

[admin](#) - Wed, 11/20/2013 - 00:00

To the extent it is thought of at all, the charitable remainder annuity trust (CRAT) is generally regarded as the “other” type of charitable remainder trust (CRT). True, a charitable remainder unitrust (CRUT) will be appropriate in far more situations than will a CRAT. Still, a CRAT can prove to be just the right vehicle in certain circumstances, now that somewhat higher IRS discount rates have – at least for the time being – brought newly-established CRATs back from the brink of extinction.

CRAT Basics

Because both CRATs and CRUTs are in fact different types of CRTs, they share quite a few characteristics. Like a CRUT, a CRAT:

- is an irrevocable trust created during life or upon death pursuant to Section 664 of the Internal Revenue Code and related regulations;
- can last either for the lifetime(s) of one or more individuals or for a term of up to 20 years (or for particular combinations of lives and years);
- makes payments each year during its existence to one or more income beneficiaries, so long as at least part of what is paid each year goes to a non-charitable beneficiary (an individual, for example, with such individuals almost always being the donors themselves), with payments taxed to each beneficiary according to the “four-tier” approach, which reflects the nature of the income earned by the trust and which generally results in income taxed at higher rates being paid before income taxed at lower rates;
- upon termination distributes its assets to one or more qualified charities, with the donor being allowed to retain the option to remove and replace charities up until termination; and
- features attractive tax benefits, specifically a charitable deduction (income, gift, and/or estate tax, as applicable) for part of the value of assets transferred to the trust, along with the ability of the trust to sell appreciated assets without paying tax on any of the capital gain due to the fact that – so long as various requirements are met – the trust is a tax-exempt entity.

Significantly, however, the payments made each year by a CRAT differ from those made by a CRUT. Specifically, a CRAT pays an annuity, i.e., a fixed amount of

money expressed as no less than 5 percent and no more than 50 percent of the value of the assets transferred to the trust as of the date they were transferred. A CRUT, by contrast, pays at least 5 percent and no more than 50 percent of the value of the trust's assets as their value changes each year. A CRUT can also be structured to pay the lesser of its annual net income or the percentage amount, whereas a CRAT must pay the same amount each year regardless of what income the trust earns. Furthermore, assets can be transferred to a CRUT at any time, but a CRAT can be funded only at inception.

CRATs vs. Charitable Gift Annuities

Of course, a charitable gift annuity (CGA) also pays an annuity each year and, like a CRAT, rewards the donor(s) with an income, gift, and/or estate tax deduction for part of the value of the assets contributed. For these reasons, donors sometimes confuse CRATS with CGAs. Nevertheless, the two are quite different in many respects.

For one thing, a CGA is not a trust. Rather, it is a contract between the donor(s) and a single charity. The charity's obligation to pay the annuity exists for as long as the contract remains in force, even if the amount contributed by the donor(s) has been exhausted. In the case of a CRAT, the trust's assets serve as the sole security for the payments. If those assets are ever exhausted, the payments cease. Moreover, the way in which a CGA's payments will be taxed is known right from the start. With a CRAT, events must play themselves out each year with the application of the four-tier approach.

In addition, no charity other than the organization issuing a CGA can benefit from the arrangement. Likewise, the annuity must be paid for the lifetime(s) of only one or two individuals, with payments made over a set number of years being an option only in the case of certain deferred CGAs. As noted above, CRATs can have multiple charitable beneficiaries and multiple income beneficiaries. Also, they can last for a term of years, although their payments cannot be deferred.

Finally, there are some practical considerations. A CGA entails minimal documentation and will typically be feasible in connection with a contribution of assets having only a modest value, say, \$10,000, as the issuing charity will pool all of its CGA contributions for investment purposes, thereby achieving some efficiencies. A CRAT, on the other hand, is established pursuant to an agreement either drawn up or reviewed by the donor's lawyer and will seldom make sense with

amounts less than \$100,000. Indeed, the minimum for a CRAT is usually going to be a function of who is appointed by the donor as the trustee, recognizing that there is sometimes a trade-off between saving money and ensuring competent trust administration. CRAT expenses tend to be less when the donor or a family member or other individual close to the donor serves as trustee, although many charities serve as trustees of CRATs and they strive to keep their costs as low as possible. A bank or other professional trustee will be the most expensive option, and its fees may translate into a CRAT being realistic only if the trust is funded with assets worth hundreds of thousands of dollars.

Why a Donor Would Choose a CRAT

CRATs often seem to lose out vis-à-vis CRUTs and CGAs. The most recent year for which the IRS has published figures on CRATs and CRUTs is 2012, and in that year tax returns were filed for 91,250 CRUTs but only 14,616 CRATs. Even though the IRS does not indicate how many of the 14,616 were established in 2012, the number probably was not very large. Likewise, CGAs are far more common than CRATs. Here again, the IRS provides no relevant statistics on CGAs, but the American Council on Gift Annuities has estimated that CGAs are offered by as many as 4,000 organizations. If each one issued just five CGAs per year, the CGAs issued in 2012 alone would have exceeded the total number of CRATs in existence that year – the vast majority of which were no doubt established in prior years.

Still, a CRAT will be the right choice for a donor who may want to:

- benefit more than one charity;
- benefit more than two individuals (or other income beneficiaries);
- arrange for payments that begin immediately but continue for a term of up to 20 years, rather than strictly for a term measured by any individual's life; or
- determine who will manage the gift arrangement once assets have been contributed.

None of these criteria can be met by a CGA. Moreover, if a donor uses long-term capital gain assets to establish a CGA for the benefit of another individual, a portion of the gain will escape taxation, but the rest will be taxed to the donor in the year of the gift. Yet if a CRAT were established to benefit the same individual, the donor would not be taxed on any of the capital gain, as it would be recognized by the trust and then passed along to the income beneficiary pursuant to the four-tier approach.

Similarly, if a donor wants or needs to establish a CRT because a CGA does not meet one or more of the donor's criteria, yet at the same time he or she wants the CRT to pay a fixed amount each year, no form of CRUT will suffice. In fact, sometimes the uncertainty associated with a CRUT, especially the possibility that payments will decline from one year to the next, will simply be a show-stopper. This will often be the case with older donors who want to arrange lifetime payments for themselves in an amount they can count on each year. Other times, cash flow may be needed by a relatively young beneficiary merely over a set number of years, but the amount needs to be predictable and consistent in order to cover the costs anticipated with something such as the purchase of a life insurance policy, the education of one or more children or grandchildren, etc.

Enter the Federal Discount Rate

Ever since 1997, both CRATs and CRUTs have had to meet the so-called "10-percent test." That is, the present value of the remainder interest associated with a contribution of assets to a CRT must be at least 10 percent of the value of those assets as calculated at the time of the contribution. Even though the present value of a CRUT's remainder interest is only modestly sensitive to changes in the monthly IRS discount, that rate exercises much more influence when it comes to CRATs. The lower the rate, the lower the present value of the trust's remainder interest.

If preliminary calculations reveal that a contemplated CRT will fail the 10-percent test, one option is to decrease the payout rate, recognizing that it can be no lower than 5.0 percent. Another option is to decrease the trust term, something that is relatively easy if the trust is to last for 20 years or less. The donor simply selects a smaller number of years. If, however, the trust term is measured by the lifetime(s) of one or more income beneficiaries, then unless a beneficiary will soon experience an increase in his or her nearest age (a factor that will increase the present value of the remainder interest, all other factors - including the discount rate - being equal), an acceptable term of years may need to be selected. Sometimes both a decrease in the payout rate and a shorter trust term will be needed in order for a CRT to pass the 10-percent test. Perhaps, too, the donor will need to wait until the discount rate rises sufficiently. One other factor can be the timing of the payments: annual at the end of the year maximizes the present value of the remainder interest, again, all other factors being equal, and monthly at the beginning of the month minimizes it, with all other possibilities falling somewhere in between in terms of their influence.

In the case of a CRAT, passing the 10-percent test is simply one hurdle. A separate test is the so-called “5-percent test.” This refers to there being no more than a 5-percent chance the trust’s corpus will be exhausted. In theory, a CRUT’s corpus will never be exhausted, for if the corpus declines, the amount the trust must pay each year will decrease proportionately. With a CRAT, though, if trust corpus declines, the amount the trust pays each year stays the same. Trust administration costs can place further pressure on the remaining corpus. If this goes on for too many years, the corpus will be exhausted, a phenomenon that eventually befell some CRATs established in the 1990s with payout rates that were far too high. Declines in corpus value early in the trust’s existence can be especially difficult to overcome.

With regard to the 5-percent test, the federal discount rate is once more a significant factor. The lower the rate, the more difficult it will be for a CRAT to pass the test. As the table below indicates, even for a CRAT with a payout rate of 5.0 percent making payments at the end of each quarter, some income beneficiaries who, by virtue of their age, would find appealing the idea of fixed payments for life will nonetheless be too young for a CRAT measured by their lives when the discount rate falls to a certain point.

Discount Rate	Minimum Beneficiary Age for a New 1-Life CRAT	Minimum Beneficiary Ages for a New 2-Life CRAT
1.0	76	78/78
1.2	75	78/78
1.4	75	77/77
1.6	74	76/76
1.8	73	75/75
2.0	72	75/75
2.2	71	74/74
2.4	71	73/73
2.6	69	72/72
2.8	68	71/71
3.0	67	70/70

Fortunately, here in the last quarter of 2013, some donors who earlier in the year (or throughout much of the two prior calendar years, for that matter) were frozen out of establishing a CRAT due to their ages (or due to the ages of any individuals by

whose lives the trust's term would be measured) are witnessing some welcomed thawing. Others, however, may still need to opt instead for a trust term measured in years.

Unfortunately, donors who want their CRATs to do more than barely pass the 5-percent test will find that the maximum permissible payout rate will be modest at best. For instance, the highest payout rate allowed for a CRAT whose term is measured by the life of an individual age 76 is only 5.0962 percent when the discount rate is 1.0 percent. Even when the discount rate rises to 2.0 percent, the highest payout rate becomes a mere 5.6494 percent. When the discount rate is 3.0, the payout rate can be above 6 percent, but not by much: it cannot exceed 6.2332 percent. **Note:** PG Calc's *Planned Giving Manager* software enables you to calculate instantly for any desired trust term the maximum payout rate that satisfies both the 10-percent test and the 5-percent test.

Conclusion

In any given year, new CRATs will probably never outnumber new CRUTs or new CGAs. Yet there will always be at least some demand for CRATs, in light of the donor needs they can fulfill that can never be met by either a CRUT or a CGA. Furthermore, gift planners – having observed the exhaustion of CRATs established in decades past with payout rates that were too high – now possess a better appreciation for what is realistic. If discount rates can hold steady or, ideally, increase somewhat, judiciously established CRATs can be expected to increase in number as well.

[Print](#)

Categories

[PG Calc Featured Articles](#)