

[Jeffrey Frye](#) - Sun, 9/18/2016 - 10:19

The persistently low IRS discount rates over the past five years has had a chilling effect on charitable remainder annuity trusts (CRATs). One reason is that these low rates have made 1-life CRATs unavailable for beneficiaries younger than their early 70s. Beneficiaries of 2-life CRATs must be even older. The roadblock has been the 5% probability of exhaustion test.

What is the 5% Probability of Exhaustion Test?

Defined in Revenue Ruling 70-452 and applied in Revenue Ruling 77-374, the 5% probability test requires that there be less than a 5% probability that a CRAT's principal will decline to \$0 before its last beneficiary dies. The donor of a CRAT that fails this test is denied a charitable deduction for the gift and the trust is not exempt from income tax.

The probability that a CRAT will exhaust its principal is computed in two steps: 1) determine how long it will take the trust to exhaust, and then 2) determine the probability at least one income beneficiary will live that long. The IRS discount rate affects step (1). The minimum CRAT payout rate allowed is 5%, yet the IRS discount rate is only 1.4% in August 2016. This means that even using the lowest payout rate possible, the IRS assumes the CRAT will shrink each year. The larger the gap between these two rates, the shorter the time to exhaust and the higher the probability of exhaustion.

The IRS Offers a Solution

On August 8, 2016, the IRS published Revenue Procedure 2016-42. Effective for CRATs created on or after this date, the ruling provides a trust provision that makes the 5% test inapplicable. A trust that includes this provision can qualify as a CRAT

even though it would otherwise fail the 5% test.

The provision is a "qualified contingency" under § 664(f). It states that the trust will terminate immediately prior to making its next payment if distributing that payment would cause the trust principal to fall below 10% of the original value of the trust, plus interest. The interest rate is the IRS discount rate used to compute the original deduction. The exact wording provided in the ruling is a safe harbor for CRAT drafters. The ruling adds that a provision similar, but not identical, to the one provided in the revenue procedure may not be a qualified contingency under § 664(f).

Per the IRS, it designed this early termination formula to ensure that the charitable remainder beneficiary will receive a significant benefit that is in line with the charitable deduction allowed to the donor, while also being exposed to some, but not all, of the trust's investment performance risk. Of course, if the trusts investments perform well enough, the early termination provision won't be triggered.

A Welcome Development

The publication of Rev. Proc. 2016-42 should be a welcome development to gift planners. Although it is unlikely to lead to a stampede of CRAT donors, Rev. Proc. 2016-42 does provide a clear solution when the only impediment standing between a donor and a CRAT is the 5% probability of exhaustion test. The ruling will be especially helpful for *testamentary* CRATs, where it can't be definitively known at the time the donor's will is written whether the trust will pass the 5% probability test at the donor's death.

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