Steve Leimberg's Charitable Planning Email Newsletter - Archive Message #244

Date: 12-Jan-16
From: Steve Leimberg's Charitable Planning Newsletter
Subject: Avi Kestenbaum & Mary O'Reilly: "Stepping-Up" CLATS, a Win-Win for Beneficiaries and Charities

"With today's high federal income tax rates and the estate tax applicable to relatively few estates and at lower rates, there has been an increased focus in estate planning to achieve a step-up in income tax basis at death. However, in most cases moving assets outside of the taxable estate and receiving a step-up in basis are mutually exclusive—you can achieve one but not both. Enter the zeroed-out testamentary charitable lead annuity trust (CLAT) when after death the estate sells its otherwise taxable assets to the family or to trusts for their behalf before the CLAT is funded. When utilized properly for clients who have already done significant lifetime planning, this technique allows for all of the client's assets to pass to the family with a full step-up in basis, while paying no estate tax, a seemingly impossible achievement."

Avi Kestenbaum and **Mary O'Reilly** provide members with their commentary on zeroed-out, testamentary CLATs.

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Journal, Special Trusts and Estates Section; and Leimberg's Estate Planning Newsletter. He has also lectured for the American Bar Association, the American Bankers Association, the New York State Bar Association, the Notre Dame Tax and Estate Planning Institute, Estate Planning Council of NYC, STEP, Long Island Branch (which he co-founded and co-chaired) and to and for many other professional institutions across the country.

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Before we get to their commentary, **LISI** has made available **Conrad Teitell**'s email to IRS/Treasury regarding an issue he believes still needs to be addressed regarding the withdrawal of the proposed regulations (See **Richard Fox**'s commentary in Charitable Planning Newsletter #243) creating an optional way for charities to enable donors to substantiate their charitable contributions: Conrad Teitell

Now, here is Avi and Mary's commentary:

EXECUTIVE SUMMARY:

With today's high federal income tax rates and the estate tax applicable to relatively few estates and at lower rates, there has been an increased focus in estate planning to achieve a step-up in income tax basis at death. However, in most cases moving assets outside of the taxable estate and receiving a step-up in basis are mutually exclusive—you can achieve one but not both. Enter the zeroed-out testamentary charitable lead annuity trust (CLAT) when after death the estate sells its otherwise taxable assets to the family or to trusts for their behalf before the CLAT is funded. When utilized properly for clients who have already done significant lifetime planning, this technique allows for all of the client's assets to pass to the family with a full step-up in basis, while paying no estate tax, a seemingly impossible achievement.

COMMENT:

For clients who own businesses and real estate, removing assets from the estate through traditional lifetime planning techniques such as GRATs and sales to grantor trusts may be great from an estate tax perspective, but forgoing the step-up in basis on the assets that are transferred may be financially detrimental to their heirs. This is particularly the case when the success of the family business rests in large part with the decedent and a sale of the business after the decedent's death is inevitable without the decedent alive to run it. Even for estates with real estate investments, where the decedent's role may be more passive and there is no expectation to sell the properties after the decedent's death, with the potential tax recapture for negative basis as well as foregoing future income tax depreciation deductions for assets with low or negative basis, the estate tax savings of removing the properties from the taxable estate may in fact prove to be far less beneficial from an overall economic and tax perspective than keeping the assets in the estate and achieving the step-up in basis.

Almost all practitioners will agree that there is only one way to achieve a step-up in basis at death—the assets must be included in the decedent's gross estate.[1] And once the assets in the taxable estate are in excess of the estate tax exemption, there are only two ways to escape the estate tax—either through the marital deduction or the charitable deduction.

As we know, the marital deduction, rather than eliminate the estate tax, merely postpones the tax until the death of the surviving spouse. While properly structured joint revocable trusts may ensure that there is full step-up in basis on all assets regardless of which spouse passes away first, there may not be enough time after the first spouse's death for the surviving spouse to do successful lifetime estate tax planning with the stepped-up assets. Additionally, depending on the circumstances, the strict rules that apply to marital deduction trusts may allow the surviving spouse to frustrate the decedent spouse's wishes or objectives by not agreeing to do more planning. Thus, relying on the marital deduction to achieve a full basis step-up and an elimination of the estate tax is not the best strategy for most estates, particularly the larger ones.

The charitable deduction—unlike the marital deduction which simply defers the estate tax—eliminates the estate tax altogether. Additionally, the estate tax charitable deduction is an unlimited deduction, unlike its counterpart in the income tax system which can only be used to offset a portion of income earned regardless of how much money is donated to charity. This unlimited nature of the estate tax charitable deduction has in fact been criticized by some as a windfall to the wealthy, who are able to pay no estate tax while charities and foundations controlled by such families continue to control this wealth.[2]

Admittedly, for most clients, this supposed tax-savings windfall of leaving most of their assets to charity is a non-starter. The goal of minimizing estate taxes for most clients is driven less by not wanting to pay money to the government and more by their desire to pass as much of their wealth as possible to their descendants and loved ones. Nevertheless, for those clients who have already done substantial lifetime planning and have already moved a large portion of their assets out of their taxable estate and having maximized all available structures and techniques to minimize estate taxes, consideration should be given to leaving their remaining assets (and in particular their negative and low basis assets) to a zeroed-out testamentary CLAT.

By utilizing a zeroed-out testamentary CLAT to receive their otherwise taxable estate, there will be no estate taxes due on death (and a step-up in basis as will be discussed later). An added benefit is often there is substantial life insurance proceeds in trusts outside the taxable estate which, if no longer needed for estate taxes, can be utilized by the family instead of being used to pay the IRS. And unlike leaving assets directly to a charity where there is no possibility for the family to receive those assets in the future, by leaving assets to a CLAT—particularly with today's low Section 7520 rates—the family may receive back the bulk of the assets originally contributed to the CLAT when it terminates.[3] The chart below illustrates how this would work with a 20 year zeroed-out CLAT funded with $1 million.[4]

Year	Beginning Principal	5.00% Growth	Charity Payment	Assets Remaining
1	$1,000,000	$50,000	$7,040	$1,042,960
2	$1,042,960	$52,148	$8,448	$1,086,660
3	$1,086,660	$54,333	$10,138	$1,130,855
4	$1,130,855	$56,543	$12,165	$1,175,233
5	$1,175,233	$58,762	$14,598	$1,219,397
6	$1,219,397	$60,970	$17,518	$1,262,849
7	$1,262,849	$63,142	$21,021	$1,304,970
8	$1,304,970	$65,249	$25,225	$1,344,993
9	$1,344,993	$67,250	$30,271	$1,381,972
10	$1,381,972	$69,099	$36,325	$1,414,746
11	$1,414,746	$70,737	$43,590	$1,441,894

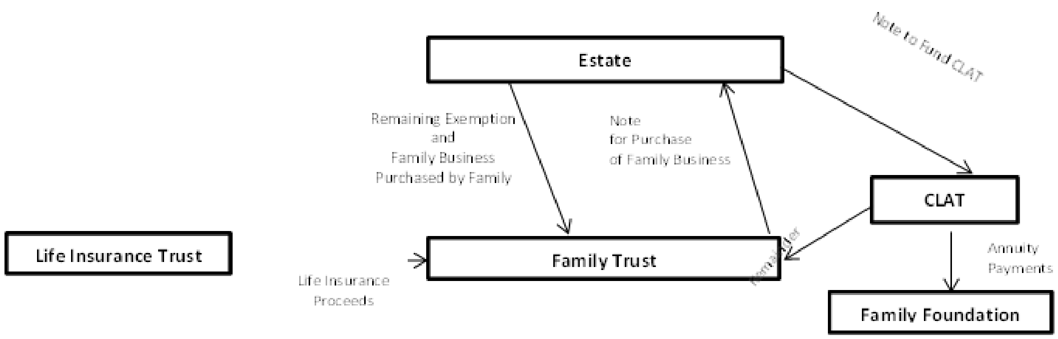
12	$1,441,894	$72,095	$52,307	$1,461,681
13	$1,461,681	$73,084	$62,769	$1,471,997
14	$1,471,997	$73,600	$75,323	$1,470,274
15	$1,470,274	$73,514	$90,387	$1,453,400
16	$1,453,400	$72,670	$108,465	$1,417,606
17	$1,417,606	$70,880	$130,156	$1,358,328
18	$1,358,328	$67,916	$156,189	$1,270,056
19	$1,270,056	$63,503	$187,427	$1,146,132
20	$1,146,132	$57,307	$224,912	**$978,526**

As illustrated above, for every $1 million that is contributed to the CLAT, the family would receive back $978,526 after the CLAT terminated in 20 years.[5] Waiting 20 years (or for whatever the duration of the charitable term), however, may not be desirable where the assets being contributed to the CLAT are interests in closely held businesses, including real estate investments. Furthermore, CLATs are subject to the various restrictions on investments and transactions that govern private foundations, including the excess business holding rules and the prohibition on self-dealing.[6] These may make it difficult, if not impossible, for a family to live with for the duration of the CLAT term.

Fortunately, there is an important estate administration exception to the self-dealing rules that explicitly permits assets (including closely held business interests and real estate) to be sold by the estate to the family or family trust so that the CLAT can instead be funded with a promissory note or other consideration the estate receives. This gives the family the ability to purchase and own the closely held business or real estate with a stepped-up basis in a vehicle such as a generation-skipping family trust that is outside of the estate in exchange for a long term promissory note.

By virtue of Section 4947(a)(2), the self-dealing rules of Section 4941 apply to CLATs. Any transaction between a disqualified person which respect to the CLAT and an organization controlled by the CLAT is prohibited.[7] It is considered self-dealing and will trigger an excise tax even if the CLAT is actually getting a great deal.[8] Thus, once a CLAT is funded with a closely held business or real estate, it becomes extremely difficult for the family to continue business-as-usual since staying clear of the self-dealing rules must be contemplated with every business transaction and family operation.[9] Additionally, the excess business holdings rule in Section 4943 of the Code prohibits zeroed-out CLATs from retaining excess business holdings after 5 years of receiving them as a gift or inheritance.[10] Failure to comply with the rule subjects the CLAT to a 10% excise tax followed by a 200% excise tax if it fails to timely correct it. However, correcting this is often difficult since in most instances the only parties who would buy the excess business holdings from the CLAT would be the family members who would be disqualified from doing so under the self-dealing rules. As such, it is often problematic under both the self-dealing and the excess business holding rules for a CLAT to hold an interest in a closely held business. [11]

Fortuitously, the applicable regulations provide an important exception to the self-dealing rules during the administration of the estate which permits the estate to sell the decedent's closely held businessbefore funding the CLAT. This allows the CLAT to instead be funded with a promissory note or other consideration.[12] The diagram below illustrates how this would work.



To take advantage of this important estate administration exception to self-dealing: (i) the executor of the will or the trustee of the revocable trust must either have the power to sell the property, reallocate it to another beneficiary or be required to sell it; (ii) the transaction must be approved by the probate court; (iii) the transaction must occur before the estate is considered terminated for federal income tax purposes; (iv) the estate must receive an amount equal to its fair market value; and (v) the transaction must either (a) result in the CLAT receiving interest at least as liquid as the one it gave up, (b) result in the CLAT receiving an asset related to its exempt purposes or (c) be required under the terms of an option that is binding on the estate.[13]

Thus, for clients who wish to avoid the negative implications of owning a closely held business or real estate in a CLAT, their family members or trusts for their benefit may purchase the business from the estate in exchange for other property, including a promissory note, before the CLAT is funded. The result is very powerful. There is no gain on the sale of the business from the estate to the family or to the family trust since it is included in the client's estate and it has a stepped-up basis. There is no estate tax due since the bequest to the CLAT is sheltered by the unlimited charitable deduction. The family trust receives full basis in the business asset it receives equal to the amount of consideration it paid for the property giving the trust basis against which it can take immediate income tax deductions as well as shelter gains against in the event of a sale. The decedent gets to benefit charities near and dear to him, including, if he chooses, his own private foundation with the CLAT payment each year and funding the CLAT with a promissory note or cash might make it easier to fund the annuity payments.[14] And, it is probable that part or even all of the note or other consideration contributed to the CLAT will eventually return to the family when the CLAT term expires as shown in the above chart. Finally, the life insurance proceeds no longer needed to pay for estate taxes and can be utilized by the family.

The estate administration exception to self-dealing was contemplated and approved by the IRS in Private Letter Ruling 200124029. In this ruling the decedent's will provided that the estate (which consisted mostly of investment real estate) passed to a marital trust and directed that upon the spouse's death the assets remaining in the martial trust pass to 3 separate zeroed-out CLATs. In the ruling, the estate wanted to sell the real estate to a family company in exchange for a promissory note secured by the real estate for its fair market value with the probate court and the state attorney general approving the sale. The IRS found that the transaction qualified for the estate administration exception to self-dealing. However, because the decedent's will in the ruling did not direct the sale of the properties prior to funding the marital trust, in order to qualify for the self-dealing exception the estate had to demonstrate why the promissory note received by the trust would not be less liquid than the real estate it would have received under the will. However, as set forth in prong (v) of the estate administration self-dealing exception, if the sale of the closely-held business or real estate would have resulted from an option that is binding on the estate, there would have been no requirement to show that the consideration received would be more liquid than the asset sold.

Conclusion

For clients who have already done significant planning and own closely held business or real estate interests, using a zeroed-out testamentary CLAT at the second spouse's passing and directing that the business or real estate be sold by the executors to family trusts prior to funding the CLAT is a great strategy that should be considered. There will be no estate taxes due and a full step-up in basis. Life insurance proceeds held in trusts outside of the estate will pass to the family rather than be used to pay the IRS and the family may ultimately receive the assets contributed to the CLAT at the end of its term—especially with today's low Section 7520 rates. Finally, with no estate taxes due there is presumably little incentive for the IRS to audit the estate, which may in fact prove very valuable depending on the prior lifetime planning that was done. Oh, and by the way, the fact that charities will now receive significant funds with the CLAT payments each year, and the family will be involved in charitable giving, which may not have even been primary objective, is an added benefit to society—one which Warren and Bill would likely approve.

HOPE THIS HELPS YOU HELP OTHERS MAKE
A *POSITIVE* DIFFERENCE!

Avi Kestenbaum

Mary O'Reilly

TECHNICAL EDITOR: RICHARD FOX

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[1] While the income tax consequences of a decedent's death while a note is outstanding from a sale to a grantor trust is uncertain, almost all practitioners are in agreement that there is no step-up in the assets held in the grantor trust at the death of the grantor.

[2] *See* Edward A. Zelinsky, *Why the Buffett-Gates Giving Pledge Requires Limitation of the Estate Tax Charitable Deduction*, 16 Fla. Tax Rev. 393 (2014). In this article Professor Zelinsky critiqued the unlimited estate tax charitable deduction as being unfair in relation to the more limited charitable income tax deduction. Zelinsky states some poignant reasons that the estate tax charitable deduction should be limited like the income tax charitable deduction. He argues that under the current unlimited estate tax deduction the billionaires of the world who sign up for the Buffett-Gates charitable giving pledge avoid paying their fair share of estate taxes and may leave their monies to family controlled foundations and charities, where their families still yield incredible weight and control over funds that really should have gone to government tax coffers.

[3]Although the CLAT is not effective for generation-skipping planning, as described below the family assets or business may be purchased from the estate by a trust that does permit generation-skipping transfer tax planning.

[4] This assumes a Section 7520 rate of 1.2%, a steady 5% annual growth rate and an annuity payment that increases by 20% each year. See Priv. Ltr. Rul. 201216045 (June 5, 2012) which permitted an annuity payment in a CLAT to increase by 20% each year, much like that allowed in a GRAT.

[5] Obviously the exact results may be better or worse depending on the rate of return, however discounts for lack of marketability and lack of control depending on the nature of the assets may be used if appropriate to make it more likely to have a very successful CLAT.

[6] Note that the jeopardizing investment rule found in Section 4944 of the Code does not apply to property that is gifted into the CLAT and would only apply if the CLAT itself made the investment. Also note that the CLAT may be subject to unrelated business taxable income (UBTI) for income derived from unrelated

business activities as detailed in Section 511 of the Code.

[7] *See* Treas. Reg. §53.4941-1(b)(5).

[8] *See* Reg. §53.4941-1(b)(6) and (7) for certain exceptions to self-dealing transactions.

[9] For example, if a CLAT owned an interest in a family real estate investment, standard business practices such as paying a management fee to a family member, loaning money between one family real estate entity to another or using assets of one real estate entity as collateral for another family investment would all be subject to a self-dealing analysis.

[10] There is an initial 5 year grace period (with potential to extend to 10 years) for an excess business holding received by the CLAT by gift or bequest.

[11] Because most rent from real property is considered a passive investment and not a business enterprise, the excess business holdings rule normally does not present any issues for CLATs that are funded with family real estate investments; however, the self-dealing rules still remain problematic with real estate investments.

[12]Treas. Reg. §53.4941(d)-1(b)(3).

[13] *Id.*

[14] The remainder interest passing to the family illustrated in the above chart assumes a 5% growth rate. If the CLAT is funded with a promissory note, presumable to attain this rate of return, the note would have to call for principal payments or permit prepayment which would need to be invested.