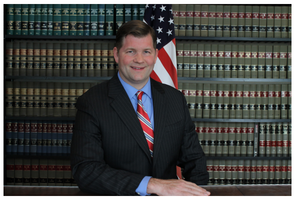

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Charitable Remainder Annuity Trust (CRAT)

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What is it?

A charitable remainder annuity trust, or CRAT, is a trust with both charitable and noncharitable beneficiaries. When the trust is created, the charity's interest in the trust assets is a "remainder interest," which means it is second in line to someone else's interest. For this reason, this trust is characterized as a remainder trust. A CRAT works like this:

- You transfer property to a trust. It can be most anything (money, securities, real property, a statue).
- You choose a qualified charity (a charity must be a "qualified" one in order for your contributions to be tax deductible).
- You designate a noncharitable beneficiary. This person can be most anyone (you, your spouse, a friend).
- You determine, within set guidelines, how much money the noncharitable beneficiary is to be paid each year out of the trust assets (called the annuity rate). IRS rules require this payment to be at least 5%, but no more than 50%, of the initial fair market value of the trust assets.
- You determine how long the trust will last. It can be for the life of the noncharitable beneficiary (or joint lives for multiple beneficiaries) or for a fixed period of years up to 20 years.
- At the end of the stated period of time, all the remaining trust assets pass to charity.

Example(s): *Frank decides to donate some money to the XYZ Charity. He transfers $100,000 to a CRAT and names his wife as the noncharitable beneficiary. Frank decides the annuity rate will be 7% and that the trust will last for 10 years. The result is that every year for 10 years, Frank's wife will receive an annual payment of $7,000, which is 7% of $100,000 (the initial fair market value of the trust assets). After 10 years, all of the remaining money in the trust will pass to the XYZ Charity.*

The distinguishing feature of a CRAT is that the annual payment is a fixed amount that remains the same over the life of the trust. The payment is based on the initial fair market value of the trust assets, which are valued only once at the creation of the trust. This is significant because the payment amount cannot be changed later to account for new circumstances, such as an increase in the value of the trust assets, inflation, or a change in the income requirements of the noncharitable beneficiary. A CRAT can be established to take effect either during your life (a living or inter vivos trust) or at your death (a testamentary trust). A CRAT operates in an identical manner in either situation. The reasons you might choose one over the other include tax consequences and the ability to see your trust in operation. For example, in the living trust situation, you are entitled to an immediate income tax deduction for the present value of the remainder interest that will pass to charity. See the Tax Considerations section of this discussion.

Caution: *On March 30, 2005, the Treasury and the IRS announced that for CRATs created on or after June 28, 2005, a donor's spouse may be required to sign an irrevocable waiver of his or her right to elect a statutory share of the donor's estate, and that failure to do so may result in the CRAT failing to qualify for tax exempt status, and the donor may be unable to take the initial income tax deduction. The Treasury and the IRS have since extended the safe harbor date of June 28, 2005, pending further guidance from the IRS. See IRS Rev. Proc. 2005-24 and Notice 2006-15 for more information, and consult a tax professional.*

When can it be used?

You want to donate to charity but want a noncharitable beneficiary to receive an income stream for life or a period of years

By establishing a CRAT, you can donate to your favorite qualified charity, reap some tax benefits, and, at the same time, retain control over an income stream derived from the donated assets. The income stream is in the form of a fixed payment, which in turn is based on the initial value of the trust assets. The payment amount is set by you and paid to your designated beneficiary at least once per year.

Strengths

Provides income tax deduction

When you establish a CRAT during your lifetime, you receive an immediate income tax deduction for the present value of the remainder interest that will pass to charity. This deduction is available even though the charity may not benefit from your gift for many years.

Provides an income tax haven for assets that have appreciated substantially

There is no IRS rule that says you must be 100% charitably motivated to establish a CRAT. Yes, you heard it right. Thus, it's perfectly acceptable, and even preferable, to set up a CRAT and fund it with an asset that has appreciated substantially in value (for example, stock, a closely held business, or real estate). When the trust sells the asset, it pays no capital gain or income taxes on the sale. The trust can then invest the proceeds and provide you or your designated beneficiary with an income stream off of a much larger principal than if you had sold the asset yourself and paid capital gain tax.

Example(s): *Gary owns $100,000 of stock that he purchased 20 years ago for $5,000. If Gary were to sell the shares, he would owe capital gain tax of nearly $15,000 (assuming a capital gain tax rate of 15% and no other variables) leaving him only $85,000 to invest. Instead, Gary can set up a CRAT and use his stock to fund it. The trust can then sell the stock and reinvest the entire $100,000, which is exempt from capital gain tax.*

Pays out fixed income every year

Many older income beneficiaries want the security and consistency of a fixed payment every year.

Caution: *A fixed payment cannot be increased in future years. So, even if the trust assets increase in value or a long period of inflation sets in, the payment remains fixed over the life of the CRAT.*

Exists with fairly simple administration

The annual payment to the noncharitable beneficiary is set at the creation of the CRAT and remains fixed over the life of the trust. It is based on the fair market value of the trust assets, which are valued only once at the inception of the trust. Thus, there are no time-consuming annual valuations of the trust property. Once a CRAT is funded, no additional contributions of property are permitted.

Provides you with positive social, religious, and/or psychological benefits for donating to your favorite charity

Yes, the tax benefits can be great. In addition, donating to charity can be a real morale booster.

Reduces potential federal estate tax liability

If all the requirements of a CRAT are met, the IRS allows the executor of your estate to deduct the present value of the remainder interest that will pass to charity from your gross estate. This will reduce the size of your gross estate. Once the value of the charity's interest is determined (using special IRS tax tables), the entire amount may be deducted from your gross estate.

Example(s): *In her will, Kathy establishes a CRAT for the life of her friend, Paige, with the remainder to go to a local charity fighting illiteracy. Assuming that the present value of the remainder interest to go to charity is $125,000, Paige's estate will be entitled to subtract $125,000 from her gross estate.*

Tradeoffs

Requires an irrevocable commitment

If you harbor reservations about leaving a portion of your estate to charity, you shouldn't jump to establish a CRAT. Once you fund it, there's no turning back. You can't even amend a CRAT once the ink is dry and it's properly executed, although you can give the trustee the discretion to choose the exact charitable beneficiary at the end of the term.

Assets donated to charity are assets lost to your family

Once you decide to donate a portion of your estate to charity with a CRAT, these assets are forever removed from your inheritable estate.

Tip: *This reality has prompted the creation of "wealth replacement trusts," so called because their purpose is to replace the wealth lost to your family. A wealth replacement trust is often an irrevocable life insurance trust (ILIT). The idea is that the donor uses part of the income stream generated by the CRAT to pay premiums on a life insurance policy in an amount roughly equal to the amount to be passed to charity. The policy is then held in trust and distributed to the family on the donor's death (free of estate tax), thus "replacing the wealth."*

Requires the fixed annuity to be paid each year, regardless of whether there is sufficient trust income available

IRS rules require that if the income from the trust (dividends, gains, and/or interest) is insufficient to meet the required annual payment to the noncharitable beneficiary, then the difference must be paid from capital gains or principal. A drastic result means the charity could end up with nothing.

Example(s): *Suppose the trust asset is an apartment house and the rents are the income from which the annual payment is made. If the rents were to fall below the required payment amount, the trustee would have to borrow against the property or, even worse, sell the property to make the required payment.*

Inflation may cause a CRAT to lose some of its value

The trust assets are valued only once at the creation of the CRAT, and the fixed annual payment is based on this valuation. Because the payment remains the same over the life of the trust, it cannot be adjusted for inflation. Thus, the purchasing power of a fixed income stream may be eroded by inflation.

Tip: *Despite this potential problem, older income beneficiaries often prefer a CRAT because they want to plan on a fixed amount of income each year.*

Prohibits the additional contribution of assets

Once a CRAT is funded, IRS rules prohibit you from making any additional contributions. Thus, it is impossible to "pour over" future bequests from your will into the trust.

Value of charity's remainder interest at inception of CRAT must be at least 10% of trust assets

The present value of the remainder interest to charity must be at least 10% of the fair market value of the trust property as of the date the property is contributed to the trust. This present value is determined by using special IRS tax tables, which take into account the age of the income beneficiary, the amount of trust assets, and the fixed annuity rate. This rule prevents you from setting up a CRAT with payments made over the life of a very young income beneficiary or with a very high payout rate and an older beneficiary. In such scenarios, it is possible that by the time the income beneficiary died, there would be nothing left for the charity.

Example(s): *This rule would prohibit a client from setting up a CRAT for 10 years with a payment rate of 10.6% and an interest rate of 3% because the remainder value for charity (using the tax tables) would be only 9.58%.*

Income beneficiary cannot have more than 5% chance of outliving trust assets

This rule is otherwise known as the 5% probability (or probability of exhaustion) test. It is a test devised by the IRS to discourage fraud and has no relation to the rule that at least 5% of the trust assets must be paid out to the income beneficiary every year. The 5% probability rule states that an income beneficiary cannot have more than a 5% probability of outliving the trust assets. Otherwise, there would be no assets left for the charity. This probability is determined using actuarial tables and takes into account the age of the noncharitable beneficiary, the amount of trust assets, and the payout rate.

At low interest rates, the use of a CRAT may be greatly limited by the 5% probability test. A CRAT that provides for annuity payments for one or more measuring lives and that is created on or after August 8, 2016 is not subject to the 5% probability test if the CRAT contains a special provision. The provision must require termination of the trust and payment of the remainder to charity immediately before any annuity payment that would reduce the value of the trust corpus, when multiplied by the specified discount factor, to less than 10% of the value of the initial trust corpus. The specified discount factor is the present value of a single sum factor $[1 / (1 + I)^t]$, where *t* is the time from inception of the trust to the date of the annuity payment (expressed in years and fractions of a year) and *I* is the IRC Section 7520 rate that was used to determine the value of the charitable reminder at the inception of the trust.

How to do it

Consult a competent legal advisor to draft the charitable remainder annuity trust (CRAT)

A legal advisor well versed in the area of charitable remainder annuity trusts (CRATs) is your best bet. A CRAT is subject to many technical requirements and must be drafted with the utmost care in order to gain favorable tax benefits. Often, additional advisors (such as tax specialists, accountants, life insurance experts, and/or CERTIFIED FINANCIAL PLANNERS™) will be necessary to devise the best strategies and "crunch the numbers."

Pick a noncharitable beneficiary

The noncharitable beneficiary can be you, a spouse, another family member, or friend. You may choose practically anyone, as long as there is not more than a 5% chance that the noncharitable beneficiary will outlive the trust assets.

Tip: *If you and your spouse, or your spouse, are the only noncharitable beneficiaries, the interest transferred to your spouse qualifies for a gift tax or estate tax marital deduction.*

Caution: *For a lifetime CRAT, if the noncharitable beneficiary is other than you or your spouse, you have made a gift for federal gift tax purposes, part of which may qualify for the annual gift tax exclusion. If you are the grantor and a beneficiary of the CRAT and die during the trust term, the CRAT will be included in your gross estate for federal estate tax purposes, but will generally qualify for a charitable deduction and, if your spouse is the only other noncharitable beneficiary, a marital deduction.*

Pick a charity you wish to donate to and verify that it is a "qualified charity"

The IRS allows you to deduct contributions only to "qualified charities." Generally, qualified charities are those operated exclusively for religious purposes, educational purposes, medical or hospital care, government units, and certain types of private foundations. Every year, the IRS publishes a list of all qualified organizations in IRS Publication 78, commonly known as the "Blue Book." Check to make sure your charity is listed in this publication.

Tip: *Once you have picked a charity, IRS regulations require you to choose an alternate charity in case the one you picked is not in existence when the trustee is to deliver the trust assets.*

Tip: *Once you have picked a charity, it is a good idea to contact the charity to make sure it is willing to accept such a gift.*

Tip: *Alternatively, the IRS does not require you to pick a charity when the CRAT is established. So, you can set up a fully operational CRAT and reserve the choice of charity for a future date. However, the trust must set forth the specifics of when and how the charity will be identified. Be sure the charity you ultimately pick is a qualified one.*

Identify the asset(s) you want to use to fund the trust

You can use any type of property to fund the trust (e.g., cash, securities, real property, life insurance, a prized stamp collection).

Tip: *Because the trust is exempt from capital gain tax on the sale of any property, it is preferable to transfer an asset that has appreciated substantially in value.*

Tip: *It is a good idea to fund the CRAT, at least in part, with marketable securities and/or cash. You don't want to transfer real estate to the trust and assume it can be sold in time to make the required payment to the income beneficiary.*

Determine how long the trust will be in existence and set the payment rate

You control the duration of the trust. The trust can be in existence for the life of the noncharitable beneficiary (or joint lives for multiple beneficiaries) or for a fixed period of years up to 20 years. The payment rate (also called the annuity rate) is the amount of money paid to the noncharitable beneficiary each year. It is a fixed amount that does not change during the life of the trust. It must be at least 5%, and no more than 50%, of the initial fair market value of the trust assets. IRS regulations allow the payment to be made within a reasonable time after the close of the year.

Caution: *Once you have established the duration of the trust and the payout rate, you must "crunch the numbers" to make sure you comply with the IRS rule that the present value of the charity's remainder interest equals at least 10% of the total trust assets and that the 5% probability test (if applicable) is met.*

Select a trustee

Once you transfer an asset to a CRAT, it is the trustee's responsibility to manage, invest, and conserve this property. The trustee has a dual fiduciary responsibility: to generate income for the noncharitable beneficiary and to preserve the trust assets for the charity. It helps to choose a trustee who is well versed in the world of CRATs.

Tip: *If you want to appoint the charity as trustee, it is a good idea to contact the charity to make sure it is willing to serve in this capacity.*

Caution: *You can appoint yourself trustee. However, you are then responsible for investing the assets to produce income sufficient to meet the requirements of the trust. If the trust income is insufficient to make the required payment to the income beneficiary, you must invade the principal to make up the difference. Frequent dips into principal may mean an early demise of the entire CRAT. Another pitfall is that the IRS periodically updates the requirements of a CRAT. As trustee, you will need to keep abreast of these regulations and comply with them in order to gain favorable tax benefits.*

Caution: *If you are both the trustee of the CRAT and the income beneficiary, some states require that a co-trustee be appointed who is not a beneficiary.*

Coordinate the CRAT with your existing will and/or living trust

It is a good idea to make sure your CRAT is coordinated with any other estate planning documents to achieve an integrated plan. A competent professional should undertake this review.

File Form 5227 — Split Interest Trust Information Return

Even though a CRAT is exempt from federal income tax, you must still file Form 5227 (Split Interest Trust Information Return) every year the CRAT is in existence. Further, if it is your first year filing Form 5227, you must also include a copy of the trust instrument and a written declaration that the document is a true and complete copy.

Tax considerations

Income Tax

Income tax deduction for donor of charitable remainder annuity trust (CRAT) established during donor's lifetime

If you itemize deductions, the IRS allows you to take an immediate income tax deduction for the present value of the remainder interest that will pass to charity. You are entitled to the deduction in the year you establish the CRAT, even though the charity may not benefit from your gift for several years.

Your deduction for the given year is limited to 50%, 30%, or 20% of your adjusted gross income (AGI), depending on the type of property donated to charity (via the trust) and the classification of the charity as either a public charity or a private foundation. (For 2018 to 2025, the 50% limit is increased to 60% for certain cash gifts.) If you cannot take the full deduction in the given year, you may carry over the difference for up to five succeeding years (assuming you still itemize deductions in those years).

Tip: *Generally, a "public charity" is a publicly supported domestic organization (e.g., the Red Cross), whereas a "private foundation" does not have the same base of broad public support (e.g., the Rockefeller Foundation). IRS Publication 78 notes whether a charity is a public or private one.*

Technical Note: *The amount of your deduction is figured using special interest rate tables established by the IRS. The current rules require the value of a remainder interest to be calculated in a certain fashion. It is calculated by using an interest rate that is*

120% of the federal midterm rate then in effect for valuing certain federal government debt instruments for the month the gift was made. In addition, the calculation uses the most recent mortality table available to determine the mortality factor. Special computer programs now exist to make this calculation easier.

Example(s): *Helen, an 80-year-old woman, places $100,000 in a CRAT, designating herself income beneficiary for life and setting a fixed annual payment of 5%, or $5,000. Assuming a 3% interest rate (using the IRS tax table described above), her allowable income tax deduction would be $64,960. If Helen's AGI for the year was $80,000 and her charity was a public charity (allowing for a 50% deduction), Helen would have an allowable income tax deduction of $40,000 for the current year. The remaining $24,960 (the difference between her authorized deduction and her allowed deduction) could then be carried over to the following year and deducted in full.*

Income tax consequences for income beneficiary of CRAT

If you are the income beneficiary of a CRAT, you will owe income tax on any payments you receive out of the income. So, although a CRAT can escape paying capital gain tax on the sale of an asset, this benefit does not trickle down to you, so you must pay income tax on any part of the income that is distributed to you.

The IRS uses a special accounting procedure to determine the tax on the income distribution to you.

Gift Tax

No gift tax if you and/or your spouse are sole beneficiaries

If you and/or your spouse are the only income beneficiaries of a CRAT, you do not owe gift tax. The income stream to your spouse falls under the unlimited marital deduction.

Caution: *In community property states, husband and wife are treated as equal owners. If community property is used to fund a CRAT that benefits only one spouse or if separate property of one of the spouses is used to fund a CRAT that provides lifetime benefits to both parties, there is a recognized gift to the other spouse. This may have implications under the particular state's gift tax law.*

Possible gift tax if someone else is beneficiary

If the income beneficiary of a CRAT is someone other than you or your spouse (or in addition to you or your spouse), gift tax rules come into play. The present value of the income stream to the beneficiary is determined at the time the gift is established. If the present value is more than the $16,000 (in 2022) annual gift tax exclusion, gift tax must be paid, unless a portion of your applicable exclusion amount (in 2022, $12,060,000 plus any deceased spousal unused exclusion amount) is available to offset the tax due.

Caution: *Any portion of the applicable exclusion amount you use during life will effectively reduce the amount that will be available at your death.*

Estate Tax

Reduces size of gross estate

One of the best features of a CRAT is its ability to reduce the size of your gross estate (and thus any potential estate tax). When you establish a testamentary CRAT, the executor of your estate can deduct the present value of the remainder interest payable to charity from your gross estate. The smaller your gross estate, the less chance you have of owing estate tax.

Example(s): *Ken sets up a testamentary CRAT, naming his friend the lifetime income beneficiary and ABC Charity the charitable beneficiary. Assume that at Ken's death the present value of the remainder interest to ABC Charity is valued at $200,000. The result is that the executor of the estate will be entitled to deduct $200,000 from Ken's gross estate.*

Caution: *If you are the grantor and a beneficiary of the CRAT and die during the trust term, the CRAT will be included in your gross estate for federal estate tax purposes, but will generally qualify for a charitable deduction and, if your spouse is the only other noncharitable beneficiary, a marital deduction.*

Questions & Answers

Can you establish a charitable remainder annuity trust (CRAT) and name yourself the sole income beneficiary?

Yes, you can be both the donor and the sole income beneficiary. However, once you establish a CRAT, it is still irrevocable, even if you are the income beneficiary.

Can you choose more than one charity as the charitable beneficiary?

Yes, you can choose more than one charity as the remainder beneficiary, as long as the trust document sets forth your right to do so and specifies the manner that the trust assets will be distributed. Of course, you must make sure that the second (or third or fourth) charity constitutes a "qualified organization" under IRS rules. Otherwise, you risk losing favorable tax treatment.

Can you choose more than one income beneficiary?

Yes, you can name more than one income beneficiary. However, if you create a CRAT with a life term for each beneficiary, you may run afoul of the rule requiring the present value of the remainder interest to charity to be at least 10% of the trust assets. So make sure to crunch the numbers when picking more than one income beneficiary.

Can you replace the trustee during the life of the CRAT?

Yes. As long as the trust agreement provides for it, you can replace the trustee.

You are the income recipient of a CRAT. How does the IRS determine the income tax you will pay on this distribution?

The extent to which the payment is taxable depends on the character of the payment, which in turn is determined under a special income tax calculation formula unique to charitable remainder trusts. Charitable remainder trusts include charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs).

The IRS uses a four-tier accounting procedure to determine the tax character of the income distribution to the beneficiary. The acronym used to describe this accounting rule is WIFO, which stands for "worst in, first out." The amounts distributed by a CRAT are classified as follows:

- Ordinary income, to the extent of ordinary income earned by the trust in the current year, along with any undistributed ordinary income from prior years (ordinary income includes interest)
- Capital gain (including qualified dividends), to the extent of the capital gains earned by the trust in the current year, along with any undistributed capital gains from prior years
- Nontaxable income, to the extent of the nontaxable income earned by the trust in the current year, along with any undistributed nontaxable income from prior years
- Principal

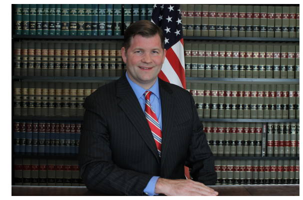
The highest tax the IRS imposes is on ordinary income. If the required annual payment cannot be paid out of ordinary income, it is then paid from capital gains. If the payment still cannot be met after exhausting capital gains, it is paid from tax-exempt income and finally, if necessary, from the principal of the trust.

Tip: *The trustee must keep track of all sales and gains by the trust in order to make these calculations — a daunting task often completed by a computer tracking system. This is one more reason to question whether you really want to appoint yourself trustee.*

Also, the IRS cares about the type of property you use to fund the CRAT. If you contribute nonappreciated property (like cash), the payment to the income beneficiary constitutes a return of principal, and no income tax is due. By contrast, if you contribute appreciated property (like stock), the payment from principal has income tax consequences for the income beneficiary. The income tax will be in the form of a capital gain tax to the extent any part of the payment is attributable to gains that were untaxed prior to the asset being transferred to the trust. In other words, the donated asset carries with it the tax characteristics that existed prior to the asset being transferred to the CRAT.

What are the advantages of using a CRAT over a CRUT (charitable remainder unitrust)?

Although a CRAT and CRUT are both charitable remainder trusts, there are differences between them. A CRAT pays out to the income beneficiary a fixed amount every year for the life of the trust. The amount is set as a percentage of the trust assets, which are valued only once at the inception of the CRAT. If the amount cannot be paid from the current income earned by the trust, the principal must be invaded. By contrast, a CRUT pays out a fixed percentage of the value of the trust assets every year. The value of the trust assets is determined on an annual basis. So the payment fluctuates with the value of the assets. A CRUT will often provide that if the payment cannot be paid from the current income earned by the trust, the principal may, but need not be, invaded. Second, once a CRAT is funded, additional contributions of property are prohibited. By contrast, new property can be added to a CRUT. These differences make the CRUT more complicated and more difficult to administer.



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