Giving That Gives Back

LARGE INCOME TAX EVENTS ARE OFTEN met with distress by tax bill recipients, but they are a nice problem to have.

Over the last several years, we have encountered this type of "problem" many times, with hedge fund principals who must recognize income on offshore deferrals (all such deferrals must be taken by 2017); executives receiving sizable bonuses or golden parachutes; individuals recognizing significant Subpart F income from offshore holdings; individuals converting a significant IRA to a Roth; collectors who have sold art or collectibles for a significant profit that will be taxed at a 28% federal capital gains rate; and investors who have significant recapture at ordinary income rates upon the sale of an asset.

There are various ways to manage the ultimate income tax liability. Many wealthy people who face this problem, for example, have the dual goals of supporting charities they care passionately about and efficiently transferring wealth to their loved ones. For these individuals, the solution is statutory and reasonably straightforward: a charitable lead annuity trust (CLAT).

"We make a living by what we get, but we make a life by what we give," Winston Churchill observed. A zeroed-out grantor CLAT embraces this philosophy by reducing or eliminating federal income tax triggered by an income tax event, while transferring significant funds to a charity the settlor cares deeply about. If the CLAT investments perform well, sizable wealth can be transferred to children and other loved ones free of gift and estate taxes.

A CLAT provides a series of annual payments to a charity over a defined number of years, with any remaining assets passing to beneficiaries. The charitable annuity is fixed at initial funding and will not change even if the assets in the CLAT grow substantially. With a zeroed-out CLAT, all of the property transferred to the CLAT plus an IRS-prescribed interest rate has to be paid to charity over the term of the trust. The donor sets the trust term, which, for this type of planning, might range between 10 and 25 years, depending on the grantor's age, health and charitable goals.

CLATs work very well when interest rates are low because their effectiveness depends on an investment return in excess of the rate the IRS uses to calculate the annuity payments that go to charity. Currently, the lowest IRS-prescribed rate is 1.2%, which means the IRS assumes that any trust funded in April 2013 will earn 1.2% for the term of the trust, and no more. If the CLAT earns greater than 1.2%, the excess return can pass to the settlor's beneficiaries free of gift and estate tax. The greater the spread between the IRS rate and the actual

rate, the larger the trust remainder.

The longer the term of the CLAT, the more time the money has to compound and surpass the IRS rate. It's also important to note that charitable annuity payments do not have to be spread out equally. Indeed, paying out very small annuity payments to the charity during the early years of the CLAT can further enhance returns. More assets are left in the trust to outperform the 1.2% hurdle rate for a longer period of time by starting with small payments and allowing the payments to increase by 20% per year. This creates a win-win situation for charities and beneficiaries: Charities receive significant funding over a term of years and, at the end of the CLAT term, loved ones can see significant assets pass to them tax-free.

Another key advantage to a grantor CLAT is the large income tax deduction generated by the annuity payments. This benefits the settlor immediately, even though payments to the charity occur over time. Typically, the deduction can offset up to 30% of the settlor's adjusted gross income (AGI) by funding the CLAT in the first year. If the settlor's AGI is not large enough in the first year to use the entire deduction, the charitable deduction can be carried forward for five additional years. The annuity should seldom be any larger than the charitable deduction amount that could be used up in the CLAT funding year plus the five following years. Most CLATs are designed to use the charitable deduction up in one to two years.

A grantor CLAT has one significant drawback: The settlor of the trust is taxed on all of the income earned in the CLAT. Outside funds must be used to pay this liability since no payments back to the settlor are permitted until the charitable annuity has been paid in full. Without additional planning, all of the trust's income and gains will be taxed to the settlor. The necessary planning should be straightforward and will, depending on the client's goals, eliminate nearly all of the federal income tax liability generated by the CLAT. The CLAT will simply hold a significant portion of its assets in a private placement life insurance (PPLI) policy or private placement annuity. The holder of a tax-compliant PPLI policy is generally not taxed on growth in the policy's value.

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>
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A PPLI policy is a variable universal life insurance policy designed to have high cash values. The policy's assets are usually invested in hedge funds or hedge-fund-like investments. The fact that the investments generate tax-inefficient returns—typically short-term capital gains and ordinary income—is irrelevant because a life insurance policyholder pays no income taxes on the policy's investment earnings. The policy will also provide a significant death benefit. Depending on the policyholder's age, a PPLI policy will typically provide a death benefit equal to three or four times the amount of cash originally invested in the policy. A PPLI policy is best used if there is $3 million to $5 million available to invest.

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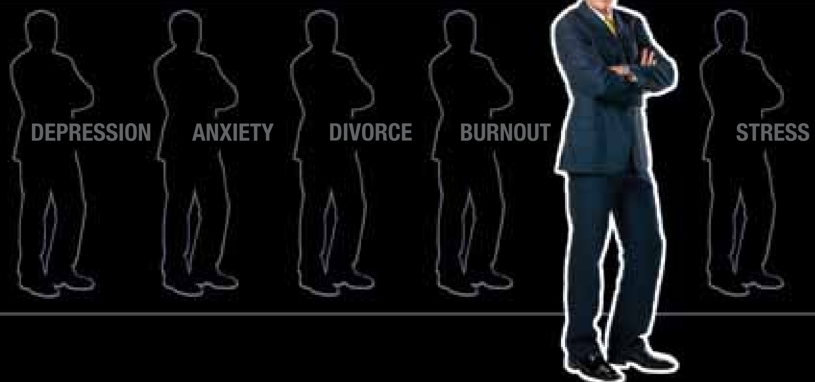

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A PPLI policy contained in a CLAT is generally designed as a non-modified endowment contract so the cash value can be accessed to make annuity payments. In most cases, this will require funding the PPLI over three to four years. Typically, with a charitable annuity that increases 20% per year, it is not unusual to leave a small percentage of the original contribution outside of the PPLI policy so that the first six to eight years of payments can be made to charity without accessing the PPLI contract. There are many intricacies to PPLI policies, but with federal ordinary income tax rates topping out at 39.6%, rising state and municipal income tax rates (New York City and California are in the low teens), and the additional 3.8% health-care tax applicable to investment income, private placement life insurance is an excellent antidote to taxes approaching or exceeding 50%. (For more on this insurance, see "Keeping What You Make" in the March/April 2013 issue of *Private Wealth*.)

Let's look at an example of how a CLAT can be used to lower tax obligations on a large tax event. Let's say a hedge fund manager has significant offshore deferrals that he must bring onshore. Under the terms of his plan, he must recognize $5 million of income this year. He also has other income of $25 million. The client would prefer not to pay 50% of the $5 million to state and federal governments, and is passionate about a particular small charity. He also has children he would like to benefit. The client sets up a CLAT and funds it with the $5 million. Because his AGI will be large enough, he will effectively offset the $5 million of income from the repatriation of the deferred income.

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Instead of having $2.5 million of after-tax income, all $5 million can be used to support the client's favorite charity. In addition, to the extent the trust's investments outperform the 1.2% hurdle rate, significant assets can pass tax-free to his loved ones. Assuming the trusts earn a net return of 8% (remember, there is no income tax drag either because the settlor is paying the tax from outside funds or because the assets are sheltered inside a PPLI policy), after 20 years, more than three times the value of the original CLAT contribution would be available for loved ones or trusts for their benefit. Nearly $5.3 million would have been paid to charity, and the CLAT was seeded with $5 million of capital free of federal income tax. State tax consequences vary depending on how state tax law limits charitable deductions.

The current interest rate environment favors this type of planning. The planning is technical and there are traps for the unwary, both with the CLAT and the PPLI portions. But for many people, the results more than compensate for the complexity of the planning. PW

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