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A Great Pairing: Charitable Lead Annuity Trusts and The Chicago Community Trust

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In the current economic environment, many professional advisors are recommending charitable lead annuity trusts ("CLATs") to their clients. With a lead trust, a client gives to charity the fruit of the tree—the apples—and keeps the tree for herself or her family. This is different from most types of gifts where the client gives away the asset itself. Also, lead trusts are very flexible and can be drafted to meet a variety of charitable and personal goals. Further, by naming a fund at a community foundation as the CLAT beneficiary, families can truly make the charitable impact they seek.

The types of CLATs most advisors recommend are either (1) a non-grantor CLAT to benefit charity, then children or grandchildren; or (2) a grantor CLAT to benefit charity, then the client gets back whatever is left in the trust. A non-grantor trust means that the client is not treated as the owner for federal income tax purposes. Typically, non-grantor CLATs are used in estate tax planning. A grantor trust means that the client is treated as the owner of the trust's assets and are often used in income tax planning. The balance of this paper will discuss these two types of CLATs, why now is one of the best times to create a CLAT, and why designating a fund at The Chicago Community Trust ("the Trust") could best serve the client's goals.

EXAMPLE 1:
Non-grantor CLAT Combined with a Donor Advised Fund at a Community Foundation

BENEFITS
- **Removes assets from donor's estate**
- **Transfers assets to children**
- **Simplifies giving**
- **Access to community foundation's services**
- **Involves financial advisor**

When clients have a taxable estate and are already giving to charity, a non-grantor CLAT combined with a donor advised fund ("DAF") at a community foundation like the Trust might be just the solution. The client creates a trust and funds it with assets that will increase in value or are eligible for discounts. The lawyer drafts the trust as a non-grantor trust, meaning the client is not treated as the owner of the assets for federal income tax purposes. During the CLAT's term, the trust pays a fixed amount to charity based upon a percentage of the initial value of the assets. Then, the balance is transferred to someone else, typically the children.

Figure 1 on the following page is a visual representation of this strategy.

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Figure 1: Non-Grantor Charitable Lead Annuity Trust for 10 Years[1]

In Example 1, the client moves $5 million of a low-basis asset out of her estate and in 10 years, transfers whatever is left in the trust to her children. The projected results are as follows:

- $5 million removed from estate;
- About $4.6 million transferred to children; and
- $2.5 million to a fund (e.g., donor advised fund, endowment fund) at The Chicago Community Trust or other charity.

Although the client is not eligible for a charitable income tax deduction, she is eligible for a gift tax deduction of about $2.4 million. There is a taxable gift of $2.5 million.[2]

For clients who would rather not make a taxable gift, the CLAT could be structured so that the value of the charitable interest equals the value of the donated assets (a/k/a "zeroed out"). There are several ways to achieve that tax result by increasing the annuity amount paid to charity.

Table 1 shows the results when three different methods of increasing the charitable gift are applied to the same facts in Example 1.

Table 1: Zeroed Out CLAT

	Level Payments (10.22%)	Stepped Payments[3]	Sharkfin Payments[4]
Gift Tax Deduction	$5 million	$5 million	$5 million
Amount to Charity	$5.11 million	$5.13 million	$5.19 million
Amount to Family	$1.29 million	$1.36 million	$1.41 million

Obviously, in this situation, the client would need to decide whether the primary purpose is to make a significant charitable gift or to benefit her family.

1 Graphics courtesy of PG Calc.
2 The additional assumptions used for this example are the August §7520 rate of 0.4%; total net return of 5.8% (1.7% income and 4.1% appreciation); annual sale of 10% of the portfolio; trustee fees of 1%; and Illinois income tax at 6.45%.
3 The payments to charity begin at about 6.43% and increases 10% each year for 10 years.
4 The payments to charity are $50,000 for the first 9 years and then $4.74 million in Year 10.

Economic Reasons for Doing This Gift Now

Now is the best time to create a CLAT. Clients who create CLATs hope that the value of the trust's assets will continue to increase in value during the term and hope the CLAT will be invested in a way that it outperforms the total of the IRS's assumed rate of return; the annuity payment to charity; and the administration costs. When that all happens, the difference is transferred to the children or grandchildren tax free.

Currently, the IRS's assumed rate of return—often called the "§7520 rate"—is below 1%.[5] Accordingly, the overall costs of a CLAT are lower than with a higher presumed rate of return and thus a greater probability of a tax-free transfer to family.

Table 2 shows the results when different §7520 rates are applied to create a zeroed out CLAT with level payments. All the other assumptions in Example 1 have remained the same.[6] With the current §7520 rate, the client's children are expected to receive over $1 million more than in 2018.

Table 2: Application of Different §7520 Rates to a Zeroed Out CLAT with Level Payments to the Facts in Example 1

	August 2018	August 2019	August 2020
§7520 Rate	3.4%	2.2%	0.4%
Fixed Annuity Rate	11.96%	11.25%	10.22%
Gift Tax Deduction	$5 million	$5 million	$5 million
Amount to Charity	$5.98 million	$5.62 million	$5.11 million
Amount to Family	$279,000	$699,000	$1.29 million

Benefit of Designating a DAF as the Charitable Beneficiary

Clients often struggle with choosing which charity or charities should receive the annuity payments. This struggle intensifies when the term of the CLAT increases in hopes that a longer term will give more money to the family. A client might feel that she knows a specific charity well today or in five years. However, what about that charity in 10, 15 or 20 years? Will the charity continue to operate or even have the same board? Will it be fiscally sound? What if a cure is found or a legal battle won? Those are some of the questions to explore with irrevocable gifts with long durations.

Designating a DAF as the beneficiary solves the issue of having to choose a single charity or multiple charities. The client serves as the advisor of the DAF and has the right to recommend which charities to support, when to support them, and what amount they receive. She can choose to support one group of charities one year and a different group the following year. Remember that, when drafting the CLAT, the beneficiary is the DAF sponsor because a DAF is a component fund at the sponsor—essentially a subaccount—and does not have a separate tax identification number.

Other benefits of choosing a DAF as the beneficiary include:

- Simplified tax reporting because the trustee receives one acknowledgment letter each year the CLAT distributes the annuity payment to the DAF;
- Continued use of a preferred financial advisor's investment expertise when permitted by the DAF sponsor; and
- Engagement of the next generations in charitable giving when the children or grandchildren are designated as the advisors on the DAF.

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5 The "§7520 rate, however, has generally been decreasing during the past 20 years. Clients have the option to elect the lowest rate, using the rate for the month that the CLAT is created or the rates for the two months preceding. Because the IRA announces the rate for the next month around the 18th of the month, some clients wait until after the IRS has announced the rate for the successive month before creating the CLAT.

6 See Footnote 2. The CLAT is funded with assets worth $5 million and a basis of $1 million.

Increased Benefit of Designating a DAF at The Chicago Community Trust as the Charitable Beneficiary

A DAF at the Trust gives clients a team. First, clients are paired with a person—a philanthropic advisor—who helps them achieve the charitable impact they wish to make, whether in Chicago or elsewhere. This service is included in the DAF's administrative fee and all DAF holders may receive this service regardless of the fund's value.

The philanthropic advisor helps clients:

- Learn about other charities doing work in their interest area (e.g., homelessness, education, environment) beyond the ones to which they typically make gifts;
- Learn more about the charities within their region; and
- For those newer to charitable giving, determine their interest areas, learn about the best-in-class charities doing that work, and obtain suggestions for amounts to give to a specific charity.

Second, clients gain access to the Trust's team of experts. Unlike other DAF sponsors, we have an endowment from which we distribute funds—"grants"—in support of our commitment to strengthening the Chicago region. These grants are awarded after thorough review by our Community Impact team, who know which organizations are making a measurable difference throughout the Chicago region. They also have relationships with staff at community foundations in other regions with whom they share ideas and best practices. Thus, clients who create a DAF at the Trust get access to our subject matter experts, their knowledge and their networks.

EXAMPLE 2:

Grantor CLAT Combined with a Donor Advised Fund at a Community Foundation

BENEFITS

- **Immediate income tax deduction**
- **Deferral of taxes**
- **Return of assets**
- **Simplifies giving**

When clients are already giving to charity, a reversionary grantor CLAT combined with a DAF or restricted fund at the Trust or another community foundation might be just the solution. This CLAT type allows the client to give away the asset and then get it back. So, when the term ends, the client could do another CLAT.

The client creates a trust and funds it, typically, with cash, securities or assets that will increase in value or are eligible for discounts.[7] The lawyer drafts the trust as a grantor trust meaning the client is treated as the owner of the assets for federal income tax purposes. During the CLAT's term, the trust pays a fixed amount to charity based upon a percentage of the initial value of the assets. Then, the balance in the CLAT is returned to the donor.

Clients who create this type of CLAT are eligible for a charitable income tax deduction. However, the client will pay tax on the income generated by the trust. Also, if the client does not survive the CLAT's term, then the client's estate will recognize either a pro-rata recapture or a full recapture of the deduction taken.[8] Full recapture occurs, as discussed later, when the client retains control over the money received by the charitable beneficiary.

Figure 2 on the following page is a visual representation of this strategy.

Figure 2: Reversionary Grantor Charitable Lead Annuity Trust for 5 Years[9]

In Example 2, the client takes a low-basis asset worth $1 million, transfers it to a CLAT for five years, and gets back whatever is left in the trust. The projected results are as follows:

- About a $247,000 income tax charitable deduction;
- $250,000 to a fund (e.g., donor advised fund, endowment fund) at The Chicago Community Trust or other charity;
- About a trust balance of $987,000 returned to the client—almost the entire original funding amount.[10]

Assuming the client pays federal and state income taxes at the highest rates, the client will pay about $121,000 in total taxes over the five-year term.[11]

Candidates for a Reversionary Grantor CLAT

This CLAT form works regardless of whether the client has a taxable estate or whether the client currently itemizes. In fact, for clients who do not itemize due to the 2017 Tax Cuts and Jobs Act, creating a CLAT may enable them to itemize in the year they create it. Other clients who may benefit from a grantor CLAT are those who would like to:

- Make a multi-year pledge to a charity;
- Create an endowment for a charity or multiple charities;
- Do retirement planning using funds received as a bonus or other income; or
- Defer gains because of a liquidity event.

Economic Reasons for Doing This Gift Now

Now is the best time to create a CLAT because the lower the §7520 rate, the higher the charitable income tax deduction. Table 3 on the following page shows the results when different §7520 rates are applied to the circumstances in

9 Graphics courtesy of PG Calc.

10 The additional assumptions used for this example are: August §7520 rate of 0.4%; basis of $400,000; total net return of 5.8% (1.7% income and 4.1% appreciation); annual sale of 10% of the portfolio; trustee fees of 1%.

11 Assumptions for client's tax rates: federal income tax rate of 40.8% (37% + 3.8& net investment income) and 20% for capital gain; Illinois income tax rates of 4.95% for ordinary and capital gain. Projected income taxes paid: YR1 = $27,230; YR2 = $25,531; YR3 = 24,058; YR4 = 22,782; and YR5 = 21,674.

Example 2. All the other assumptions remained the same.[12] With the current §7520 rate, the client is eligible for a charitable income tax deduction that is about $21,000 more than in 2018.

Table 3: Application of Different §7520 Rates to Facts in Example 2

	August 2018	August 2019	August 2020
§7520 Rate	**3.4%**	**2.2%**	**0.4%**
Income Tax Deduction	**$226,390**	**$234,310**	**$247,030**
Amount to Charity	**$250,000**	**$250,000**	**$250,000**
Balance Returned to Client	**$986,747**	**$986,747**	**$986,747**

Benefit of Designating a DAF as the Charitable Beneficiary

The same reasons for designating a DAF as the charitable beneficiary for a non-grantor CLAT apply to grantor CLATs, namely:

- Flexibility when choosing charities—even changing them from year-to-year;
- Continued use of their preferred financial advisor's investment expertise when permitted by the DAF sponsor; and
- Engagement of the next generations in charitable giving when the children or grandchildren are designated as the advisors on the DAF.

However, there's an even more persuasive tax reason to select a DAF. If the client designates the family foundation as the beneficiary and (i) dies during the CLAT's term and (ii) participated in decisions about how to distribute the money received from the CLAT, then the client's estate must recapture **the entire deduction** taken by the donor.[13] By contrast, if the client had designated a DAF or other type of fund at a community foundation, then the recapture is limited to the deduction received minus the discounted value of all income taxed to the donor.[14] Thus, it's better to name a DAF as the beneficiary.

Increased Benefit of Designating a DAF or Other Fund Type at The Chicago Community Trust as the Charitable Beneficiary

As previously stated, by designating a DAF at the Trust or other community foundation as the charitable beneficiary, a client gets a person to help them achieve the impact they seek and access to our team of subject matter experts and their networks because the Trust makes grants to other charities from its own endowment.

However, there are other fund types at the Trust or other community foundations that may meet the client's goals. Clients seeking to create an endowment for one or more charities—whether in Chicago or elsewhere—might choose to have the CLAT benefit a designated fund. With a designated fund, the client creates a fund for one or more favorite charities, yet the assets remain outside of the reach of those charities.

This feature may be helpful for newer charities or charities with more modest operating budgets. It is particularly helpful for soon-to-be former board members who want to create the charity's first endowment or limit a future board's access to the charity's assets. Also, clients benefit by creating a designated fund at the Trust because they:

- Create a fund at a single institution, rather than having to track funds at multiple institutions; and

12 See Footnote 10. The CLAT is funded with assets worth $1 million and a basis of $400,000.

13 Internal Revenue Code §2036(a) and §170(f)(2)(B).

14 Internal Revenue Code §170(f)(2)(B). Although there appears to be a conflict with Treas. Reg. §1.170A-6(c)(4), the IRC prevails per Rev. Proc. 2007-45, §8.01(5).

- Only need to meet the fund minimum established by the Trust or another community foundation, rather than having to meet the fund minimum for an endowment at each charity.

Clients who have a specific area of interest they wish to support—like the arts, children, food and shelter—but would rather not select the specific charities might consider designating a field of interest fund. This is the type of fund where the donor tells the Trust the areas he or she wishes to support and our staff select the charities providing "best in class" services to receive the funds. In a sense, we act as the client's philanthropic fiduciary.

Finally, clients with strong ties to our region and the work of the Trust might consider designating an unrestricted fund as the CLAT's beneficiary. Our board, in its fiduciary capacity, ensures that the funds are used for our region's most pressing needs.

Conclusion

Whether a non-grantor CLAT or a grantor CLAT best fits your clients' goals, the best time to create one is now. Current, low §7520 rates allow your clients to:

- Maximize the likelihood of tax-free transfers of assets to children; or
- Maximize eligibility for an income tax charitable deduction.

Like any gift, clients ought to assemble their team of professional advisors—lawyer, financial advisor, and accountant—to ensure their tax goals are met. Similarly, advisors and clients could also talk to the team at The Chicago Community Trust about which fund type could ensure the client's charitable goals are also met.

If you have any questions about charitable lead trusts or would like to learn more about our trustee services, please contact Don Gottesman, Director of Gift Planning, at dgottesman@cct.org or at 312-616-6141 or Tim Bresnahan, Senior Director of Gift Planning, at tbresnahan@cct.org or at 312-565-2832. We would also be happy to provide you or your client with an illustration.

Best Fund Type for Meeting Client's Goals

Client's Goal	Fund Type	Benefit to Client
Flexibility to choose charities; engage next generation	Donor Advised Fund	Chooses which charities to support, when to support them, and how much
Create an endowment for a single charity or several charities	Designated Fund	One-stop shopping: one place, one fund minimum; outside fiduciary
Restrict gifts to the causes they care about most (e.g., food, shelter, children) rather than specific charities	Field of Interest Fund	The Trust's staff select charities providing "best in class" services only in client's interest area or areas
Ensure that the Chicago region remains a thriving, equitable place for all	Unrestricted Fund	Give locally; fiduciary oversight of a more than 100 year-old institution

IMPORTANT LEGAL DISCLOSURE

The information provided is general and educational in nature. It is not intended to be, and should not be construed as, legal or tax advice.

The Chicago Community Trust does not provide legal or tax advice. You should consult your tax advisor to properly determine the tax consequences of making a charitable gift to The Chicago Community Trust.

Contributions to The Chicago Community Trust represent irrevocable gifts subject to the legal and fiduciary control of the Trust's executive committee.

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Since 1915, donors have partnered with The Chicago Community Trust to leverage the power of their philanthropy in ways that transform lives. By connecting the generosity of donors with the needs of the community, together we are building a thriving, equitable and connected Chicago region.

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