Daily Journal

Oct. 22, 2019

Charitable lead annuity trusts may make you yawn, but they work

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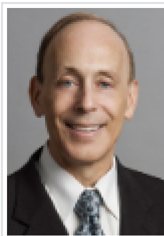

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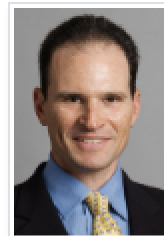

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April 15, 2020, the due date for your personal income tax return (IRS Form 1040) is almost exactly six months away. If you have a closely held business which sponsors a tax qualified employee retirement plan, e.g., a Section S401(k) and/or a defined benefit pension plan, you can make a large tax deductible contribution as late as the due date, plus extensions, for the business's return. If your business is an "S" corporation, typical for a law firm, that would be March 15, 2020 (extended to as late as Sept. 15, 2020).

However, for deductions not tied to your closely held business, you only have until the end of 2019 — a little less than 2.5 months from now — to generate legal and ethical deductions that will impact the amount of tax you owe on April 15, 2020.

In this age, any legal and ethical deductions will not be — using baseball (potentially a sore subject in Los Angeles) as a metaphor) — a home run or even a triple. However, for at least some people a good, solid double is available. And there is enough time between now and year end for you to put it into effect.

A charitable lead annuity trust ("CLAT") can provide payments to a charity for fixed term of years. You can pick your favorite charity, which might be your own family foundation, your favorite public charity or a donor advised fund. (Donor advised funds are offered, for example, by the California Community Foundation, most universities, and most big money managers, e.g., Schwab and Morgan Stanley.) At the end of that term of years, whatever is left in the trust can revert to the donor or be transferred to a trust for the donor's children. (There are other ways to use a CLAT: It can, for example, continue for the donor's entire lifetime.) This structure is especially attractive right now due to the low interest rates the IRS requires for purposes of computing the charitable deduction's value: 1.8% for October. Here is an example:

Mom and Dad establish a 16-year CLAT before the close of business on Dec. 31, 2019. They contribute $500,000 to it. The charity which is the remainder beneficiary is private foundation which they dictatorially control. Mom and Dad are the CLAT's trustees so they determine how the $500,000 is to be invested. As trustees they have the CLAT buy a single family residence, debt free, that generates $11,000 of distributable cash flow of per year. That $11,000 is enough to pay all the CLAT's expenses, the biggest of which is the cost of having their CPA prepare the CLAT's tax return (IRS Form 5227). There is enough left over to distribute $9,000 per year (1.8% of $500,000) to the private foundation.

The CLAT is disregarded for income tax purposes, meaning Mom and Dad must pay the tax on the CLAT's income. However, since the CLAT bought a piece of income producing real property, the depreciation covers the rental income: $500,000 purchase price of which half is allocable to the structure — $250,000 divided by the 27.5 year depreciable life = $9,090 per year. During the 16 year period the property appreciates 5% per year. As a result, at the end of the 16 year term, the property is worth $1,000,000. The CLAT borrows $500,000 and distributes the loan proceeds to the charity. The property, subject to the mortgage, is distributed free of estate, gift and income tax to the trust for Mom and Dad's children.

If Mom and Dad have a large estate, the ability to get their children an extra $500,000 that does not count against Mom and Dad's combined lifetime transfer tax exclusion ($11,400,000 per parent, dropping to $6,500,000 per parent in 2026), is a nice benefit.

So, in this example, the CLAT has three advantages. (1) Mom and Dad get an up front deduction equal 100% of their contribution (which they can use against up to 20% of their adjusted gross income). (2) Mom and Dad pick their favorite charity, which happens to be their own private foundation. (3) Mom and Dad convey to their children's trust free of estate, gift and income tax an amount that does not count against their lifetime transfer tax exclusion. The structure's potential negative — the CLAT is disregarded for income taxes so Mom and Dad must pay the tax on its income — is eliminated due to the thoughtful investment in income producing real estate.

What if Mom and Dad do not want to buy income producing real estate? If they invest in stocks and bonds, they will be taxed on the CLAT's income. They can minimize that negative by investing in securities that mostly appreciate in value rather than generate dividends. This way the "tax burn" will be limited to a small amount of capital gains tax each year.

The current low (1.8%) interest rate required by the IRS is only good for October. It will increase to 2% in November. Both of these low interest rates give taxpayers faith that they can, over a long period of time, have assets outperform those rates. If that occurs, good value can pass to their heirs (or revert to the taxpayers) free of estate, gift and — with thoughtful planning — income tax.

There are, of course, other ways to generate income tax deductions as we get to the close of calendar 2019. Buying a building will generate some deductions. The same is true with vineyards and similar properties, e.g., land that grows almonds. But buying those properties is primarily an economic, not a tax decision. Primarily tax motivated decisions will come in the form of programs that will be offered such as oil and gas drilling (it's not the deductions which are the issue — it's the economics); conservation easements (which the IRS does not like); and heaven knows which new ones will be popping up. Beware. CLATs may be boring. But they are sanctioned by the Internal Revenue Code. And they work. □