I. **A. Using Charitable Lead Annuity Trusts (the "CLAT") to transfer income-producing assets without a gift tax.**

B. Using lifetime CLATs for individuals with a short life expectancy.

C. Why lifetime CLATs are superior to testamentary CLATs (the "TCLAT").

D. Using CLATs to reduce the phaseouts of itemized deductions

We know that a CLAT works the same way as a GRAT except the annual annuity is given to charity instead of retained by the trust creator. Since there is no retained annuity interest, and if the remainder interest is gifted away at formation, there is no exposure to estate tax inclusion if the creator of the CLAT dies during the CLAT term as there is with a GRAT. It is the use of financial leverage (the assumption that the investment rate of return is greater than the Section 7520 rate) and the compounding of that financial leverage over a long period that produces favorable results. The lifetime CLAT for someone with a short remaining life expectancy is an ideal vehicle to take advantage of the compounding over a long period of time.

Below are four alternative scenarios using a $1,000,000 income-producing asset and the net results under each alternative.

The most effective way to illustrate the tax savings is to start with a situation where no tax plan has been used so as to compare the benefit of the planning technique

The following example uses a lifetime charitable lead annuity trust (a "CLAT") to illustrate how to accomplish the communication objective in a brief amount of time without the use of technical terms. Remember, it is always easier to communicate by the use of illustrative examples.

> **Example** Senior, a resident of Florida, a state without an income tax on individuals,[1] with little or no charitable intentions, owns a $1,000,000 portfolio of bonds, paying $52,400 of annual interest (a 5.24% return). The individual transfers these bonds to a CLAT with a 25-year fixed term. The current gift tax rate is 40%. Assume that the IRS published Section 7520 rate is 2.2%.[2]

ALTERNATIVE No. 1

Senior retains the $1,000,000 investment portfolio, earning 5.24% annually, pays the income taxes on the $52,440 of ordinary income each year and allows all earnings, after the payment of income taxes, to accumulate. At the end of 25 years, the investment fund has grown to $2,063,128. Senior gifts the entire $2,063,128 of accumulated funds directly to her children. After the payment of the $825,251 in gift taxes, computed at the 40% gift tax rate, on this taxable gift, the children effectively net $1,237,877.

---

[1] The combined Federal income tax on interest income is 43.4% as the 3.8% newly-enacted Medicare surtax tax is added to the regular 39.6% income tax rate.

[2] Charitable lead trusts can not only use the Section 7520 rate for the month the trust is established, but also use that rate for the two succeeding months. The April 2014 rate is 2.2% and can be used for May and June of 2014 if the rate for those months is higher. The March 2014 rate is 2.2% and the February 2014 rate is 2.4%.

ALTERNATIVE No. 2

Each year Senior gifts the entire $52,240 of annual investment income to charity and gifts the $1,000,000 investment portfolio to her children at the end of 25 years. The children effectively net $600,000 after the payment of gift taxes at the 40% rate, and the charity receives a total of $1,306,000 over the 25-year period.

ALTERNATIVE No. 3

Senior contributes the $1,000,000 investment portfolio to a lifetime CLAT which in turn is required to distribute a fixed annuity of $52,240 to charity over a 25-year period (the expected annual income). Since the value of the gifted remainder interest to Senior's children is zero (hence the term a "zeroed-out CLAT"), there is no gift at the time the trust was created. At the end of 25 years, the CLAT terminates and distributes all $1,000,000 to the children without incurring any gift taxes. Therefore, the children net $1,000,000, and the charity receives the same $1,311,000 over the 25-year period.

Alternative	Net to Children	Charitable Contributions	Total to Intended Beneficiary(ies)
Alternative No. 1 No tax planning No charitable contribution	$1,237,877	None	$1,237,877
Alternative No. 2 No tax planning $52,240 annual charitable contribution	$ 600,000	$1,311,000	$1,776,680
Alternative No. 3 CLAT makes $52,240 annual charitable contributions	$ 1,000,000	$1,311,000	$2,311,000
Alternative No. 4 Use of a discounted FLP, CLAT makes $39,323 annual charitable contributions	$1,647,502	983,081	$2,630,583

ALTERNATIVE No. 4

Senior uses a family limited partnership ("FLP"), contributing the $1,000,000 investment portfolio to a family limited partnership. After taking a conservative 25% valuation discount, Senior contributes the discounted limited partnership interest, valued at $750,000, to a CLAT, which is required to pay $39,323 annually to charity over the 25-year CLAT term.[3] Over the 25-year period, the charity receives $983,075. And, upon termination of the CLAT, it distributes $1,647,502 to the children, free of all gift taxes.

By having the CLAT make the annual charitable contributions under Alternative No. 3, an individual can pass almost as much to her children than doing no tax planning and still give over $1,000,000 to charity.[4] For an individual who is already making significant charitable contributions in their individual capacity, using the CLAT for the same charitable giving allows that individual to take advantage of the potential gift and estate tax savings that the CLAT provides.

By comparing Alternative No. 1 to Alternative No. 3, the total of $1,311,000 in annual distributions to charity only cost the individual $237,877.[5] The individual is giving to charity the equivalent of the gift taxes one would have otherwise paid if the charitable lead trust had not been used.

By using a family limited partnership, as illustrated in Alternative No. 4, the transfer tax savings show that the individual's children are significantly better off.

One must be aware that the use of the CLAT produces this favorable result only because of the historically low Section 7520 rate. At a higher Section 7520 rate the same annual annuity needed to zero out the CLAT would be longer than 25 years.

There are significant advantages with the lifetime CLAT for individuals in their late 80s or early 90s. One of the most significant wealth shifting factors is the use of financial leverage and the compounding of that benefit over a long period of time. For individuals with a short life expectancy, the compounding period is limited. The lifetime CLAT for a fixed period of time is a convenient method to achieve that compounding over a long period of time even if the individual does not survive the CLAT term.

Reduce an individual's adjusted gross income so as to decrease the phase outs of itemized deductions, personal exemptions and reduce exposure to the alternative minimum tax.

Certain itemized deductions are based on a percentage of the individual's adjusted gross income. For example, the medical expense is reduced by an amount equal to 10% of adjusted gross income. Likewise, miscellaneous itemized deductions are reduced by an amount equal to 2% of adjusted gross income. All itemized deductions except the medical and charitable itemized deductions are reduced by the 3% phase out. And, there is also the reduction for the personal exemption deductions, again measured by adjusted gross income. Finally, the exposure to the alternative minimum tax is based on an individual's level of income.

---

[3] Using the 2.2% Section 7520 discount rate, the present value of $39,323 annually for 25 years is $750,000.

[4] This illustration assumes that the individual desires to give to charity. If the individual has no charitable desires, then the individual may have been able transfer more on to the children using another estate planning technique, such as a GRAT.

[5] Had the individual directly given the same $52,240 each year to charity over a 25-year period, it would have cost the individual $742,026 (after taking into account the income tax savings for the annual $52,240 charitable deduction, assuming an effective Federal income tax rate of 43.4%.

If one can reduce gross income, it is possible to reduce, and sometimes eliminate, these phase outs of deductions. Therefore, assignment of income to another taxpayer can be helpful even if the assignee taxpayer is not in a lower marginal income tax bracket.

For individuals who make recurring and predictable annual charitable donations and take their charitable income tax deductions on their individual income tax returns, they are missing the opportunity to shift the income used to make their charitable contributions to another taxpayer. If a CLAT is used for estate planning with the remainder interest passing to the children, and given the historically low Section 7520 rate (2.2% can be used for April, 2014[6]), a non-grantor charitable lead annuity trust for a fixed term can be designed to structure the annual annuity to charity for a fixed term so that the value of the remainder interest is zero. Alternatively, the settlor of the CLAT can retain a remainder interest that is worth less than 5% of the value of trust assets[7] so that it need not be a zeroed out CLAT. Thus, the income donated to a charity can be shifted to the non-grantor CLAT, thereby reducing the settlor's adjusted gross income.

Example Senior has an income producing $1,000,000 asset that pays $56,000 annually,[8] all ordinary income. Senior contributes the asset to a family limited partnership in exchange for a limited partnership interest and then contributes the discounted limited partnership interest to a non-grantor CLAT paying $56,000 a year for the next 22 years. If the section 7520 rate is 2.2%, the value of the retained remainder interest is $3,800. There is no gift if Senior retains the remainder interest.

If Senior had gifted the remainder interest to his children upon formation of the CLAT, his taxable gift would have been only $3,800.[9] Since the annual annuity is satisfied by the income from the trust principal, none of the trust principal is depleted, and at the end of the 20-year CLAT term, all trust principal passes to the children free of all gift and estate taxes.

---

[6] For charitable lead annuity trusts, the Section 7520 rate can be the rate for the current month or the rates for the two preceding months.

[7] If the settlor retains a interest in the trust valued at greater than 5% of trust assets, the trust is a grantor trust. § 673.

[8] The contributed asset was a limited partnership interest created by a $1,400,000 capital contribution that was earning 4.0% annually or $56,000. After discounting the limited partnership interest to $1,000,000, the artificial rate of return on the $1,000,000 discounted value of the limited partnership interest is now 5.6%.

[9] As discussed in Note 5 above, the retained interest cannot exceed 5% of trust assets.