AUGUST 30, 2016

Good News for CRATs!

A charitable remainder annuity trust ("CRAT") is a trust that pays a fixed amount to a beneficiary (typically the donor) for his/her life or a term of years, and then pays the remainder to one or more charities. The fixed amount is generally defined as a percentage of the initial value of the asset(s) contributed to the trust, and cannot be less than 5%. The donor receives a charitable contribution deduction upon formation of the CRAT, based on the present value of the expected distribution to charity. To qualify as a CRAT, the trust has to pass two tests, measured at the date of creation, related to the expected charitable interest: (1) the 10% minimum remainder requirement (which requires that the present value of the future charitable interest be at least 10% of the amount contributed to the trust), and (2) the 5% probability test (which requires that the probability that the trust will run out of funds before it terminates in favor of the charity be less than 5%). The former can be satisfied with even a relatively young beneficiary, but the latter test is very hard to satisfy with today's low interest rates. Consequently, many trusts pass the 10% remainder test but fail the 5% probability test – for example (using an AFR of 1.8%), a CRAT paying 5% of its initial asset value will satisfy the 10% test with a beneficiary as young as 52, but won't pass the 5% probability test unless the beneficiary is at least 73 (at which point the remainder interest is a whopping 47%, almost five times the required minimum!).

Two members of the ACTEC Charitable Planning Committee, Chip Parks and Bill Finestone, met with the IRS and proposed an alternate approach to addressing the 5% probability test: rather than measure the probability of exhaustion at the time the trust is created, add an early termination to the trust, tied to the actual value of the trust, such that the trust would terminate early if it was about to run out of assets (so it would never "exhaust"). They argued that such a provision should be considered a qualified contingency – IRC section 664(f) provides that if a trust would, but for a qualified contingency, meet the requirements for a CRAT, then the trust will not be deemed to fail by virtue of containing the qualified contingency.

Well, sometimes good things happen. The IRS just issued **Rev. Proc. 2016-42**, which adopts the general idea proposed by Chip and Bill. It includes sample language that can be included in a CRAT document which the IRS will respect as a qualified contingency and will not cause the trust to fail to qualify as a CRAT. If the language is included, the trust does not need to meet the 5% probability test.

A few cautions, though. First, the sample language only applies to trusts created after August 8, 2016. Second, the ruling only applies if the drafter uses the "precise language" set forth in the ruling – any deviation will not necessarily disqualify the trust, but it will not be assured of treatment as a qualified contingency. Finally, the sample language is

RELATED CATEGORIES

- Charitable Gift Planning
- IRS

AUTHOR

Erik Dryburgh
Senior Counsel

ABOUT OUR BLOG

Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

EDITORS

Stephanie L. Petit
Principal

Eric K. Gorovitz
Principal

not a straightforward calculation (as proposed by Chip and Bill), but instead a rather complicated formula. It would appear that the IRS wanted to guarantee that the charity gets the 10% minimum remainder value; this is more than the amount actually required to satisfy the 5% probability test, which only looks to whether the trust would “exhaust” before it terminates in favor of the charitable beneficiary). Still, this ruling should be a welcome development.

Adler & Colvin | 135 Main Street | 20th Floor | San Francisco, CA 94105 | (415) 421-7555 www.adlercolvin.com