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THE OPTIMIZED CLAT

FREQUENTLY ASKED QUESTIONS

We recommend that you review the 1-page "Optimized CLAT – Overview" before these FAQs.

Basic FAQs

- **What is the ideal client profile?** The ideal OCLAT client (i) is philanthropic, (ii) has a high income or is selling a highly-appreciated asset, (iii) has sufficient savings outside the OCLAT, (iv) lives in a high tax state, and/or (v) wants to minimize inheritance taxes paid by children.

- **Why should I fund an OCLAT?** With the OCLAT, the Tax Code rewards your philanthropic and family wealth legacy goals by giving you immediate tax benefits. Upon funding the OCLAT, you enjoy an income tax deduction (reducing your taxes this year) *and* you remove the OCLAT assets from your estate (the OCLAT is entirely exempt from estate taxes at your death).

- **How does this work?** During the initial charitable term (also known as the "charitable Lock-Up Period"), you invest the OCLAT assets while also paying a portion of the OCLAT assets to charities. After the charitable period is over, assuming you invested the OCLAT assets at a reasonable 5-7% per year, there will be assets inside the OCLAT account equal to 2-5 times the amount of your initial contribution. These assets can be gifted to your children or other family members (including in continuing trusts that you still control) without paying any income taxes, gift taxes or estate taxes.

- **Can you give me a simple example**? Say you put $1M into an OCLAT. You enjoy a $1M tax deduction, saving you ~$500k in taxes.[1] Let's assume you select a 30-year charitable term and fund in February 2022 when the current IRS benchmark rate is just 1.6% (*discussed below*). On these assumptions, the OCLAT must pay just ~$1.5M to charities over the 30-year term and ~$5M will be available at year 30 to transfer to children (assuming a 7% rate of return).

- **That kind of sounds like a retirement account with a charitable component – is this better than my 401(k)?** You should still fund your other retirement accounts (IRA; 401(k); profit sharing plan). The problem is the funding limit: you can only move ~$60,000 per year into those vehicles. The OCLAT, on the other hand, can be funded with 30% of your annual income, regardless of how much you make (i.e. if you earned $10M this year, you can put $3M into the OCLAT). Another major advantage of the OCLAT is that, unlike your other retirement plans, there are no income taxes or gift/estate taxes when the OCLAT assets are paid out at the end of the charitable term. Your retirement assets, on the other hand, are subject to 40-50% ordinary income tax upon withdrawal *and* the 40% estate tax upon death – effectively, a ~70% tax.

[1] Assuming you are in the top federal tax bracket (37%) and a California resident (13.3% top rate).

- **This seems too good to be true, what's the catch?** There's no magic. The OCLAT simply leverages the near-all-time-low IRS benchmark rate which is locked in at funding. If the OCLAT investments do not outperform the IRS benchmark rate, there will be nothing in the account at the end of the charitable term. The IRS basically says "we don't think your investments will earn more than 1.6% per year, and if they do, your family may keep the excess."

- **I understand that I have until 12/31 to fund the OCLAT to enjoy a deduction this year - can't I just wait?** The problem is that the IRS changes the benchmark rate each month (it roughly tracks movements in the 10-year Treasury yield). Since you lock in the IRS rate in the month you fund the OCLAT, there is urgency to act ASAP (at least if you believe rates will increase).

- **Why *shouldn't* I fund an OCLAT**? The OCLAT is not a good fit if (i) you are not charitable,[2] or (ii) you do not have sufficient personal assets or savings outside the OCLAT (during the charitable Lock-Up Period, you cannot withdraw or borrow the OCLAT assets).

- **I wish I had known about this years ago - why didn't my CPA tell me I could save 30% of taxes each year?** The CLAT is a notoriously underutilized vehicle – most tax lawyers and CPAs have only seen a couple of CLATs in their entire career, particularly because the CLAT is viewed as a complex and enigmatic vehicle reserved for the ultra-wealthy (Jackie Onassis famously funded a CLAT) and interest rates have never been this low. In 2016, Silicon Valley-trained attorney Jonathon Morrison discovered that a CLAT could be repurposed as a synthetic retirement account for both the "working rich" and ultra-wealthy, alike; after hundreds of hours of research and development, the "Optimized CLAT" was born. In September 2020, Mr. Morrison's OCLAT strategy was published and featured on the cover of the national *Estate Planning Journal* which is widely viewed as the most esteemed professional journal in the tax & estate planning world. As of January 2022, Mr. Morrison has been involved in more than 150 CLAT transactions and has funded ~100 OCLATs.

<u>Is This IRS-Approved? How Much Risk Is Involved?</u>

- **Has the OCLAT been approved by the Tax Code?** The CLAT has been in the Tax Code since 1969. (In fact, the IRS published a very basic CLAT legal form for use in 2007, and the former IRS Commissioner John Koskinen set up a CLAT in 1998 for Duke University.) The "Optimized CLAT" is a special variant of a CLAT and all aspects are firmly-supported by the Tax Code, Treasury Regulations and/or IRS rulings. Please refer to the legal citations in the *Estate Planning Journal* article.

- **Is this a peer-reviewed strategy?** Yes. As part of the publishing process for the *Estate Planning Journal* article, there was a lengthy 6-month peer-review process. The OCLAT strategy and legal

[2] The Tax Code absolutely requires that the creator of the OCLAT possess bona fide charitable intent – if not, all of the tax benefits are forfeited. Our law firm has a strict policy that we will not assist clients with OCLAT planning if we sense that philanthropy is not a key objective.

article were critiqued by more than a dozen attorneys at four (4) different law firms and financial firms throughout. All attorneys uniformly agreed that the OCLAT passes muster.

- **Are these tax and economic benefits measurable?** Yes. In our *Estate Planning Journal* article, we published results using JP Morgan's stochastic Monte Carlo software that proves that a family has between 2-3x additional wealth[3] by funding a 30-year OCLAT versus doing nothing, all things equal.

- **Will an OCLAT trigger an IRS audit**? As of January 2022, Mr. Morrison has funded ~100 OCLATs without a single known IRS audit.[4] In the event of audit, our law firm Frazer Ryan (the predominant tax and trust planning law firm in Arizona) has multiple former IRS litigators who have reviewed the OCLAT strategy and stand ready to defend it.

The Upfront Tax Deduction

- **How much can I put into the OCLAT?** The max is 30% of your adjusted gross income (AGI). (Suppose you sold your business for $9M and have $1M of wages/bonuses for a total AGI of $10M – you could put $3M into the OCLAT and reduce your taxable income from $10M to $7M.)

- **What if I accidentally put more than 30% into the OCLAT…do I lose the excess deduction**? No, you don't lose it – the excess just carries forward for up to five (5) tax years.

- **Do I have to fund my OCLAT with cash?** No – many clients want to preserve their cash, so they will transfer existing stocks/bonds into the OCLAT. This makes it as simple as "moving stocks/bonds from one account to another" to generate a large income tax deduction.

- **If I put $1M into the OCLAT, do I save $1M of taxes**? No, it is a $1M tax *deduction*, not a $1M tax *credit*. For example, a $1M deduction for a California-based client in the top 50% bracket (37% federal; 13.3% CA) translates to $500,000 less taxes paid when the tax return is filed next April.

- **I make $1M/year as a surgeon, but I also sold some Tesla stock for a $3M long-term capital gain. If I put $1M into the OCLAT, I'd like my $1M tax deduction to apply first to my $1M ordinary income – is that possible?** Yes – the tax deduction automatically reduces your ordinary income before long-term capital gains.

- **I have a $600,000 IRA that I'd like to convert to a Roth IRA, but that would result in $600,000 of Roth conversion income – can I use the OCLAT tax deduction to reduce this tax?** Yes, this

[3] This depends on the extent of donations that the client would have otherwise made, with or without the OCLAT in place. A client who would have given the same charitable gifts without the OCLAT has ~3x as much wealth at year 30 by funding the OCLAT. A client who would not have donated at all, absent the OCLAT, still has ~2x at year 30.

[4] IRS Circular 230: audit risk should not be considered when making a tax planning decision; we cannot guarantee the absence of an audit.

is a common transaction. But to eliminate the $600,000 of Roth conversion income with a $600,000 OCLAT, you'll need to have $2M of total income for the year (recall the OCLAT deduction is limited to 30% AGI, or $600,000 if you have $2M of income). Therefore, many of our clients will wait to convert an IRA to a Roth in a tax year when they know they will have a large capital gain (such as the sale of a business) and have adequate AGI.

During Charitable Lock-Up Period – Administration

- **Who invests the OCLAT funds?** You are the trustee. So you have total control of the investments.

- **Are there investment restrictions?** Virtually none, except (i) you cannot use the OCLAT funds for your business operations, and (ii) there are tax penalties if you take extreme risks with the funds (the OCLAT is essentially subject to a "gross negligence" standard).

- **How much does the OCLAT pay to charity?** This depends on the length of the term, the funding amount, and the IRS benchmark rate in effect at funding. As of February 2022, the IRS rate is near an all-time low (1.6%). This translates to a 30-year $1M OCLAT paying just ~$1.5M to charities over the 30-year term (with the bulk of the ~$1.5M paid in the final 5 years, as discussed below).

- **Why can't I use a shorter charitable term?** You can, but it's probably not worth it. If you select a term less than 10 years, the OCLAT assets won't have enough time to grow and appreciate since too much comes out to charity, too soon. There is no maximum (the IRS has approved a 118-year CLAT), but most clients select a 20-30 year term which seems to be the "sweet spot."

- **When do the charitable payments from the OCLAT become due**? There is a fixed schedule at the time of funding. The IRS has approved the OCLAT's "backloading" of charitable payments where there are very small charitable payments in the early years which gradually increase, such that approximately 70% of the OCLAT's charitable giving does not occur until the final 5 years of the term. This is optimal since it gives the OCLAT assets plenty of time to appreciate and make up for any "bad markets" without large charitable amounts required to come out of the account.

- **What if I need to change the charity or if I'm not sure which charity I want to select when setting up the OCLAT**? Good news. Each year, the OCLAT's required charitable payment is paid into a separate charitable account known as a "donor advised fund" or "DAF". Once the funds are inside your DAF, you can continue to invest those funds (free of taxes) although all of your DAF funds must be paid, at some point in the future, to charities of your choosing. At any time, you can direct as much or as little from your DAF to any qualified 501(c) charities that you like.

- **Can the OCLAT transfer stock to the charity/DAF as its annual payment?** Yes; however, the IRS takes the position that the OCLAT sold the stock immediately prior to the transfer so this might result in capital gains.

- **If the OCLAT sells an asset for gain, who pays the tax**? You pay it, not the OCLAT. (All income and gains (and deductions and losses) generated by the OCLAT pass through to your personal Form 1040 tax return.) This is a tremendous benefit as it allows the OCLAT assets to appreciate and grow without paying any income tax.

<u>During Charitable Lock-Up Period – Unexpected Problems & Circumstances</u>

- **What if I need to withdraw the OCLAT funds before the end of the charitable Lock-Up Period**? Good news. The IRS has approved termination of the OCLAT before the end of the charitable Lock-Up Period; however, this requires that the OCLAT pay all of the remaining charitable payments. This is a particularly attractive solution when OCLAT asset performance greatly exceeded expectations (a "homerun" OCLAT) and the family wants early access to the OCLAT funds.

- **What happens if the OCLAT makes bad investments and runs out of money – say, halfway into the charitable Lock-Up Period – and cannot make the remaining promised charitable payments**? Good news. First, you still enjoy the upfront tax deduction in the year of funding – that is not taken away. Second, you have no personal liability to make the OCLAT's remaining payments – rather, charity simply doesn't receive the full promised amount from the OCLAT.

- **What are the tax consequences if I die before the end of the charitable Lock-Up Period**?

    - The good news is that your family does not have to pay the 40% federal estate tax on any of the OCLAT assets - this is true even if you die the next day after funding your OCLAT. Therefore, in addition to the upfront income tax deduction, there is effectively a 40% estate tax savings enjoyed as soon as you fund the OCLAT.

    - The *potential* bad news is that, if you died early in the charitable Lock-Up Period,[5] a portion of the upfront income tax deduction may be subject to "partial income tax recapture", i.e., your estate may have to pay some income taxes. In most OCLAT cases, the client is relatively young (ages 30-70), healthy, and not contributing a significant portion of their net worth to the OCLAT; therefore, recapture risk is usually not a material factor in deciding to proceed. For other clients, there are techniques we can use to "hedge" or minimize

[5] The Tax Code provides that the amount of recapture income that your estate must pay depends on the amount of taxable income that the OCLAT produced during your lifetime – the greater the amount of income that the OCLAT produced, the less the recapture amount. In most financial projections, the amount of recapture steadily decreases and eventually goes to zero at some point between years 10-20 of the charitable Lock-Up Period.

recapture risk.[6] Recapture is probably the most complex concept vis-à-vis OCLAT planning; for more information, please refer to PDF page 36 of the separate *Estate Planning Journal* article.

- **OK I understand the tax consequences if I die before the end of the charitable Lock-Up Period – but what happens to the OCLAT**? The OCLAT just "keeps on going", just like you are still living. You name a successor trustee (such as a child, sibling or friend) to manage the OCLAT investments and make the charitable payments. Of course, as explained above, the successor trustee can also decide to pay the charity early and terminate the OCLAT to "unlock" the balance for heirs.

Return of OCLAT Remainder Assets at End of Charitable Term

- **How much can my family expect to receive back from the OCLAT?** This depends to what extent the OCLAT investments outperform the IRS benchmark rate (which is fixed upon funding). For CLATs funded in February 2022, the benchmark rate is very low (1.6%) such that a 30-year $1M OCLAT returning 7% per year could expect to return ~$5M to the family at year 30.

- **How does the transfer of remainder assets out of the OCLAT work?** It's simple – the OCLAT account terminates and the assets are transferred, in-kind, to the remainder beneficiaries.

- **Are there taxes on the money my family receives from the OCLAT**? Zero. Unlike an IRA or 401(k), there are no income taxes when the assets transfer back to you or your family.[7] Moreover, if you set up your OCLAT so that it transfers the remainder assets to your children or other family members, the 40% gift tax and estate tax does not apply.

- **If I initially name my children as remainder beneficiaries of the OCLAT, but later decide that I want to give the assets to my siblings…or maybe even get the remainder assets back for myself. Can I do that?** Yes; however, for tax reasons, these types of changes usually require the consent of a special powerholder called a "Trust Protector" who is typically a close friend of yours or non-immediate family member.[8]

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[6] For older clients or clients who are contributing a significant amount of their net worth into the OCLAT where recapture would cause a significant liquidity issue at death, we may (i) purchase term life insurance outside the OCLAT to provide the necessary liquidity to pay the recapture tax, and/or (ii) contribute low basis assets to the OCLAT and then sell the assets immediately within the OCLAT to immediately reduce (or eliminate) the amount of potential recapture.

[7] The OCLAT's tax basis in the assets simply transfers to the remainder beneficiaries. Once the assets are sold in the hands of the beneficiaries, there could be capital gains.

[8] Rest assured, the Trust Protector cannot make these changes without notice to you and typically the consent of your attorney. You also have the power to remove the Trust Protector at any time.

Tax Filings for OCLAT

- **What tax filings are required for the OCLAT**? It's simple. Your CPA must file a one-time gift tax return (Form 709) and the OCLAT has annual federal tax filings (Forms 5227, 1041-A) and perhaps state tax filings (depending on your residence). We provide these details in the final memo at the end of the process and copy your CPA.

- **My CPA has no idea how to do those tax filings – do you have a referral**? Yes, we have a number of referral partners.

Logistical

- **I am busy – how easily can we create the OCLAT?** After completing ~100 OCLATs and putting hundreds of hours into fine-tuning the OCLAT documents and process, Mr. Morrison has streamlined the process so that it takes just a couple hours of your time. In most cases, the OCLAT account is ready to be funded within a couple of weeks. This is important since interest rates are rising – the longer you delay, the less attractive the OCLAT.

- **Your law firm is located in Arizona – can you help me even though I don't live in Arizona**? Yes, Mr. Morrison routinely sets up OCLATs for clients around the country.

Fees

- **What are the setup fees for the OCLAT?**
  - Our law firm charges a one-time flat fee to set up the OCLAT based on our published fee schedule that is then in effect (which is subject to change).
  - For a typical 30-year OCLAT funded with $1M, our legal setup fee translates to <2% of the upfront income tax savings and expected return of assets from the OCLAT at the end of the charitable Lock-Up Period.
  - We also offer a discount for multiple family members or business partners that engage us at the same time for OCLATs.
  - Please refer to separate "Fee Information & Process" document for details.

- **Can I deduct the legal fee that I pay your firm for setting up my OCLAT**? Yes, but the legal fees must be attributable to tax planning for business income (not personal income such as salary or bonus income).

- **Are there any ongoing fees?** Other than relatively small annual OCLAT tax preparation fees, there are zero ongoing or recurring fees for the OCLAT.