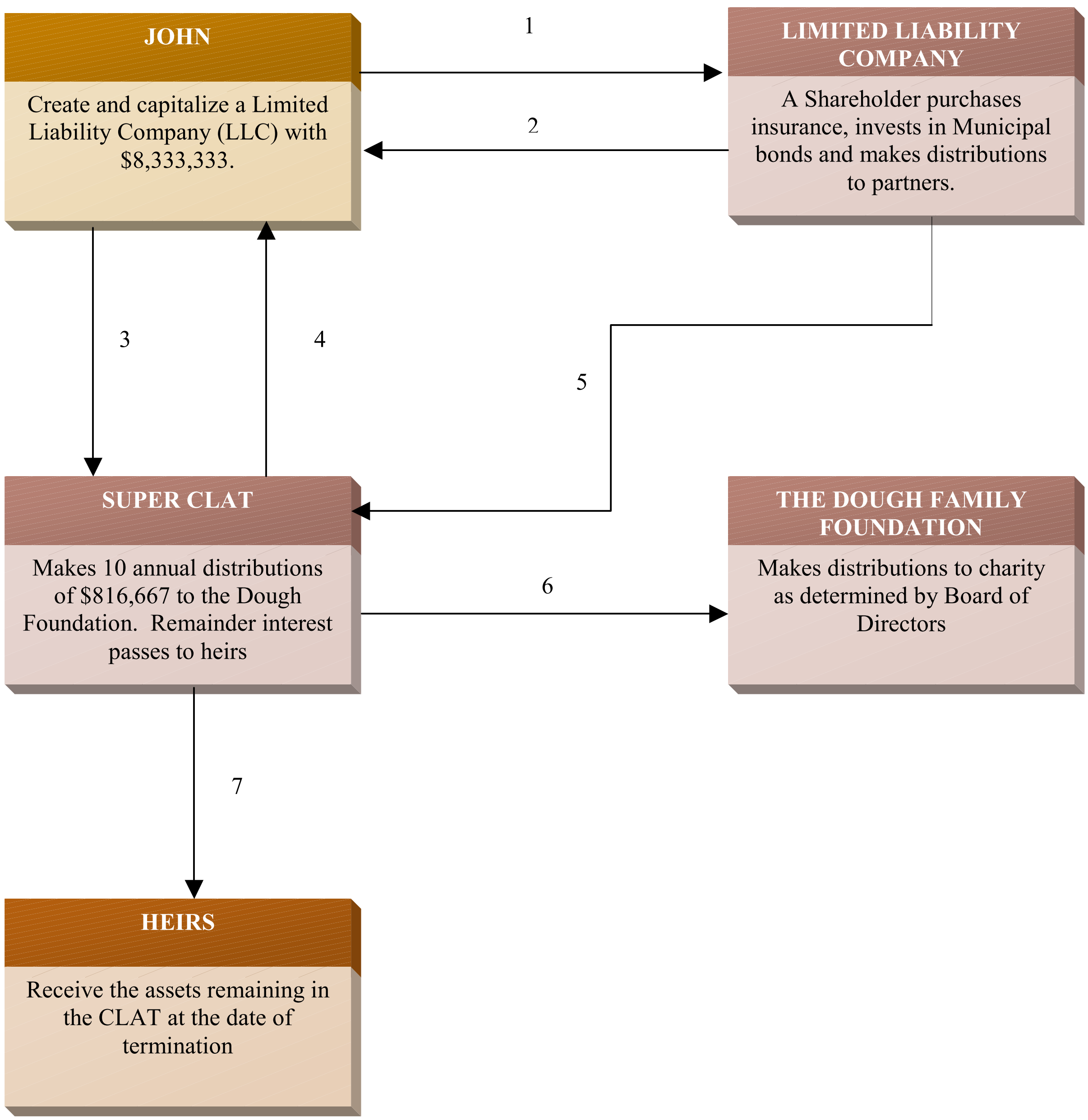
Income Tax Analysis	
Value of stock acquired	$ 15,000,000
Exercise price	(5,000,000)
Taxable income	10,000,000
Estimated income tax at 40%	4,000,000
Cash Analysis	
Gross proceeds	15,000,000
Less income tax	(4,000,000)
Less exercise price	(5,000,000)
Net cash proceeds	$ 6,000,000

The following figures indicate what may happen if John exercised his options, paid the tax, reinvested the net proceeds, made annual payments to charity, and distributed these proceeds to his heirs at any of the years listed.

Year	Year End Account Value	Taxable Earnings at 2.0%	Principal Growth at 8.0%	Charitable Gifts	Tax Liability (Savings)	Potential Net to Heirs After 55% Tax
1	5,992,333	120,000	480,000	816,667	(209,000)	2,696,550
2	5,983,946	119,847	479,387	816,667	(209,046)	2,692,776
3	5,974,770	119,679	478,716	816,667	(209,096)	2,688,647
4	5,964,732	119,495	477,982	816,667	(209,151)	2,684,129
5	5,953,750	119,295	477,179	816,667	(209,212)	2,679,188
6	5,941,736	119,075	476,300	816,667	(209,277)	2,673,781
7	5,928,592	118,835	475,339	816,667	(209,350)	2,667,867
8	5,914,214	118,572	474,287	816,667	(209,428)	2,661,396
9	5,898,483	118,284	473,137	816,667	(209,515)	2,654,317
10	5,881,274	117,970	471,879	816,667	(209,609)	2,646,573
Totals		1,191,051	4,764,205	8,166,667	(2,092,685)	
NPV at 6.0%		877,405	3,509,621	6,010,738	(1,540,000)	1,477,833

Now let's examine what would happen if John chose to utilize the Super CLAT strategy instead:

Super CLAT Diagram



Explanation of Super CLAT Diagram

1. John contributes cash and/or high basis assets to a new Limited Liability Company.

2. In exchange, he receives voting (A) and non-voting (B) shares. The value of the B shares should be lower than the value of the underlying assets contributed since B shares have limited liquidity and marketability and B shareholders have no voice in management decisions.

3. John contributes his B shares to a Super CLAT.

4. This contribution should produce a charitable income tax deduction equal to approximately $5,833,333. This is the present value of the future income to charity. The portion of the contribution not attributable to charity is considered to be a gift to the family. John may use all or part of his remaining lifetime exemption to shelter this family gift from transfer tax.

5. John, as the A shareholder, acquires a variable universal life (VUL) insurance policy on himself to be owned by the LLC. He pays the premium with cash he contributed to the LLC and invests the balance of the cash in municipal bonds. After a year, John ,as A shareholder, liquidates enough bonds so that (a) he can distribute sufficient cash to the shareholders enabling the Super CLAT trustee to make the required distribution to charity and (b) he can pay the second premium. This pattern continues for four years until the munibonds are liquidated and all the assets have been transferred to the VUL policy. In years 6-10, John takes tax-free withdrawals or loans from the VUL policy and distributes them to the partners so that the Super CLAT trustee can make the distributions to charity

6. The Super CLAT makes distributions to charity for a period of 10 years. These distributions are fixed and based on the initial value of the B share contribution times the payout rate of 14.0%. It is required of John, as the A shareholder, to see that the LLC makes distributions to the shareholders such that the trustee of the Super CLAT has sufficient assets to make the annual required distributions to charity. Distributions from the Super CLAT are added to the Family Foundation. These funds are invested and accumulated for charitable purposes. The board of directors makes decisions periodically as to which charitable organizations the Family Foundation will support.

7. At the end of the term of the Super CLAT, all assets remaining in the trust are distributed to the heirs or a trust for the heirs. At this point these assets should include only the B shares of the LLC that owns a life insurance policy on John. With a VUL annual investment return of 10.0%, we estimate that the cash value of the policy at this point may be as much as $5,028,921 and the potential death benefit to be $10,065,389. John will continue to be the A shareholder of the LLC and, as such, make all management decisions.

Now let's look at the hypothetical cash flows of the Super CLAT strategy:

Super Charitable Lead Annuity Trust

Assumptions

Section 7520 rate (also NPV rate)	6.0%
CLAT payout rate	14.0%
Term of CLAT	10
Tax exempt yield of munibonds	6.0%
Growth of munibonds	0.0%
Total return of Private Placement VUL investments	10.0%
LLC B share value reduction	30.0%

Maximum Super CLAT Contribution

Income Tax Analysis		**Cash Analysis**	
Value of stock acquired	$ 15,000,000	Gross proceeds	15,000,000
Exercise price	(5,000,000)	Less exercise price	(5,000,000)
Less charitable deduction	(5,833,333)	Less income tax due	(1,666,667)
Taxable income	4,166,667	Contrib. to LLC for SCLAT	(8,333,333)
		Additional cash proceeds	$ -
Income tax due at 40%	$ 1,666,667		

Tax Deduction Details

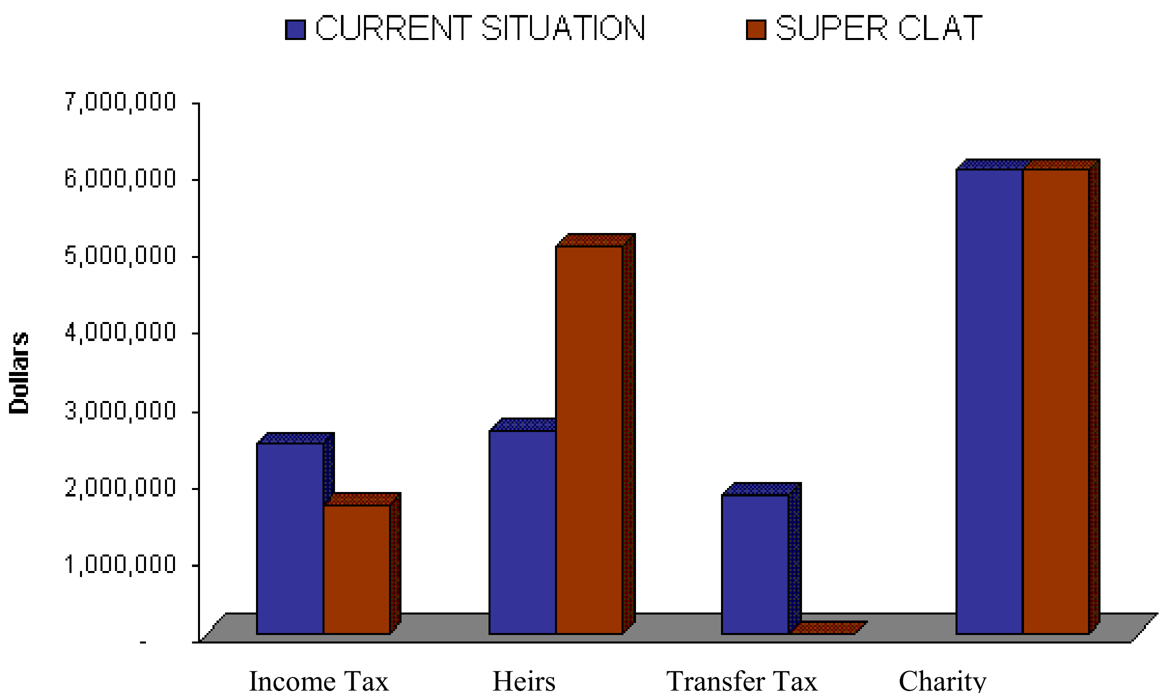
Income Tax Deduction		**Gift Tax**	
Cash contribution to LLC	$ 8,333,333	Contribution to Super CLAT	5,833,333
FMV reduction at 30%	(2,500,000)	Portion attributable to charity	(5,833,333)
B share FMV to SCLAT	$ 5,833,333	Balance deemed a taxable gift	$ -
Char. deduction of 100%	5,833,333	Hypothetical gift tax due	$ -

Super CLAT Cash Flow

Cash contrib. to LLC	8,333,333	LLC B shares to SCLAT	5,833,333
First premium paid	1,095,884	Annual payout to charity	816,667
Net invested in munis	7,237,450		

Year	Year End Munibond Account Value	Beg. Of Year Premiums Paid from Munibond Account	End of Year SCLAT Disbursement from Muni-bond Account	End of Year SCLAT Disbursement from VUL Policy	Estimated Cash Value of VUL[v]	Estimated Death Benefit of VUL[v]
1	6,855,030	1,095,884	816,667	-	1,120,936	14,148,724
2	5,288,028	1,095,884	816,667	-	2,350,565	14,148,724
3	3,627,007	1,095,884	816,667	-	3,701,654	14,148,724
4	1,866,324	1,095,884	816,667	-	5,184,767	14,148,724
5	(0)	1,095,884	816,667	-	6,815,561	14,148,724
6	(0)	-	-	816,667	6,523,834	13,332,057
7	(0)	-	-	816,667	6,203,615	12,515,390
8	(0)	-	-	816,667	5,850,505	11,698,723
9	(0)	-	-	816,667	5,461,505	10,882,056
10	(0)	-	-	816,667	5,028,921	10,065,389
Totals		4,383,535	4,083,333	4,083,333	5,028,921	10,065,389
NPV at 6.0%		4,616,261	3,440,097	2,570,641	2,649,173	5,302,321

Comparison of Results



	CURRENT SITUATION	SUPER CLAT
Income Tax Liability Less NPV to Charity[vi]	2,460,000	1,666,667
Benefit to Heirs in 10 Years	2,646,573	5,028,921
Hypothetical Transfer Tax	1,806,240	-
NPV of Assets to charity	6,010,738	6,010,738

Income tax savings	793,334
Increase in Assets to Heirs in 10 Years	2,382,348
Transfer tax savings	1,806,240
Increase in NPV of Assets to charity	-

Endnotes

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[i] If the trust makes payments to a public charity the deduction can be used against up to 30% of the trustmaker's contribution base with a five year carryover of any excess deduction. If the trust provides income to a private non-operating foundation, the percentage limitation is reduced to 20%. Any deduction exceeding the amount deductible in the year of contribution can be carried forward up to five additional years. The amount that may be deducted for income tax purposes, however, cannot exceed 100% of the fair market value of the property transferred to the trust upon which the deduction is calculated.

[ii] Care must be exercised when creating an intentionally defective trust because the Service has been unwilling to rule affirmatively that Section 675(4)(C) applies. Instead, the Service is postponing its conclusions regarding the grantor trust rules until it can evaluate the facts to determine whether the individual with the substitution right is in fact acting in a non-fiduciary capacity.

[iii] PPLI may be seen as an aggressive investment and therefore put the Super CLAT at risk of excise taxes under "jeopardy investment" rules, but no category of investments is treated as a per se violation. However, the Service will closely scrutinize trading on margin (which will also cause debt-financed income), trading in commodity futures, investments in working interests in oil and gas wells, calls, puts, straddles, warrants, and selling short. To avoid these risks, the PPLI investment portfolio should instead be a well diversified, blue chip portfolio.

[iv] See Private Letter Rulings 9936031, 9713017; & 9642039

[v] Private Placement VUL policy hypothetically illustrated for a 55-year-old, non-smoking male at standard rates with a 10% annual rate of return realized on invested assets.

[vi] Income Tax Liability Less NPV to Charity equals, for the current situation, the income tax owed the year of option exercise of $4,000,000 less the NPV of the 10 future charitable payments valued at $1,540,000. For the Super CLAT, this number equals the $10,000,000 difference between the strike price of the options and the stock FMV less the $5,833,333 Super CLAT charitable deduction leaving $4,166,667 subject to tax at 40%. This figure assumes that the income tax deduction generated by the Super CLAT can be taken all in year one.