The Leveraged Family Business CLAT

By Douglas W. Stein

Although charitable lead trusts have been with us for decades, their use was thrust into the limelight after the death of Jacqueline Kennedy Onassis in 1994. Mrs. Onassis's will contained a long-term charitable lead annuity trust (CLAT) that was funded by her residuary estate. On the termination of the lead interest, the trust assets were to be distributed to the descendants of her children. Based on the applicable Code § 7520 rate in effect on the date of her death, her estate was entitled to a charitable deduction of approximately 97% of the assets passing to the CLAT. W. Birch Douglass III & Kristen E. Smith, *Generation-skipping Planning Is Essential When Using Split-interest Trusts*, J. Tax'n, Oct. 1996. Since Mrs. Onassis's death, several published articles have discussed the benefits of testamentary charitable lead trusts.

This article discusses a technique that allows decedents to pass their closely held businesses to their beneficiaries through a testamentary CLAT while simultaneously allowing the beneficiaries to reap some of the benefits of outright ownership. Most important, this technique allows decedents to pass S corporation stock, limited liability company interests, or partnership interests to their children without violating the self-dealing and other private foundation rules applicable to CLATs and simultaneously generate a significant charitable deduction.

Overview of a CLAT

A CLAT is an inter vivos or testamentary trust arrangement that allows a donor to give an annuity stream, payable at least annually, to a charity and have the remainder pass to someone other than the charity. Usually, the remainder beneficiary is the grantor's descendants or a trust for their benefit. CLATs can be thought of as the reverse of a charitable remainder annuity trust and pooled income fund, in which the donor retains the income interest and the charity receives the remainder. If the CLAT satisfies the requirements of Code §§ 170(f)(2)(B), 2522(c), and 2055(e)(2)(B) and the Treasury Regulations thereunder, the actuarial value of the income interest is deductible in the year the grantor establishes the CLAT. Thus, the actuarial value of the income interest of a testamentary CLAT will be deductible for federal estate tax purposes. As will be analyzed below, a leveraged family business CLAT (LFB CLAT) is a testamentary trust. The tax advantage of a CLAT is that there is a current deduction for the value of the annuity interest even though the charity receives its annuity interest over time. The corollary is that the beneficiaries must wait until the charitable term has expired to receive their interest.

Generally speaking, a CLAT will not be effective in passing wealth to the remainder beneficiaries unless the underlying assets of the CLAT consistently appreciate at a rate equal to or in excess of the Code § 7520 rate originally used to value the charitable deduction. Even a few years of poor performance could have disastrous consequences and may cause the remainder beneficiaries to receive substantially less than initially anticipated. But even if the assets of the CLAT do not perform at a rate equal to or in excess of the Code § 7520 rate, the estate is entitled to an estate tax charitable deduction equal to the actuarial value of the remainder interest.

Overview of the Technique

The purposes behind the LFB CLAT are to pass the family business to the decedent's children immediately as remainder beneficiaries of the CLAT, allow any increase in the income stream generated by the family business to accrue to their benefit, allow the children to immediately enjoy any growth in the family business in excess of the annuity amount paid to the CLAT during the term of the CLAT, obtain a significant estate tax charitable deduction, obtain a full basis step-up on the family business, and avoid the private foundation rules. This technique provides a significant benefit to the family

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because most deferred gifts require the children to wait to enjoy any significant benefit of the family business. In addition, the LFB CLAT resolves numerous issues associated with CLATs such as assuring sufficient cash flow to meet the annual annuity payment and determining what the remainder beneficiaries will actually receive.

If the CLAT is "zeroed" out, then the family business will pass to the children estate tax free. Depending on the prevailing Code § 7520 rate, however, it may take a very long time or a very high annuity to zero out the CLAT. For example, in February 2007, an estate could use an AFR of 5.6% to calculate the interests in a CLAT. A zeroed-out 20-year CLAT, paying annually on the anniversary of the decedent's death, would require an annuity of 8.43747%. The CLAT having a term of 10 years requires an annuity of 13.33049% to zero out the remainder interest. As illustrated, zeroing out a CLAT often requires a long period of time or a very high annuity.

The LFB CLAT

The first step in implementing the LFB CLAT requires the client's dispositive instruments (the will or revocable trust) to be modified to include a testamentary CLAT. Although the CLAT is often structured as a near-zero or zeroed-out CLAT, it need not be. The dispositive instrument may direct that the client's interest in the family business, or the proceeds thereof, be used to fund the testamentary CLAT. The terms of the CLAT are often set out as a formula. For example, the CLAT may state that it shall be for a term of 20 years and the annuity amount shall be expressed as a fixed percentage of the fair market value of the initial contribution to the trust, as finally determined for federal estate tax purposes, such that the actuarial value of the remainder interest is one dollar.

Simultaneously, the client grants an option to his or her children to purchase the client's interest in the business from the client's estate. The terms of the option must require that the children purchase the family business at its fair market value, as determined on the client's date of death, but only if the sale has been approved by the Probate Court. This option also requires the children to issue a long-term note, not exceeding the term of the CLAT, as consideration for purchasing the family business. In essence, rather than receiving the actual business ownership, the CLAT receives a note reflecting the purchase price of the business itself.

The note should be structured so that the annual payments under the note, including principal, if any, will equal the annuity payments required by the CLAT. Thus, the option must be carefully structured to ensure that the terms of the note are sufficiently flexible to accommodate the annual payments under the note, that those payments are sufficient to meet the annuity obligation of the CLAT, and that the terms of the note will be approved by the probate court.

Key Issues

CLTs are subject to all of the private foundation rules, including the rules prohibiting self-dealing, under Code § 4947(a)(2). The rules prohibiting excess business holdings (Code § 4943) and jeopardizing investments (Code § 4944), however, only apply if the actuarial value of the income interest in the CLT exceeds 60%. Code § 4947(b)(3).

This technique hinges on the estate administration exception to the self-dealing rules. The self-dealing rules are intended to penalize certain transactions between a private foundation, including a CLAT, and a disqualified person (DQP). A DQP is defined in Code § 4946 to include an estate, a personal representative, and family members. The acts of self-dealing are delineated in Code § 4941 and include the sale or exchange of property between a private foundation and a DQP.

The Treasury Regulations contain certain exceptions to the self-dealing rules that only apply during the administration of an estate. The regulations, contained in Treas. Reg. § 53.4941(d)-1(b)(3), state that if all five of the following criteria are met, then no act of self-dealing will occur on the sale or exchange of the family business to a DQP:

1. the fiduciary has the power to sell the property or is required to sell under an option;
2. the sale is approved by a court of competent jurisdiction;
3. the sale occurs during the estate administration period;
4. the trust receives an amount that equals or exceeds the fair market value of the assets that are going to pass to the private foundation (a CLT, for example); and
5. as a result of the sale, the charitable lead trust receives an interest or expectancy at least as liquid as the one it gave up.

If any one of these criteria is not met, the sale or exchange of property to a DQP will be an act of self-dealing and subject the parties to an excise tax on the act of self-dealing. Although a detailed analysis of the amount of the tax and the responsible person for paying the tax is beyond the scope of this article, the tax imposed on the DQP is either 10% or 200% of the amount involved. In addition, the tax on the foundation is either 5% or 50% of the amount involved.

The first requirement is that the fiduciary must have the power to sell the property or is required to sell the property under an option. Virtually every state, by statute or case law, authorizes a fiduciary to sell or convey property. In addition, most instruments specifically authorize the fiduciary to sell or convey property. Nevertheless, it is still best to explicitly state in the dispositive instrument that the fiduciary is authorized to sell or convey the family business to the children under the terms of the option and that the fiduciary is empowered to engage in all acts necessary to discharge its obligations under the option.

The second criterion requires that the estate or trust obtain court approval. It is vital that before the estate consummates the sale of the option that it petition the probate court to approve the terms of the sale and, for bootstrap purposes, to determine that the purchase price is the fair market value of the family business. Although, under *Commissioner v. Bosch*,

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387 U.S. 456 (1967), the IRS is usually not bound by the decision of the probate court, the IRS appears to be bound by the decision of a probate court in this matter because the regulations specifically require that the sale be approved by the probate court. Implicit in this requirement is that the probate court determine that the terms of the sale are reasonable and that the terms of the option are being followed. Because the option requires that the purchase be for fair market value, it appears that the probate court can and must make that determination.

Although there are good arguments that the IRS is not bound by a probate court's determination of fair market value, it is hard to imagine a probate court approving a sale without first determining if the sale price is the price set forth in the option, to wit, fair market value. Thus, despite the *Bosch* decision and the silence of the regulations, it appears that the IRS may be bound by the probate court's determination of fair market value.

The third requirement, that the property be sold during the period of estate administration, must be carefully adhered to. This is usually an easy requirement to meet because estate administration will remain open during any period of time that the estate has pending litigation. It is noteworthy that sometimes the estate administration period, for tax purposes, terminates before the estate has been fully administered. See Treas. Reg. § 1.641(b)-3(a) and *Estate of Berger v. Commissioner*, 60 T.C.M. (CCH) 1079 (1990).

The last two requirements are that the CLAT receive at least fair market value for the property being sold and that the property received be at least as liquid as the property sold by the CLAT. The issuance and terms of the option permits the CLAT to meet both of these requirements. The probate court's ability to determine the fair market value of the business and the effect that determination has on the IRS are discussed above. The more difficult requirement is the "at least as liquid" requirement.

The IRS has issued several PLRs that help to form the contours of the at-least-as-liquid requirement. What appears to be clear is that the use of an option ensures that the note received by the CLAT will be at least as liquid as the family business used to fund the CLAT. See PLR 200124029 and PLR 9501038. It appears clear that, when a sale occurs because of a binding option, the IRS appears to assume that the note is at least as liquid as the property being sold. If the family business is structured to be nontransferable, then the issue of whether the family business is at least as liquid as the note should be moot. Of course, if the trustee and the beneficiaries wanted to err on the side of caution, the note could be transferable while the option and the family business are nontransferable. In the alternative, the note could be secured by a letter of credit, by the property being purchased, or by an unlimited personal guarantee. PLR 200124029 and PLR 9501038. Any of these techniques should ensure that the note received by the CLAT meets the at-least-as-liquid requirement.

After the children purchase the family business from the estate, they will be able to manage the business without regard to the self-dealing rules. In addition, the children can use the cash flow from the business to meet their obligations under the note. The appreciation in the business in excess of the interest rate on the note will accrue solely to the benefit of the children, and, if the note is unsecured, they are free to dispose of the business at will. Any disposition of the business will be at a reduced capital gain because the family business will receive a fair market value basis, as of the decedent's date of death, under Code § 1014.

Excess Business Holdings

The excess business holdings tax is intended to prevent CLTs, other charitable trusts, and DQPs from owning more than 20% of a business entity. But, if a non-DQP has control over the business, then DQPs and the CLT can own up to 35% of the business. If the excess business holdings tax is applicable to the CLT, then the CLT must dispose of the excess business holdings within five years of acquiring the property. The IRS is authorized to give a five-year extension if the CLT diligently tried to dispose of the business and was unable to do so. Code § 4943(c)(7).

Excess business holdings means the amount of stock or other interest in any business enterprise that a CLT would have to dispose of to a person other than a disqualified person for its remaining holdings to be permitted holdings. If a CLT violates the excess business holdings, it must pay a tax equal to 10% of the value of such holdings. Code § 4943(a)(1). This tax can be as high as 200% of the value of such holdings if such holdings are not disposed by the end of the taxable period. Code § 4943(b).

If a CLT receives the excess business holdings by gift or bequest, however, the CLT will have five years from the date of acquisition to dispose of the excess business holdings before it will be subject to the excess business holdings tax. Code § 4943(c)(6)(A). Although this five-year period can be extended, it is usually unnecessary to do so. Most estates can obtain court approval and consummate the sale of the closely held stock within the five-year period. In a particularly litigious estate or in a complex estate, however, it is not beyond reason that obtaining the necessary court approvals and consummating the sale may take more than five years.

Conclusion

In conclusion, the LFB CLAT is a viable technique that allows the transfer of the family business to the next generation. The children will be free to operate the business in any manner they see fit, and the client's estate will be eligible for a significant estate tax charitable deduction. ■

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