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Timing Right to Create Charitable Trusts

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With interest rates at historic lows, now is a better time than ever for individuals who are charitably inclined to create Charitable Lead Annuity Trusts ("CLATs"). CLATs provide significant income, estate and gift tax advantages, and, of course, benefit your favorite charity. Being able to provide for charity, generate numerous tax benefits of your own and benefit your loved ones makes it possible to "have your cake and eat it, too."

A CLAT is created by transferring cash or other assets to an irrevocable trust. The charity that you select will receive fixed annuity payments from the trust for a term of years. At the end of that term, any assets remaining in the trust will be transferred to, or held in further trust for, the non-charitable remainder beneficiaries (often family members) that are specified in the trust document.

You can set up a CLAT so that you will receive an immediate income tax deduction equal to up to 100 percent of the funds contributed to the trust. In such a case, you would remain subject to income tax on any taxable trust income throughout the term, even though it is paid to charity. This acceleration of the deduction may be important for individuals who have a very high bracket year when setting up the CLAT, and can then spread the income in lower bracket years. The alternative is to forego the accelerated deduction and allow the trust to pay any tax due on the trust income from year to year.

What are even better are the gift tax savings. At the end of the CLAT term, when the remaining assets in the trust are transferred to the non-charitable remainder beneficiaries, much of the appreciation on the value of the assets passes free of gift tax. CLATs are typically structured so that when the gift is first made to the CLAT, there will be little or no gift tax payable on the present value of the gift of the remainder interest to the non-charitable beneficiaries.

Escaping the gift tax altogether is possible if the CLAT is structured in a way that will cause the remainder interest to have an actuarial value of zero and the charitable deduction to be equal to the full amount transferred to the trust (a so-called "zeroed out" CLAT), regardless of how large the surplus is that may remain for the non-charitable beneficiaries at the end of the CLAT term.

It is easier to increase the size of that surplus when the IRS Section 7520 interest rate is lower since that is the number to beat; the trust assets only need to grow at a rate higher than the 7520 rate in order to have a surplus remaining at the end of the CLAT term for the benefit of the non-charitable remainder beneficiaries. The currently applicable 7520 rate for a CLAT is at an all-time low of 1 percent.

To illustrate how a “zeroed out” CLAT works, if a person creates a $1 million CLAT in which the trust pays an annuity of $55,420 (5.542 percent of the starting value) to the charity each year for 20 years, at the end of the 20-year term, assuming that the trust grew at 5 percent each year, there would be $820,782 remaining in the trust. That surplus amount would be distributed to, or held in further trust for, the non-charitable remainder beneficiaries gift-tax free at the end of the term. Since the trust was able to earn 5 percent in the marketplace, which is greater than the applicable 7520 rate of 1 percent, the trust generated $820,782. In this scenario, everyone benefits, making it possible to have your CLAT and eat it, too.

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