
Splitting Assets Between Family and Charities at Death: Using CLATs to Improve the Opportunity Set*

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Peter Melcher, Matthew Zuengler and Caryl Shortridge Peters illustrate the advantages of using a CLAT when dividing assets between family and charities at death.

When a decedent dies, there are three places his or her assets can go: noncharitable beneficiaries, charitable beneficiaries or the government, in the form of taxes.¹ Many wealthy decedents wish to divide their assets (or a portion of their assets) between family and charity in varying proportions, with as little as possible going to the government. If the children are willing to wait for part of their inheritance, a testamentary charitable lead annuity trust (CLAT) can be used to greatly improve the choices the decedent has for dividing the assets among the three possible recipients. If rapidly-appreciating assets are used to fund the CLAT, it is even possible for family members to end up with more assets than if the decedent had made an outright bequest to them.

Opportunity Set

In general, an opportunity set is the set of all possible economic outcomes available to a decision

maker. In the present context, the decedent's opportunity set is the set of all possible ways of dividing the estate assets among the family, the charity and the government.

First, consider the opportunity set for outright bequests. Suppose that a decedent (D) wants to split the last \$1,000,000 of his estate between his son (S) and a charity (C). Assume that the marginal estate tax rate is 55 percent. At one extreme, D can give the full amount to his S. This will have the effect of including the full \$1,000,000 in D's estate and will produce the following division of the \$1,000,000:

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Splitting Assets Between Family and Charities

| | |
|------------|-----------|
| Son | \$450,000 |
| Government | \$550,000 |
| Charity | \$0 |

At the other extreme, if D gives the \$1,000,000 to C, the division looks like this:

| | |
|------------|-------------|
| Son | \$0 |
| Government | \$0 |
| Charity | \$1,000,000 |

D also could split the assets between S and C. Examples of the transfer combinations possible for D are provided in Table 1. The information shown in Table 1 can also be expressed in the form of a graph (see Graph 1). D can achieve any combination shown by the line in Graph 1. Note that the slope of the line is 1/2.22. This means that for every dollar by which D reduces the bequest to S, the bequest to C increases by \$2.22 and the amount received by the government decreases by \$1.22. Explained in another way, D can make charitable bequests at a cost of \$0.45 on the dollar (in terms of the cost to D's family). This is probably not a large enough reduction to encourage most decedents to make large out-

Table 1

| Total | Charity | Son | Government 55% |
|-------------|-------------|-----------|-------------------|
| \$1,000,000 | \$0 | \$450,000 | \$550,000 |
| \$1,000,000 | \$100,000 | \$405,000 | \$495,000 |
| \$1,000,000 | \$200,000 | \$360,000 | \$440,000 |
| \$1,000,000 | \$300,000 | \$315,000 | \$385,000 |
| \$1,000,000 | \$400,000 | \$270,000 | \$330,000 |
| \$1,000,000 | \$500,000 | \$225,000 | \$275,000 |
| \$1,000,000 | \$600,000 | \$180,000 | \$220,000 |
| \$1,000,000 | \$700,000 | \$135,000 | \$165,000 |
| \$1,000,000 | \$800,000 | \$90,000 | \$110,000 |
| \$1,000,000 | \$900,000 | \$45,000 | \$55,000 |
| \$1,000,000 | \$1,000,000 | \$0 | \$0 |

right charitable bequests unless they have a strong charitable inclination. However, some of the combinations toward the top of the chart involving relatively small charitable contributions might be appealing.

Zeroed-out Testamentary CLAT

By using a testamentary CLAT, the opportunity set can be expandable. Provided that the trust assets produce a return in excess of the Code Sec. 7520 rate and that both the family and charity receive some assets, using a CLAT will

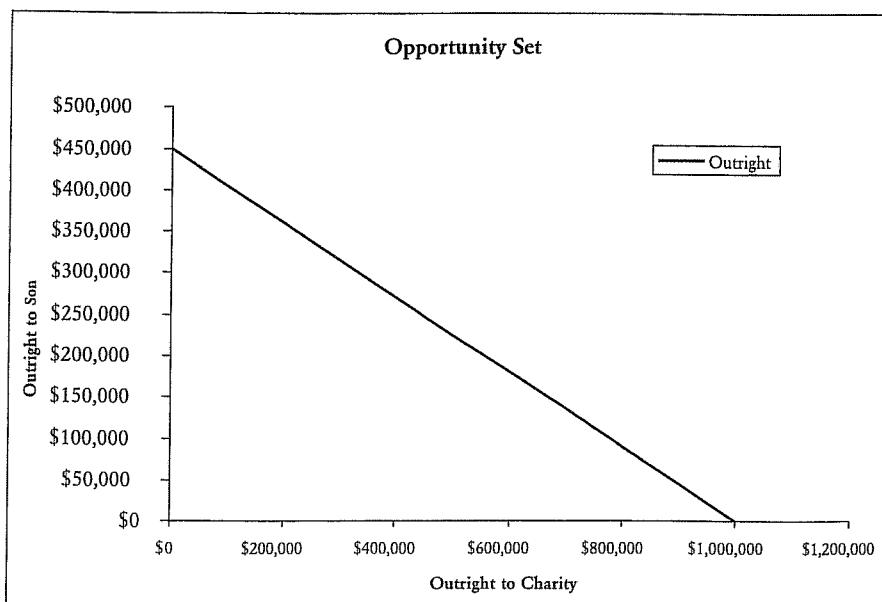
always produce a better result than outright transfers regardless of how the assets are split.

A CLAT is a split-interest trust that pays an annuity interest to a charity for the life of some person or for a term of years, with the remainder interest payable to a noncharitable beneficiary (typically, the settlor's children). The charity receives annual payments from the CLAT for a period of time, and what is remaining in the CLAT at the end of the term belongs to the decedent's family and passes to them with no further tax consequences. All estate tax consequences are fixed at the time the CLAT is created.

The decedent receives an estate tax charitable deduction for the present value of the lead interest while the present value of the remainder interest is includable in the gross estate. The present value of the remainder (the taxable interest) is equal to the total value of the property transferred to the CLAT minus the present value of the lead interest owned by the charity.

It is possible to set the value of the lead interest equal to the full value of the property transferred to the CLAT, making the value of the remainder interest zero.² This is done by fixing the amount of the annual payment equal to the

Graph 1



value of the assets transferred to the trust divided by the applicable annuity factor.³

Example 1. Assume that X wants to create a \$1,000,000 zeroed-out 20-year CLAT at a time when the Code Sec. 7520 rate is 6.2%. The term certain annuity factor necessary to produce a zeroed-out CLAT for a 20-year term and 6.2% Code Sec. 7520 rate is 11.285993.⁴ Because the value of the charitable lead interest is equal to the annuity factor multiplied by the amount of the annual payments, dividing \$1,000,000 by this factor will give the annual payment amount necessary to zero-out the CLAT ($\$1,000,000 / 11.285993 = \$88,605.41$); ($11.285993 \times \$88,605.41 = \$1,000,000.03$).

Why a CLAT Produces Advantages over an Outright Bequest There are two reasons why a CLAT can produce more favorable results than an outright bequest. One is that the remainder interest can be undervalued, and the other is that the assets inside the CLAT can generally grow tax-free if the trust is properly structured.

Undervaluation of the Remainder Interest. In valuing the remainder interest of the CLAT, the IRS assumes that the return on the trust assets will be equal to the Code Sec. 7520 rate. This rate varies and is equal to 120 percent of the applicable federal midterm rate. However, the Code Sec. 7520 rate is merely a statutory convention used to predict the return a trust would produce. If the total appreciation of CLAT assets (after tax) is equal to the applicable Code Sec. 7520 rate, it will turn out that the CLAT was

fairly valued. If the appreciation rate is more than the Code Sec. 7520 rate, the remainder interest will turn out to be undervalued and there will be tax savings.

If the actual return on the trust assets exceeds the Code Sec. 7520 rate, assets will remain in the trust to pass to the noncharitable beneficiaries at the end of the trust term. Since the amount of the taxable gift in the zeroed-out CLAT is zero, any assets remaining in the trust at the end of the term pass estate tax-free.

Example 2. D transfers \$1,000,000 to a 20-year testamentary CLAT. Assume that the applicable Code Sec. 7520 rate is 6.2%. The payout rate is fixed so that the value of the remainder interest is equal to zero. Under these facts, the annual payout necessary to zero out the CLAT is \$88,605.41 or 8.860541%, as explained in Example 1.

Table 2

| Trust Term | Beginning Underlying Value | Growth | Annual Payment | Ending Balance |
|------------|----------------------------|----------|----------------|----------------|
| | | 6.20% | | |
| 1 | \$1,000,000 | \$62,000 | (\$88,605) | \$973,395 |
| 2 | 973,395 | 60,350 | (88,605) | \$945,140 |
| 3 | 945,140 | 58,599 | (88,605) | \$915,133 |
| 4 | 915,133 | 56,738 | (88,605) | \$883,266 |
| 5 | 883,266 | 54,762 | (88,605) | \$849,423 |
| 6 | 849,423 | 52,664 | (88,605) | \$813,482 |
| 7 | 813,482 | 50,436 | (88,605) | \$775,312 |
| 8 | 775,312 | 48,069 | (88,605) | \$734,776 |
| 9 | 734,776 | 45,556 | (88,605) | \$691,727 |
| 10 | 691,727 | 42,887 | (88,605) | \$646,008 |
| 11 | 646,008 | 40,053 | (88,605) | \$597,455 |
| 12 | 597,455 | 37,042 | (88,605) | \$545,892 |
| 13 | 545,892 | 33,845 | (88,605) | \$491,132 |
| 14 | 491,132 | 30,450 | (88,605) | \$432,977 |
| 15 | 432,977 | 26,845 | (88,605) | \$371,216 |
| 16 | 371,216 | 23,015 | (88,605) | \$305,626 |
| 17 | 305,626 | 18,949 | (88,605) | \$235,970 |
| 18 | 235,970 | 14,630 | (88,605) | \$161,994 |
| 19 | 161,994 | 10,044 | (88,605) | \$83,433 |
| 20 | 83,433 | 5,173 | (88,605) | \$0 |

If the trust assets actually appreciate at 6.2 percent, the amount left in the CLAT at the end of the trust term will be zero and it will turn out that the remainder interest was fairly valued. (The present value of the interest was determined to be zero for transfer tax purposes, and that is what the interest was actually worth in retrospect.) See Table 2.

Example 3. Suppose, however, that the actual after-tax appreciation of the trust assets was 12% instead of 6.2%. Under these facts, there will be \$3,262,057 left in the CLAT at the end of the trust term (see Table 3). This amount passes to the children tax-free! In addition, the charity will have the future value of the \$88,605

annuity stream accumulated for 20 years. Assuming the same 12% rate of return, this amount is \$6,384,236. The last column shows the present value of the assets left in the trust at the end of the term (discounted back to present value at 12%). This amount reflects what the children would receive from the CLAT at the end of the trust term.

Achieving a Return in Excess of the Code Sec. 7520 Rate. Valuing interests in split-interest trusts by reference to the 7520 rate is a concession to administrative convenience. Neither the IRS nor the Tax Court wants to do a thorough valuation analysis every time someone transfers assets to a split-interest trust. The Code Sec. 7520 rate is meant to approximate the average return that might be expected on investment assets or perhaps a conservative return.

Of course, investment assets can have a broad range of expected returns. In creating a split-interest trust, the planner has the advantage of being able to choose the assets that will be contributed. In the case of a CLAT, where a high return produces a large advantage, the planner will try to find the fastest-appreciating assets possible given the client's risk tolerance. For grantors willing to invest in moderately risky assets, it generally has not been difficult to produce a return substantially in excess of the Code Sec. 7520 rate.

While the assets needed to produce a return substantially in excess of the Code Sec. 7520 rate may be riskier than average, they need not be anything out of the ordinary. Since the IRS began using the Code Sec. 7520 rates in 1989, the average rate has been about eight percent. By contrast, the average

compounded return on small cap stocks during that period has been about 13 percent. This latter rate is similar to the compounded rate of return produced by small cap stocks from 1925–2000, which was 12.6 percent.⁵ The rate of return on large cap stocks over the same period was about 11.5 percent.⁶

While this average rate of return is already substantially above the average Code Sec. 7520 rate, it can be enhanced by putting some hot assets into the trust (e.g., closely-held stock). Since most of the distributions probably will have to be made in kind and because the grantor probably doesn't want the charity to have these assets, the percentage of hot assets should not be too high.

Despite the fact that stocks have historically produced a total return substantially above the Code Sec. 7520 rate, it should be pointed out that some times might be better

than others to create a CLAT. Given the extremely low (or negative) current returns, many planners might not want to create a CLAT despite the fact that Code Sec. 7520 rates are at very low levels. Such planners might want to wait until the market shows some signs of life. Others might want to lock in a low Code Sec. 7520 rate now. Given the fact that the CLAT will run for 15 or 20 years, it is likely that total returns over this long period of time will approximate their long-term average. Moreover, the low current prices on stocks suggest that there is substantial room for growth at this time.

Tax-Free Growth of Trust Assets.

Unlike a charitable remainder trust, a CLAT is a taxable entity subject to the regular trust income tax rules of subchapter J. However, a CLAT is entitled to a charitable deduction for amounts it contributes to charity.⁷ The payments must be

Table 3

| Trust Term | Beginning Underlying Value | Growth | Annual Payment | Ending Balance | PV of Ending Balance |
|------------|----------------------------|-----------|----------------|----------------|----------------------|
| | | 12.00% | | | 12.00% |
| 1 | \$1,000,000 | \$120,000 | (\$88,605) | \$1,031,395 | \$920,888 |
| 2 | 1,031,395 | 123,767 | (88,605) | \$1,066,557 | 850,252 |
| 3 | 1,066,557 | 127,987 | (88,605) | \$1,105,938 | 787,185 |
| 4 | 1,105,938 | 132,713 | (88,605) | \$1,150,045 | 730,874 |
| 5 | 1,150,045 | 138,005 | (88,605) | \$1,199,445 | 680,597 |
| 6 | 1,199,445 | 143,933 | (88,605) | \$1,254,773 | 635,707 |
| 7 | 1,254,773 | 150,573 | (88,605) | \$1,316,740 | 595,627 |
| 8 | 1,316,740 | 158,009 | (88,605) | \$1,386,144 | 559,840 |
| 9 | 1,386,144 | 166,337 | (88,605) | \$1,463,876 | 527,888 |
| 10 | 1,463,876 | 175,665 | (88,605) | \$1,550,935 | 499,360 |
| 11 | 1,550,935 | 186,112 | (88,605) | \$1,648,442 | 473,888 |
| 12 | 1,648,442 | 197,813 | (88,605) | \$1,757,650 | 451,145 |
| 13 | 1,757,650 | 210,918 | (88,605) | \$1,879,963 | 430,839 |
| 14 | 1,879,963 | 225,596 | (88,605) | \$2,016,953 | 412,708 |
| 15 | 2,016,953 | 242,034 | (88,605) | \$2,170,382 | 396,521 |
| 16 | 2,170,382 | 260,446 | (88,605) | \$2,342,222 | 382,067 |
| 17 | 2,342,222 | 281,067 | (88,605) | \$2,534,683 | 369,162 |
| 18 | 2,534,683 | 304,162 | (88,605) | \$2,750,240 | 357,640 |
| 19 | 2,750,240 | 330,029 | (88,605) | \$2,991,663 | 347,352 |
| 20 | 2,991,663 | 359,000 | (88,605) | \$3,262,057 | 338,167 |

made pursuant to the governing instrument⁸ and qualify for the deduction only to the extent of the trust's distributable net income (DNI). Ordinary income of the trust that is distributed to beneficiaries is included in DNI.⁹ Although under the general rule capital gains are excluded from DNI, an exception is made for capital gains deductible under Code Sec. 642(c) as charitable contributions.¹⁰

The rule that DNI includes capital gains that are deemed allocated to charitable contributions is designed to insure that any payment to charity is fairly divided between capital gain and ordinary income. If not for the rule, a trustee could allocate only ordinary income to the payments to charity. Since the ordinary income typically is taxable at a much higher rate, this would produce an important tax advantage.

The effect of the Code Sections described above is that, if the CLAT is properly structured, it can substantially avoid income tax on the trust assets. Suppose, for example, that the CLAT produces a total return of 12 percent, of which 10 percent is appreciation and two percent is dividend. Suppose further that the annual payout to the charity is seven percent. The CLAT could distribute the two-percent dividend and sell enough of the assets to provide the other five percent. Alternatively, it could distribute enough assets in kind to make up the additional amount needed to make the seven-percent payout. The gains on these assets would be taxed the same as if the assets had been sold and the proceeds distributed to the charity. In any case, the total income of the trust would be seven percent and all of it would be distributed to the charity. Thus, if the trustee can control the receipt of income, income tax on earnings within the CLAT can be eliminated.

If, instead of using a zeroed-out CLAT, the settlor had made an outright bequest of the assets to the children, then the full amount of ordinary income and capital gain produced by the assets would have been taxable to the children. The assets could appreciate at the full 12-percent rate in the hands of the CLAT, but the appreciation rate in the hands of the children would be reduced by the amount of any income tax paid, reducing the effective growth rate of the assets in the hands of the children.

Opportunity Set for CLAT vs. Opportunity Set for Outright Bequest

We will now compare the opportunity set for a zeroed-out CLAT with the opportunity set for an outright gift when income tax consequences are taken into account. Because we are comparing the values the assets will grow after a period of time and presuming that they are being accumulated for the children's future use, we will assume that, in the case of an outright gift, the children would invest the assets mainly for growth. Thus, the bulk of the total return would be appreciation, but there might be minimal dividends as well. In addition, the portfolio of assets would likely experience some degree of turnover each year to readjust the portfolio holdings.

The following examples will assume an income tax rate of 39.6 percent for income generated on assets outside of the trust, applicable trust income tax rates on undistributed ordinary income generated inside of the CLAT, a capital gains rate of 20 percent, and a turnover rate equal to 15 percent. Further, it is assumed, unless otherwise stated, that yearly income (dividends) is generated at two percent, with a 10-percent

capital growth rate (12-percent total return).

The asset turnover factor could be reduced significantly if the assets were all invested in an index fund or increased significantly if the assets were actively managed. Further, the income produced by the assets could be affected significantly where the particular assets favored by the investor produced higher dividends.

For purposes of determining present value, all calculations assume an applicable present value rate equal to the total rate of return. For example, an assumed income return of two percent and capital return of 10 percent would give rise to a total return of 12 percent, and this rate would be used as the discount rate in calculating present value.

Example 4. D has \$1,000,000. D is trying to decide whether to make an outright bequest of this amount to S or to transfer it to a CLAT at his death. Assume the facts as outlined above. If D makes a \$1,000,000 outright bequest to S, S immediately would receive \$450,000 after taxes (assuming a 55% estate tax rate). If the assets generate a 2% income and 10% appreciation, S's assets would appreciate to \$3,568,371 at the end of the 20-year period (12% total return).

Assuming these facts, the comparison of future values looks like this:

| | Son | Charity |
|------------------------|-------------|-------------|
| Outright bequest | \$3,568,371 | \$0 |
| All to zeroed out CLAT | \$3,257,106 | \$6,384,236 |
| Difference | \$311,265 | \$6,384,236 |

Splitting Assets Between Family and Charities

Thus, by transferring \$311,265 of future value away from the family, D can increase her gift to the charity by \$6,384,236 in future value terms.¹¹

The opportunity set for D based upon these assumptions (illustrated on a present value basis) is shown in Graph 2. Line ABC represents the opportunity set (in present value terms) for outright bequests to C and to S. Point A represents an outright bequest of the full \$1,000,000 to S, Point C represents an outright bequest of the full \$1,000,000 to C and the points in between represent various combinations of the two.

Line ABC represents the opportunity set with the inclusion of a CLAT. Points between A and B represent combinations of transfers to a zeroed-out CLAT and an outright bequests. That is, they represent transfer of a portion of the \$1,000,000 to the CLAT and a portion to an outright bequest to S. Points between B and C represent combinations of transfers to a zeroed-out CLAT and an out-

right bequest to C. The optimal point on line ABC depends on D's charitable inclination.

Compare lines ABC and ADC. If D wants to transfer the full value of the property to S or the full value of the property to C, there is no difference (only endpoints A and C are relevant). If D wishes to transfer a portion to S and a portion to C, the CLAT *always* provides a better alternative. For any given value received by C, S receives more, and for any given value received by S, C receives more. Compare, for example, points B and D. Line BD represents the increased value S receives in a CLAT, compared to the amount received by S when D transfers \$1,000,000 outright to C.

Creating Negative Costs for the Family

If the appreciation of the trust assets is high enough, it is possible to provide the children with more at the end of the 20-year period by using a CLAT rather than by making an outright bequest of 100 percent of the assets to the children.

Moreover, the charity still will receive almost as much. The only loser in the equation is the government.

Consider the following example.

Example 5. Assume the same facts as in Example 4, except that the expected asset appreciation is 13%, while the asset continue to generate 2% income (a 15% overall pre-tax return).

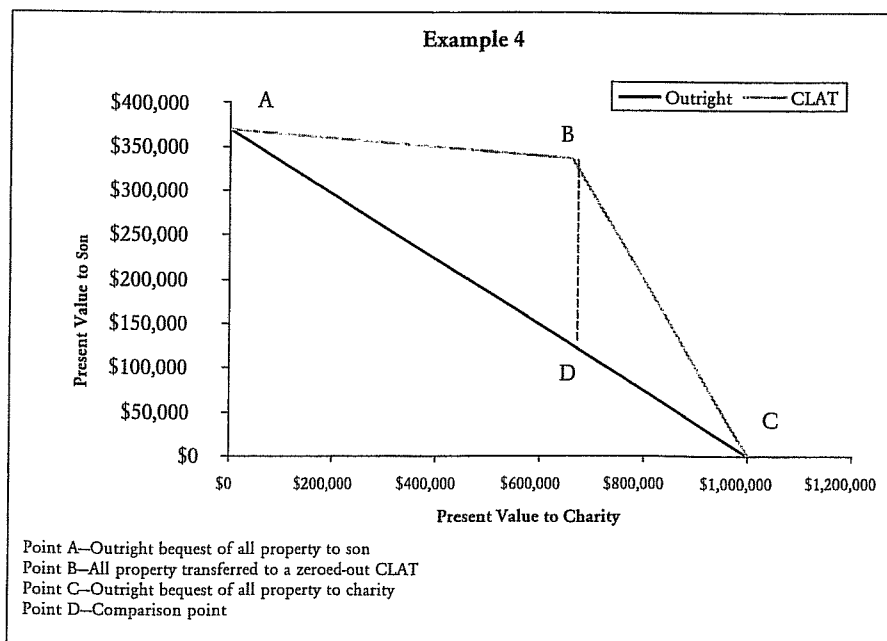
Now the numbers look like this at the end of the CLAT term:

| | Son | Charity |
|------------------------|-------------|-------------|
| Outright bequest | \$5,990,065 | \$0 |
| All to zeroed out CLAT | \$7,086,961 | \$9,077,055 |
| Difference | \$1,096,896 | \$9,077,055 |

D has transferred \$1,096,896 more to S (in future value terms) than in the outright gift scenario and has given \$9,077,055 to C as well. If the expected return of the assets is high enough, using a CLAT to transfer assets to C can actually have a negative cost for the family—the noncharitable beneficiary can end up with more than if D had made an outright bequest of the full amount.

Graph 3 illustrates Example 5 on a present value basis. Note that an outright gift to children on a present value basis is valued at \$365,995 rather than \$450,000. This difference is attributable to the fact that as each year passes, the holdings outside of the CLAT will be subject to both ordinary income tax as well as capital gains tax. At the end of the a 20-year term, the assets will therefore have appreciated at a rate less than 12 percent. Thus, when the growth is brought back to present value, the result is a present value much less than the \$450,000 with which the children began.

Graph 2



Clients willing to fund the CLAT with moderately risky growth stocks plus perhaps some stock in a fast-growing family business might have a fairly high probability of providing more assets for the children (in 20 years) than they would by making an outright bequest.

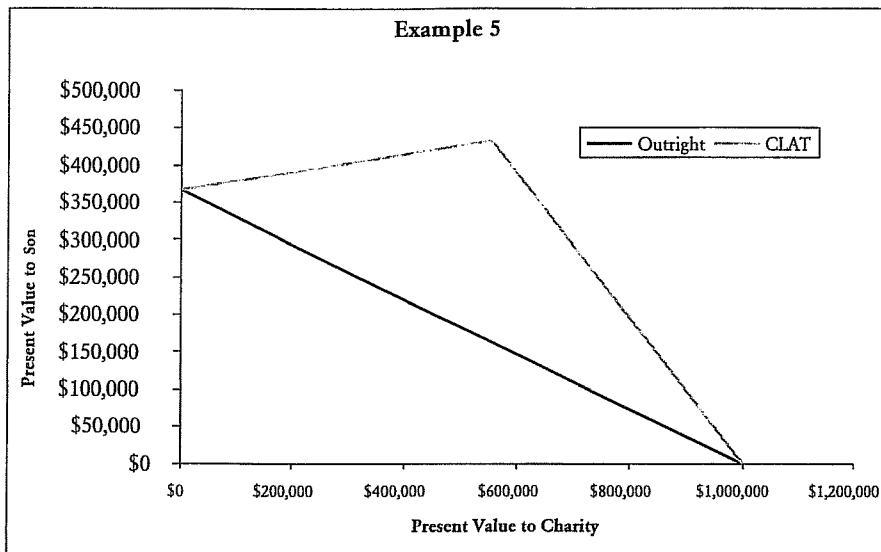
Increasing Payout CLATs

The benefits of a zeroed-out CLAT can be enhanced greatly if the CLAT is structured so that payments to the charity begin at a low level and increase by a given percentage each year during the trust term. Several commentators have pointed out that so long as the amounts to be paid are ascertainable on the date of the initial transfer to the trust, there appears to be no Code provision prohibiting increasing payout amounts to the charity.¹² Such back-end loading would keep more property in the trust in its early years. As a result, there would be more property to grow at a rate in excess of the Code Sec. 7520 rate, increasing the amount left in the trust for the noncharitable beneficiaries at the end of the CLAT term.

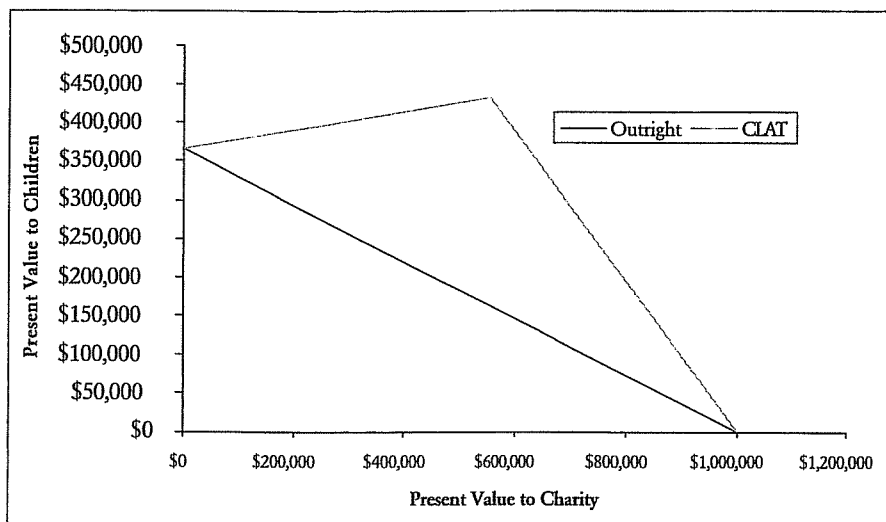
It is not clear how much the payments could increase from one year to the next. The most extreme case would be simply to have one balloon payment at the end of the trust term, but this arrangement would presumably not work because it is not really an annuity. The IRS might also argue that a series of very small payments (e.g., one dollar per year) with a balloon payment at the end of the term would also fail to qualify as an annuity.

Reg. §25.2702-3(b)(1)(ii)(A) provides that an annual payout from a grantor retained annuity trust (GRAT) may exceed the payout from the previous year by as much

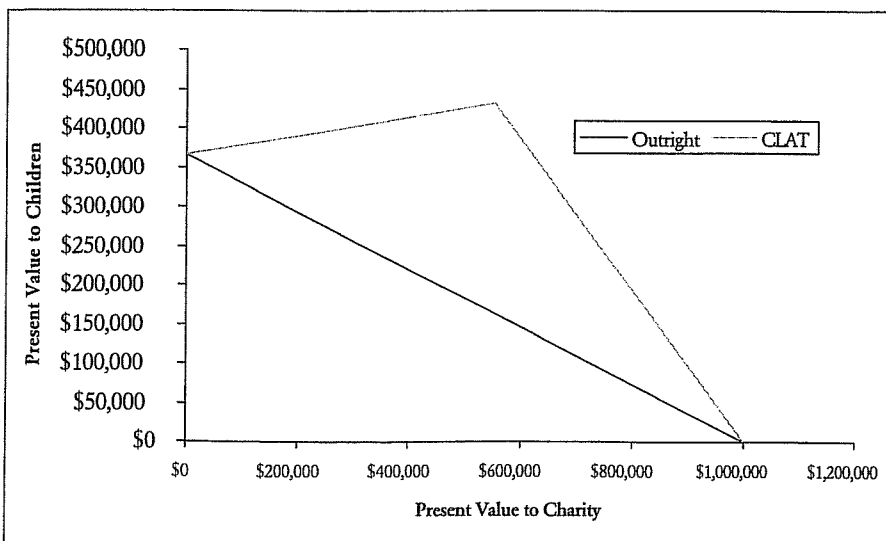
Graph 3



Graph 4



Graph 5



as 120 percent. To illustrate, if the payment for year one is 100, the payment for year two can be as much as 120 and the payment for year three, 144 and so on.

Using an increasing payout feature reduces the rate of return necessary for the CLAT to provide more to the children than they would receive with an outright gift. However, the structure of increasing the annuity payment in the early years may necessitate recognition of income tax as the annuity payment may be insufficient to negate income and capital gain recognized within the trust entirely, somewhat mitigating the benefit.

Consider the following example using the 20-percent increase allowable for grantor retained annuity trusts (GRATs).

Example 6. Operating under our basic set of assumptions, assume a growth rate of 10% with income generated at 2% (as was the case in Example 4). However, assume that the payout to C increases by 20% each year. In this case, the opportunity set is illustrated in Graph 4.

It may be possible to have annual increases in the charitable payout far greater than 20% per year. The following example illustrates how a higher rate would improve the results even more.

Example 7. Assume the same facts as in Example 6 except that the annual increase is 40%, as shown in Graph 5. Note that from the graph the increase from 20% to 40% did not have a significant effect on the amount of wealth passing to the children. On a present value basis, the difference in the amount passing to children is relatively small. Under

the same assumptions, a 40% increasing annuity yields \$505,648 on a present value basis, while a 20% increase yields \$485,725, a difference of slightly less than \$20,000.

Lifetime Nongrantor CLATs

Similar benefits can be produced with lifetime zeroed-out, nongrantor CLATs set for a term of years. Lifetime CLATs will not perform as well as testamentary CLATs when compared with an outright gift, because the lifetime gift is subject to a lower effective transfer tax rate than a transfer at death. While the tax base for the estate tax is the value of the assets in the taxable estate before estate tax is paid, the base for calculating the gift tax is only the amount of property the beneficiaries actually receive after payment of taxes. Thus, the gift tax is said to be tax-exclusive, while the estate tax is tax-inclusive.

The tax-exclusive rate is equal to the applicable tax-inclusive rate divided by one plus that rate. For example, if the transfer tax rate is 55 percent, the tax-exclusive rate is $.55/1.55 = .3548387$. For a 60 percent tax-inclusive rate, the tax-exclusive rate is $.6/1.6 = .375$. For a 50 percent rate, it is $.5/1.5 = .33333$.

To illustrate, suppose that D is in the 50 percent marginal transfer tax bracket and has \$90 he or she wants to transfer to the children. If D transfers the property at death, the full \$90 is subject to the estate tax. The tax payable will be \$45 and the beneficiaries will receive \$45. If D transfers the property during life (and survives for at least three years after the transfer), the tax payable will be \$30 and D's beneficiaries will receive \$60. Note that the tax payable is $.5 \times \$60$.

As a result of the lower tax-exclusive rate, it will be much more difficult for a CLAT to outperform an outright gift than to outperform an outright bequest because the children will start out with significantly more money in the gift scenario. No transfer tax is paid on the zeroed-out CLAT in either case, so there is no corresponding advantage to the CLAT. Nevertheless, the opportunity set for D still can be far more favorable than the opportunity set for an outright gift.

Conclusion

Wealthy individuals who wish to divide assets between their children and charities at death can always greatly improve their options by using a CLAT, provided that the assets have an expected return in excess of the Code Sec. 7520 rate. For moderately high expected returns, CLATs provide a tax-favored way of dividing assets between family members and charity. Under more favorable return assumptions, using a CLAT to transfer assets to a charity can have negative costs for the family, particularly if payouts increase from one year to the next.

ENDNOTES

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¹ Since this article was first conceived, the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) repealed the estate tax for estates of decedents dying after December 31, 2009. However, a sunset provision included in the Act repeals all of its provisions, effective December 31, 2010, thus reinstating the estate tax (at its current rates) in 2011. There is talk of the sunset provision itself being repealed, but most knowledgeable professionals that the authors have spoken with believe that it is unlikely that the full estate tax repeal will ever go into effect. In any case, the fact that the instrument discussed in this article, a zeroed-out CLAT, involves no current tax-

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income in excess of the annuity payment. In Example 3, it was assumed the annuity was always high enough to eliminate all income tax payable. However, in Example 4 and the examples following, we assumed flat income and asset turnover rates. As the amount in the CLAT increased, the income tax payable began to exceed the amount covered by the distributions to charity in the last few years of the CLAT term.

¹² See e.g., Jonathan Gopman and Daniel Mielnicki, *Planning with Testamentary Charitable Lead Annuity Trusts*, TRUSTS AND ESTATES, June 1999, at 46; and Byrle Abbin, *University of Miami Heckerling Institute* 2000, at §10.

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able gift and can be unwound before death if it appears that the estate tax has been permanently repealed makes it an excellent hedging strategy for wealthy taxpayers who wish to benefit charity.

² Reg. §20.2055-2(f)(2).

³ This factor can be found in Table B of IRS Pub. 1457 (1999), or more accurately derived as follows: $(1 - ((1 / (1+i))^n)) / i$; where i is the Code Sec. 7520 rate and n is the number of years the CLAT will be in existence.

⁴ $(1 - ((1 / (1+.062))^20)) / .062 = 11.285993$.

⁵ Ibbotson & Associates.

⁶ *Id.*

⁷ Code Sec. 642(c).

⁸ Code Sec. 642(c)(1).

⁹ Code Sec. 643.

¹⁰ Code Sec. 643(a)(3).

¹¹ Note that the amount passing to the son with a CLAT under the assumptions in Example 4 is slightly less than amount illustrated as passing to the son in Example 3. This difference is attributable to the CLAT recognizing