MAKING THE CLT YOUR NEW BEST FRIEND

SHARK-FIN CLATS WITH CHIEF BRODY OPTION

A. I Create a 50 year CLAT.

Suppose I create a CLAT within the window to use a 7520 rate of 1.4%. I fund the CLAT with $1,000,000. The term is 50 years. During the first 49 years the CLAT pays $1,000 per year to Worthy Charity at the end of the year. In year 50 the CLAT pays $2,000,000 to Worthy Charity and pays whatever amount remains to my children. My children are the trustees.

I have not made a gift to my children because the IRS believes that $2,000,000 in 50 years is worth $1,000,000 this year. [1.014^50 = 2.004]. Actually the $2,000,000 balloon may be somewhat lower taking into consideration the $1000 per year payments.

The IRS sample forms specifically allow back-loaded annuities, unlike with, say a Grantor Retained Annuity Trust. If you were to graph payments that started low and went up at the end it would look like a shark's fin, hence the common name of these, Shark-Fin CLAT.

B. My Children Approach the Charity.

My children, being clever souls, look at the calendar and conclude that - - despite excellent health habits - - they might not survive 50 years and thus are unlikely ever to see a benefit from my largesse. They are not encouraged by my reminder that half the people must die prematurely. Being extra-clever souls they hit upon a plan. They do not discuss the plan with me and I know nothing of it until it is completed.

My children approach Worthy Charity with calculator in hand and inquire of its development and finance department what they think the present value of $2,000,000 will be worth in 50 years. Worthy Charity expects that it can earn 5.5% a year over the next 50 years so in fact it believes that $2,000,000 then is worth a paltry $137,533 now. [$2,000,000/ (1.055^50) = $2,000,000/14.54196 = $137,533]

My children do not want to take advantage of Worthy Charity. They decide to make Worthy Charity an offer it cannot refuse: $225,000 today for Worthy Charity's interest in the CLAT. That is an assumed earnings rate of about 4.466% a year over the term. Every bit Worthy Charity earns above 4.466% is profit on the deal. For instance, if Worthy Charity actually earns 5.5% then at the end of

50 years it would have $3,272,000 versus the original $2,000,000. After a few minutes of cogitation, Worthy Charity takes the offer and transfers its interest to my children.

My children are elated: they have bought $1,000,000 for $225,000. Ought they to be elated or is there something faulty here? Does the trust terminate with the purchase of the interests from Worthy Charity? That would seem desirable and, depending on the wealth of my children, may be necessary.

C. Is Anyone Going To Jail, Metaphorically or Actually?

Has Worthy Charity done anything wrong? Given the numbers, might Worthy Charity do something "wrong" if it does not agree to sell? (Does that mean a charity that is the beneficiary of a CLAT ought be seeking buyers for its interest?)

Is this a prohibited transaction, perhaps self-dealing. CLTs are subject to the self-dealing rules. Do those prohibit a charity from selling its interest in a CLT?

Is this a commutation and if so is it prohibited? Rev. Rul. 88-27 prohibits the trustee from having the power to commute the charitable interest. The Ruling states:

> If the trustee has the discretion to commute and prepay the charitable "lead" annuity interest prior to the expiration of the specified term of the annuity, the interest does not qualify, as a guaranteed annuity interest under section 2522(c)(2)(B) of the Code, and under section 2522(a), no deduction is allowed for the amount of the transfer to charity.
>
> The result would be the same even if the trust instrument provided that the prepayment amount were to be calculated using the discount rate and methodology used to calculate the present value of annuity payments under the Code and regulations in effect on the date the annuity was established, because the exact amount payable to charity can not be determined as of the date of the gift.

Treas. Reg. §25.2522(c)-3(c)(2)(vi)(a) states in part:

> An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the date of gift. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the donor, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed as a fraction or percentage of the cost of living index on the date of gift.

If the trust terminates by operation of law - - the children who have the remainder interest purchasing the charitable lead interest - - is that a commutation? The trustee would not be involved in the transaction.

D. Going Forward.

The point of this illustration is not necessarily to inspire you to go out and create 50 year Shark-Fin CLATS but rather that you begin to think about the low section 7520 rate versus the likely experience of charitable investments. The longer the term the more leverage that exists. However, prudence suggests that overly long terms not be used.

E. Don't Some People Suggest That Life Insurance Be Owned in a Shark-Fin CLAT? Any other planning tips?

Yes. Folks who sell life insurance. The theory is that if I have a 25 year life expectancy the life insurance will pay off and furnish the money to make the balloon payment. Life insurance in this context is an investment and it is either good or bad. However, it limits your ability to pay-off the charity early.

A CLAT may either pay its own income taxes - - and receive an income tax deduction only for distributions it makes to charity - - or all the income can be taxed every year to the grantor in which case the grantor gets an income tax deduction in the first year for the amount with which the CLAT is funded (e.g. $1,000,000 in my example). The first is more typical. Consideration should be given to having mini-balloon payouts every few years to "clear out" accumulated capital gains.

F. What's In A Name?

Why the name? Jaws. Chief Brody goes out to get the shark. His boat sinks, he's bloodied, heck he's almost eaten, but he survives and paddles back to shore.

If music helps you think like it does me … Flatt & Scruggs and The Beverly Hillbillies ... hum along the first verse and then choose the second verse you are happier with:

Come and listen to my story about a man named Fred,
He wasn't 'specially poor but he sure hated the Feds.
One day while looking at his portfolio, all flat,
Someone came along and suggested he try a CLAT.

(Not Just Any CLAT. A Shark-Fin CLAT With Chief Brody Option)

Well the next thing you know ole Fred's passed all his wealth,
And he's done it, with almost total stealth.
Along come his children who appear to be all grateful,
And in fact they promise always to be faithful.
(The kids will visit. Bring mac & cheese. Occasionally Sudoku.)

OR

Well the next thing you know ole Fred's passed all his wealth,
And he's done it, with almost total stealth.
He's pretty pleased until that day he gets a notice in the mail,
And Fred finds out he's gonna spend some time in jail.
(The kids will visit. Bring mac & cheese. Occasionally Sudoku.)

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