DOING GOOD BY DOING WELL

Why Business Owners Should Embrace the Grantor CLAT

[Charitable Lead Annuity Trust]

CENTURA WEALTH ADVISORY

DOING GOOD BY DOING WELL:
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EXECUTIVE SUMMARY: While interest rates remain relatively low, owners of business interests or high-income producers with charitable motivations should seek to combine their income tax reduction objectives with structured yearly donations to worthwhile causes by using a grantor charitable lead annuity trust (G-CLAT). In most cases, it will be preferable to structure the G-CLAT so that the annual charitable donations paid from the trust are heavily weighted in the latter years of the trust's existence. Locking in the benefits of the G-CLAT deduction now before interest rates rise will leverage the charitable deductions taken for both income and gift tax purposes. Additionally, involving a relative or close associate in the transfer of closely-held business interests to the G-CLAT can enhance certain tax consequences and minimize the risk of a successful IRS challenge. The income tax deduction can be up to the contribution to the G-CLAT. The G-CLAT can include providing an additional significant leverage for wealth transfers to intended heirs as optional benefit.

High-income producers may continue to avail themselves of the benefits of a large charitable deduction despite limitations on other deductions imposed by the Tax Cuts and Jobs Act (TCJA) within the parameters of existing tax law limits based on their adjusted gross income (AGI) thresholds. This paper will discuss simple and sophisticated uses of a G-CLAT using a series of responses to frequently asked questions (FAQs) to introduce various concepts and illustrate how income tax and wealth transfer results may be achieved. An alternative strategy using a paid-up insurance policy instead of, or in addition to, transferring business interests is briefly explored but is generally beyond the scope of this paper. Also, combining the G-CLAT with other charitable giving techniques to provide the grantor with additional cash flow is mentioned as a consideration that is part of a final comprehensive example.

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[1]The comments and opinions contained in this paper are those of the author, Mark C. Morris, JD, CPA, LL.M. They do not necessarily represent the position of LevitZacks, CPAs, his employer. Each taxpayer should rely upon the tax advice of his or her own tax preparers or representatives regarding the specific facts relating to their own situation and unless otherwise expressed in a separate written engagement letter, the author does not represent any specific taxpayer in possession of this paper. Mark C. Morris is a graduate of Brigham Young University B.S. Accounting (cum laude), J. Reuben Clark Law School (BYU Law) (J.D. cum laude) and the University of San Diego, Graduate School of Law (LL.M. Taxation summa cum laude). He is a member of the California State Bar and a certified public accountant in California. He serves as Tax Counsel to LevitZacks, CPAs and has been very involved in researching estate planning and tax related issues for clients well over thirty-six years.

13 FAQS ABOUT G-CLATS:

1 What Is A G-CLAT And Does The IRS Approve Of Their Use?

A grantor charitable lead annuity trust (G-CLAT) is just one type of charitable lead trust (CLT). CLTs fall into a special category of trusts that have both charitable and non-charitable beneficiaries, so they are referred to as "split-interest trusts." There are three approved types of split-interest trusts in the tax law that must comply with certain requirements to achieve a charitable deduction: CLTs, charitable remainder trusts (CRTs), and pooled-income funds (PIFs). This paper will focus on CLTs and primarily on G-CLATs. CLTs provide for an annual (or more frequent) payment to charitable beneficiaries. There are two types of CLTs: CLATs which pay a fixed amount (or annuity) to charity and CLUTs (charitable lead unitrusts) which pay a fixed percentage of the trust to charity. For various reasons, including the fact that they are not as efficient in achieving most grantors' tax and economic objectives, CLUTs are rarely used.

There are two basic types of CLATs; namely, grantor lead trusts and the non-grantor lead trusts. In the case of the non-grantor type lead trust created during lifetime, no income tax deduction is available to the grantor (only a gift tax charitable deduction). Instead, the trust itself receives an income tax deduction each year income is used to make the charitable annuity payments. In the case of a grantor lead trust (G-CLAT), the grantor retains powers which cause the trust to be treated as though the trust assets were owned by the grantor for income tax purposes. This allows the grantor to receive a large charitable income tax deduction in the year a G-CLAT is established based on the actuarial value of the annuity income stream paid to charity over the trust term.

CLATs may also be characterized into two types depending on when they take effect. A testamentary CLAT comes into existence on the death of the grantor and are formed pursuant to a will provision or a sub-trust designation within the grantor's revocable trust dispositions. Since they arise after the grantor's death, all testamentary CLATs are non-grantor CLATs. A grantor that creates a CLAT during her or his lifetime is referred to as an "inter vivos" CLAT. In the early existence of G-CLATs, it was prudent to obtain a private letter ruling (PLR) to ensure the anticipated tax benefits would be obtained. This was especially true for navigating the rules to achieve "grantor trust" status for income tax purposes by having the grantor retain sufficient administrative powers, but not retain so much power as to cause estate tax inclusion of the trust assets. In 1996, the author of this paper assisted a client in obtaining one of the earliest PLRs dealing with G-CLATs involving a unique use of these retained powers by lodging a non-fiduciary power of substitution with a relative of the grantor (a sister or brother). In subsequent years, many others followed suit and also obtained such favorable rulings. See PLRs 200011012, 200010036, 19922007, 199908002, and 9810019. With the promulgation of Rev. Proc. 2007-45, Section 8.09, 2007-2 CB 89 it is no longer necessary to seek a PLR regarding this type of G-CLAT since the sample language issued by the Internal Revenue Service provides a template for such trusts that all taxpayers may rely upon.

2 What Type Of Charities May Be Annuity Beneficiaries Of A G-CLAT And How Does That Affect The Charitable Deduction?

The grantor may select a public charity, a donor advised fund, or a private foundation as the charitable beneficiary of a G-CLAT. Direct gifts to a public charity or donor advised fund of a public charity of cash are generally limited to 60% of the taxpayer's "contribution base" (hereafter "contribution base" will be referred to as "AGI" since it closely approximates that figure in most cases; in addition, for tax years after 2025 the limitation reverts to a 50% of AGI threshold). However, the IRS and the Tax Court have imposed a further restriction of G-CLATs because they consider that all charitable trust transfers are "for the use of" rather than "to" a charitable organization. Treas. Reg. Section 1.170A-8(a)(2); James v. Comm'r., 62 T.C. 209 (1974). See also, Rev. Proc. 2007-45, Section 8.01(3), 2007-2 CB 89. Contributions "for the use of" qualified charitable organizations are subject to a limitation of 30% of the taxpayer's AGI. A special rule applies to certain long-term capital gain property donated "for the use of" public charities and "to" or "for the use of" other organizations such as private foundations. In those cases, the contribution is limited to 20% of the taxpayer's AGI. See IRC Section 170(b)(1)(D). The deductions so limited by these AGI thresholds for a contribution tax year may be carried over to the next five tax years.

3 How Long May A G-CLAT Be In Existence And Who May Be Designated As The Remainder Beneficiary?

The payments to charity may be structured based on (a) a fixed number of years; (b) the life (or lives) of an individual (or individuals), or (c) the shorter of a fixed term or the life of an individual. Selection of the lead term paid to charity will affect the actuarial determination of the value of this beneficial interest and thus the contribution deduction. The only individuals other than the donor and donor's spouse who are permitted to serve as the measuring life or lives of a CLAT are those who are lineal ancestors or spouses of lineal ancestors of remainder beneficiaries. In addition, the individuals chosen must have at least a 50% chance of surviving a full year after the contribution is made. If there is any question about the terminal condition of an individual then a written opinion from the doctor indicating there is at least a 50% chance of one-year survival should be obtained.

4 May The G-CLAT Distributions To Charity Be Structured So That A Retained Or Gifted Remainder Interest Is Valued At Or Near Zero?

Yes, this is possible for G-CLATs with a fixed term of years. It is accomplished by intentionally setting annuity amounts so that the present value of the entire charitable annuity is exactly equal to the contribution. However, current Treasury regulations make it impossible to effectively zero out a level payment life term G-CLAT. The mechanics of the calculation preventing a complete zeroing out of a life-term G-CLAT are beyond the scope of this paper. If a life term is chosen some value will be assigned to the remainder interest but calculations can be performed to arrive at an optimal value for the remainder interest given certain variables (i.e., the interest rate for month of contribution, the amount of the annuity, and the normal life expectancy of the individual selected). For example, a grantor could form a G-CLAT with $1 million cash in June 2018 (when the applicable interest rate will be 3.2%) with the charitable term set for 20 years. If $68,470 (6.847% of the contribution amount) was paid annually to charity, the charitable deduction would be $1 million and the remainder interest (which could be retained by the grantor or given to family members) would be valued at zero for gift tax purposes. If instead 5% of the contribution amount (an annuity of $50,000) were paid to charity for the 20 years, then the charitable deduction would be about $730K (remainder of about $270K). If the grantor was age 57 and there was a $50,000 annuity for his lifetime paid to charity then approximately the

same charitable deduction of $730K (remainder of about $270K) could be obtained even if the grantor dies prematurely (say, within two years following a contribution). In that case, the grantor's designated remainder beneficiaries receive a windfall (the entire balance of the G-CLAT at that time). Thus, the charitable lead interest is subject to a mortality risk when a G-CLAT with a life term is used. As a result of mortality risk, if the grantor was age 65, the annuity to the charity during lifetime could be increased to $59,800 if the same $730K charitable deduction was desired.

5 What Happens To The Charitable Income Tax Deduction If The Grantor Dies Prematurely (Before The Term Of The G-CLAT Or Before His Or Her Normal Life Expectancy)?

The charitable deduction taken on the individual grantor's income tax return is locked in if all the terms of the G-CLAT were complied with on formation and the transaction was properly reported. In fact, after the normal three-year statute of limitations for personal income tax returns, the IRS cannot challenge the transaction. If the grantor reported a gift of the remainder interest in the G-CLAT to others on his gift tax return (e.g., a gift of $270K using up a portion of his $11,180,000 available gift tax exclusion amount in the example described within Answer #4 above) then that properly disclosed gift tax value would also not be subject to IRS challenge involving resulting gift tax consequences after three years. However, the G-CLAT had a 20-year term so if the grantor dies after the 10th annuity amount was paid, then approximately half of the previous charitable income tax deduction should be reported as an income tax item on the grantor's final return. See IRC Section 170(f)(2)(B). This is sometimes referred to as an income tax recapture of the previous charitable deduction. The actual amount of the recapture is the difference between (a) the amount of the previous income tax deduction, and (b) the discounted value of all the amounts previously paid to charity at the time the CLAT lost its grantor trust status (in this case, because of the death of the grantor). See Treas. Reg. Section 170A-6(c)(4). The rationale for this recapture rule is that the trustee of the former G-CLAT which becomes a non-grantor CLAT on the death of the grantor still must finish paying the annuity amount during the remaining term of the CLAT so each payment results in charitable deduction under Section 642(c) (not subject to any AGI limitations) against any CLAT income for each year a payment occurs. The recapture rule prevents a double deduction benefit (i.e., a deduction for both the upfront G-CLAT deduction on formation and the recurring Section 642(c) deductions after grantor trust status is lost. A premature death of a grantor of G-CLAT based on the lifetime of the grantor (or premature death of another individual that is the measuring life of the G-CLAT) does not result in any recapture income according to the current regulations.

6 What Income Tax Consequences, Besides The Potential Recapture Rule For A Premature Death During The Term Of A G-CLAT, Are There To The Grantor Following The Trust's Formation?

Since all G-CLATs are grantor trusts, any income generated by the trust assets will be taxable to grantor. However, unless the grantor retains the remainder interest in the G-CLAT, he or she is not a beneficiary. Moreover, only annuity payments are made to charity during the term of the G-CLAT so the trust's taxable income will be reported on the grantor's income tax return with no means of providing funds to pay the associated income tax liability. Some commentators have expressed that the grantor's increased income tax liability for assets no longer accessible to the grantor is a severe economic disincentive in forming a G-CLAT. They recommend only forming a G-CLAT that is funded with tax-exempt municipal bonds so the benefits of the charitable deduction may be obtained without incurring an onerous income tax liability over the trust's term. Some even suggest finding ways to place a life insurance policy around the intended trust investments and then transfer a paid-up policy into the G-CLAT to avoid the recurring income tax liability associated with

the trust assets during the term. Both of those techniques are viable alternatives to consider in the right set of circumstances. However, wealthy individuals that may otherwise be subject to estate tax should find the G-CLAT's grantor-trust status a very useful tool not only to obtain a substantial charitable income tax deduction but also as a means to achieve significant wealth transfer to the next generation. Indeed, estate planners have been touting the benefits of an intentionally defective grantor trust (IDGT) for years as a means to transfer significant wealth to future generations. It is almost humorous to see some commentators discuss the grantor's recurring income tax liability of G-CLATs in negative terms but in other contexts extol the benefits of an IDGT in transferring wealth without acknowledging they are discussing the same concept. A G-CLAT is a form of an IDGT that, with the exception of having a charitable beneficiary which allows for a sizable income and gift tax charitable deduction so it is also a "split-interest trust", has all of the same wealth transfer benefits if the leveraged remainder interest is structured to be another grantor trust for the benefit of future generations. The only major estate planning downside in choosing a G-CLAT for wealth transfers (acknowledging of course that an income stream is dedicated to charitable causes) rather than an IDGT is that the grantor's generation skipping transfer tax (GST tax) exemption cannot prudently be assigned to the G-CLAT during its term because of some special GST rules. Consequently, if the remainder interest beneficiaries consist of non-skip persons (e.g., children of the grantor rather than grandchildren) such a GST tax disadvantage is not relevant. Otherwise, additional techniques beyond the scope of this paper may need to be employed to remove this GST tax disadvantage.

7 If The Grantor Transfers Appreciated Assets To The G-CLAT Or If The Trust Assets Appreciate During The Term, May Those Assets Be Used To Pay The Charitable Annuity Amount Or Should Only Income Generated By The Assets (E.G., Cash) Be So Used For The Payments?

A "payment-in-kind" of the trust assets may be used to pay the annuity amount due to charity for a particular charitable payment. However, the IRS takes the position that any such payment with appreciated property will cause the G-CLAT to recognize gain that will in turn be reported to the grantor since it is a grantor-trust. See PLR 200920031. This is sometimes referred to as an application of the "Kenan rule." See also Rev. Proc. 2007-45, Section 8.02(2), 2007-2 CB 89. The IRS may be incorrect in its position that the Kenan rule applies in this circumstance, but there is not yet a test case by a taxpayer willing to challenge this position.

8 Are There Additional Restrictions On The Grantor In Dealing With The G-CLAT Assets?

Yes. CLTs are considered to be the equivalent of a private foundation with regard to certain potential excise tax rules in the tax law. For example, IRC Section 4941 prohibits certain acts of "self-dealing" and that provision to this situation which prevents the grantor from entering into most transactions (e.g., borrowing, selling assets, etc.) with the G-CLAT without risking imposition of certain penalties (the private foundation excise tax provisions). Thus, even though most IDGTs have a provision allowing the grantor to substitute his or her personal assets or cash with assets owned by the grantor trust under IRC Section 675(4)(C), the actual exercise of this typical grantor trust provision by a grantor of a G-CLAT would constitute an act of self-dealing. This is why creative advisors came up with the idea of lodging these types of "swap powers" with certain relatives of grantor (e.g., a brother or sister of the grantor). Such persons are not considered to be closely enough connected to the grantor to cause an act of self-dealing in exercising their right to substitute assets with the G-CLAT. Specifically, IRC Section 4946(d) defines certain relatives that will not be considered to be a "disqualified person" for purpose of the excise tax rules and omits a sibling relationship from the definition of a prohibited "family member." See also the answer to FAQ #1 above discussing this concept.

9 Are There Adverse Tax Consequences For A Non-grantor CLAT To Become A G-CLAT?

The IRS favorably ruled in PLR 201730017 that no income tax consequences would result when a non-grantor CLT became a grantor CLT. Moreover, the IRS also opined that there were no adverse self-dealing rules when a swap power as described in the answer to FAQ #8 was added by a Trust Protector to cause grantor status for the trust to become applicable pursuant to IRC Section 675(4)(C). Specifically, the Trust Protector in that situation lodged a power in the sister of the grantor allowing her to substitute her assets of equal value with assets of the CLAT. The desired outcome of the taxpayer going through this effort to lodge such a "swap power" with the grantor's sister was an attempt to obtain an accelerated large charitable income deduction for the present value of all the remaining annuity payments not yet made under the terms of the original CLT. However, the IRS disallowed the grantor from taking this remaining large charitable deduction even though it approved the tax-free conversion to a G-CLAT. Thus, this ruling indicates that the grantor will only receive a charitable deduction each year as the converted G-CLAT actually makes a payment to charity. This PLR not only affirms the IRS's longstanding position that swap powers may be lodged with a brother, sister or other person to create grantor trust status for a CLAT but also that the actual exercise of any such power would not be a prohibited act of self-dealing as long as the person is not the grantor, the trustee, or a person defined in Section 4946(a)(1).

10 Are There Any "Unrelated Business Taxable Income" (UBTI) Concerns With Regard To G-CLATs If It Acquires A Closely-held Business Interest? If Not, Are There Other Concerns?

No. The tax on UBTI, as defined in IRC Section 512, which applies to many types of tax-exempt entities and certain types of split-interest trusts, including CRTs, is not applicable to a G-CLAT. In fact, the grantor status of the G-CLAT allows it to be an eligible shareholder of S corporation stock without terminating an S election. Care must be exercised if a G-CLAT acquires a closely-held business interest, however, to make sure there is compliance with the other private foundation excise tax rules such as the self-dealing rule of Section 4941 mentioned in the answer to FAQ #8. In addition, the sample language provided by the IRS in Rev. Proc. 2007-45, 2007-2 CB 89 as a template for properly structuring CLATs specifically requires a prohibition against the trust retaining any "excess business holdings" within the meaning of IRC Section 4943 and against investments that jeopardize the exempt purpose of the trust within the meaning of IRC Section 4944. Both the excess business holdings and jeopardy investment prohibition rules are modified by Section 4947(a)(2) and Section 4947(b)(3). In particular, if a G-CLAT contribution results in a charitable income tax deduction that is 60% or less than the total value of the contributed assets, then such prohibitions against any excess business holdings under Section 4943 or jeopardy investments under Section 4944 may be omitted. See Rev. Proc. 2007-45, Section 8.06(1), 2007-2 CB 89. Another way to generally avoid the application of Section 4943 is to only contribute non-voting stock. See IRC Section 4944(c)(2). Simply holding closely-held non-voting stock or other business interests, in and of itself, should not be considered to be a jeopardy investment for purposes of Section 4944. There should be several other factors that would first need to be applied (e.g., the length of time the closely-held business interest was to be held, whether it was a concentrated position relative to other CLT assets, whether there was a proper exit strategy for the CLT holding such interests, whether there was sufficient cash flow to provide a source for the CLT to make the charitable annuity payments in accordance with its deemed exempt purposes, etc.). Moreover, no one factor would appear to be controlling for this determination. In many situations, a position could be taken that a business interest investment may be a prudent course of action by a G-CLAT trustee and not considered a jeopardy investment under Section 4944.

11 Why Are CLTs Particularly Attractive Tools When Established In A Low-interest Rate Environment?

The charitable deduction is determined based on the present value of the annuity payments for the expected term of the trust. The assumed interest rate for making this calculation is called the Section 7520 rate. That rate is 120% of IRS published mid-term "applicable federal rate" (AFR) for the month in which the trust is funded. If the Section 7520 rate is lower in the previous two months, the taxpayer may apply the lowest rate for any month during that time period. Thus, if the assets of CLT perform better than the assumed Section 7520 rate over time, there should be more funds left for the remainder beneficiaries. Also, the lower the Section 7520 rate the higher the computed charitable deduction will be, all other variables being equal. The past few years the Section 7520 rate has been historically low. The average rate over an extended period of time has been between 4 to 5% and currently the June 2018 rate is 3.4% with May and April's rate being 3.2%. During the previous two years the Section 7520 rate was in the low 2% range so it is beginning to rise. Locking in a relatively low rate for a G-CLAT to maximize the leverage of wealth transfer to the remainder interest holders and a more significant charitable deduction is prudent and should be done currently rather than even a few months or a year from now assuming the grantor has charitable motivations.

12 Is It Acceptable To Structure A G-CLAT So The Annuity Payments Are Back-loaded To Increase The Probability Of Investment Success?

Yes. Such back-loading of the annuity payments goes by a number of different names (e.g., Shark-fin CLATs, Variable CLATs or V-CLATs, Enhanced Charitable Trusts or E-CLATs, a "balloon CLAT" or "hockey stick CLAT"). When the IRS published Rev. Proc. 2007-45, 2007-2 CB 89, it contained language that certainly "opens the door" for Shark-fin CLATs as being allowable. Whether the IRS intended a complete capitulation of this possibility is not clear. In PLR 201216045, the IRS approved a 20% per year payment increase (the grantor retained annuity trust or GRAT rules limit for payment increases) for a testamentary CLAT. However, the typical Shark-fin CLAT has much more dramatic increases. For example, payments in a Shark-fin CLAT may have modest $2,000 annuity payments for many years followed by a payment in the hundreds of thousands or even millions in the final year or years. Analogizing that the GRAT regulatory limitations should somehow be superimposed onto CLATs is making up rules that don't exist and like comparing apples to oranges (they are both round and fruit, CLATs and GRATs are both trusts and involve annuity payments to beneficiaries). The Shark-fin CLAT is not without its critics but a critical analysis of the arguments they raise in the face of no actual governing authority compared to well-reasoned counter arguments in favor of Shark-fin CLATs indicates that such concerns are unfounded in the opinion of this author. Several taxpayers have disclosed charitable deductions derived from Shark-fin G-CLAT structures in gift tax and income tax returns filed with the IRS and to date there has not been a reported audit of any such situations by the IRS. Moreover, if the three-year statute of limitations for assessing a tax deficiency has run after a proper reporting (see answer to FAQ #5), then the possibility of any such challenge is foreclosed.

13 Have There Been Any Recent Successful IRS Challenges To Funding Business Interests In A CLAT?

There is the much reported "bad facts makes bad law" case of Estate of Powell v. Comm'r., 148 T.C. 18 (2017) involved an attempted "deathbed" funding of a CLT that was ignored by the Tax Court. The Tax Court finding that the CLAT was invalid is unremarkable given the facts and this case has nothing to do with the myriads of validly formed CLATs approved by the IRS over the years both before and after compliance with the IRS's own sample language provisions as set forth in Rev. Proc. 2007-45, 2007-2 CB 89. In the Powell case, on the same day cash and securities were used to fund a family limited partnership (FLP), the decedent's son, acting under a power of attorney, attempted to transfer a 99% FLP interest into a CLAT. One day prior to the transfer to the CLAT, the decedent was determined to be incapacitated by two physicians and passed away seven days after the FLP funding. The Tax Court found that the power of attorney used by the son in the attempted transfer did not even comply with state law. Unsurprisingly, the CLAT was ignored. The only reason the Powell case has received so much attention is not for the invalid attempt to transfer assets to a CLAT but because the case contains language not necessary to reach the result (so it is so-called dicta) which indicates for the first time that assets of a limited partnership could be pulled back into a gross estate of a decedent who held only a limited partnership interest. This dicta has estate planners worried that there may be future cases in which its rationale may be used for other FLP situations to bring assets back into decedent's estates that would not have otherwise occurred under the precedent established by many other cases. Powell is certainly an outlier and completely distinguishable from most, if not all, other CLAT situations involving business interests.

Comprehensive Illustration Of G-CLAT Opportunity

Having established both the general rules and many details of a G-CLAT structure through the previous FAQ answers, this paper will now present one illustration of how these rules might be combined to achieve superior tax consequences for a business owner. Other income tax rules necessary to the desired outcome that are not unique to G-CLATs will also be discussed.

In this example, Grantor (G) owns closely-held non-voting stock in an operating S corporation and is a high income earner that desires a charitable deduction to reduce his current year's taxable income. He has a cooperative sister (S) that he has assisted in the past. G takes $1 million of available cash and contributes it to validly formed G-CLAT that provides for back-loaded annuity payments over a 10-year period and results in a $807,000 charitable deduction for gift and income tax purposes. Thus, there is a reported gift to a trust for the benefit of his children (i.e., the designated remainder beneficiary) equal to $193,000 and this is reported on a timely filed gift tax return following the tax year of the gift. G has available unused gift tax exemption to avoid paying any gift tax on the reported $193,000 gift. The G-CLAT allows S to exercise a non-fiduciary power to substitute property she may own for trust assets as long as the values are equal. The annuity payments are structured as back-loaded shark-fin arrangements so that $10,000 payments are made in years 1 through 9 with a $1 million payment in year 10. The non-voting S corporation yields an overall 8% growth over the 10-year term so there will be about $1,024,000 in value available to the children's trust on termination of the trust.

As mentioned in the response to FAQ #8, G cannot directly sell assets to the G-CLAT without committing a prohibited act of self-dealing even if full consideration is paid. Here, G sells shares of his low basis appreciated non-voting stock worth $1 million to S in exchange for an interest-only balloon promissory note with annual interest payments at the AFR. The gain on the sale of the stock is deferred under IRC Section 453 until a principal payment is made by S to him. S acquires a $1 million basis in the purchased stock and holds it for a two-year period so that she may re-sell the shares in the future without triggering any of G's deferred gain since she is a related party to G under Section 453(f) for purposes of that section. S, even though a sister to G, is not

a disqualified person in relation to the G-CLAT under Section 4946(a)(1) because she is not considered to be a member of the family as defined in Section 4946(d). Alternatively, if instead of lodging the power to substitute assets with S, the G-CLAT provides that the power is held by another person who is not the trustee or a disqualified person under Section 4946(a)(1) nor related to G under Section 453(f), then the two-year wait for a second disposition of the non-voting stock is not necessary.

After waiting two years S sells, or if a non-relative to G is used instead of S then that person immediately sells, the stock to the G-CLAT by exercising the retained substitution power and obtains the $1 million originally contributed. This is not considered an act of self-dealing and the G-CLAT may now hold the stock and collect distributions each year from the S corporation to make the annuity payments to charity. As mentioned, the person holding the substitution power (S) will have a tax basis equal to the $1 million purchase price so no gain will be recognized on a subsequent sale for the same price. Specifically, if there is stock appreciation during the two-year wait period some gain will be recognized unless the basis has been increased by undistributed S corporation earnings. Since the G-CLAT will also have a stepped up stock basis, any gain from the potential application of the Kenan rule when using such stock to fulfill a charitable annuity payment would be minimized. S may loan the $1 million back to G or make payments on the note receivable held by G. However, to the extent principal payments are made on G's note receivable, then some of G's deferred gain on the original sale of the stock to S will be recognized.

Alternatively, the G-CLAT could be structured so that back-loaded annuity payments are made over the lifetime of G and a paid-up life insurance policy on G's life is transferred to the G-CLAT using a non-fiduciary substitution power. The purchase of the paid-up policy avoids any prohibition for certain charitable split-dollar life insurance arrangements in Section 170(f)(10) because the charity receiving the CLAT annuities is not involved in the policy transfer and because no premium payments were ever made by the G-CLAT. A full discussion of the intricacies of why Section 170(f)(10) is not applicable in such a situation is beyond the scope of this paper but they are adequately covered in Jordan Smith's November 2014 article in Trusts & Estates titled "Time to Head Back Into the Water – Overcoming unwarranted fears of the Shark (Fin CLAT)." That article also contains a good discussion of any potential "insurable interest" state law risk in transferring a paid-up policy. The author persuasively argues that there is no abuse of the tax system in using a Shark-fin CLAT and analyzes the weaknesses of the few critics' unfounded concerns. The examples in in the article show that an alternative situation using a paid-up policy yields even better results to both the grantor and the remainder interest beneficiary while insuring that the chosen charity gets every dollar provided for in the trust document if G achieves his anticipated life expectancy.

Finally, if the grantor desires to avoid the capital gain tax haircut on the note receivable received from S when the stock was initially sold, this receivable could be contributed to a pooled income fund (PIF) maintained by a charity. The PIF will provide the grantor with a stream of income payments during his life and it also eliminates future estate taxation. Sophisticated PIF planning is beyond the scope of this paper but it could allow the grantor an additional charitable deduction that is more favorable than a CRT, cap the upside amount eventually passing to charity on the death of the grantor, while putting the whole value of the contributed asset to work in maximizing the retained income stream from the PIF. These tax benefits of the PIF when combined with the G-CLAT are significant and are especially beneficial to high-income producers who have the taxable income that can be sheltered by large charitable deductions.

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