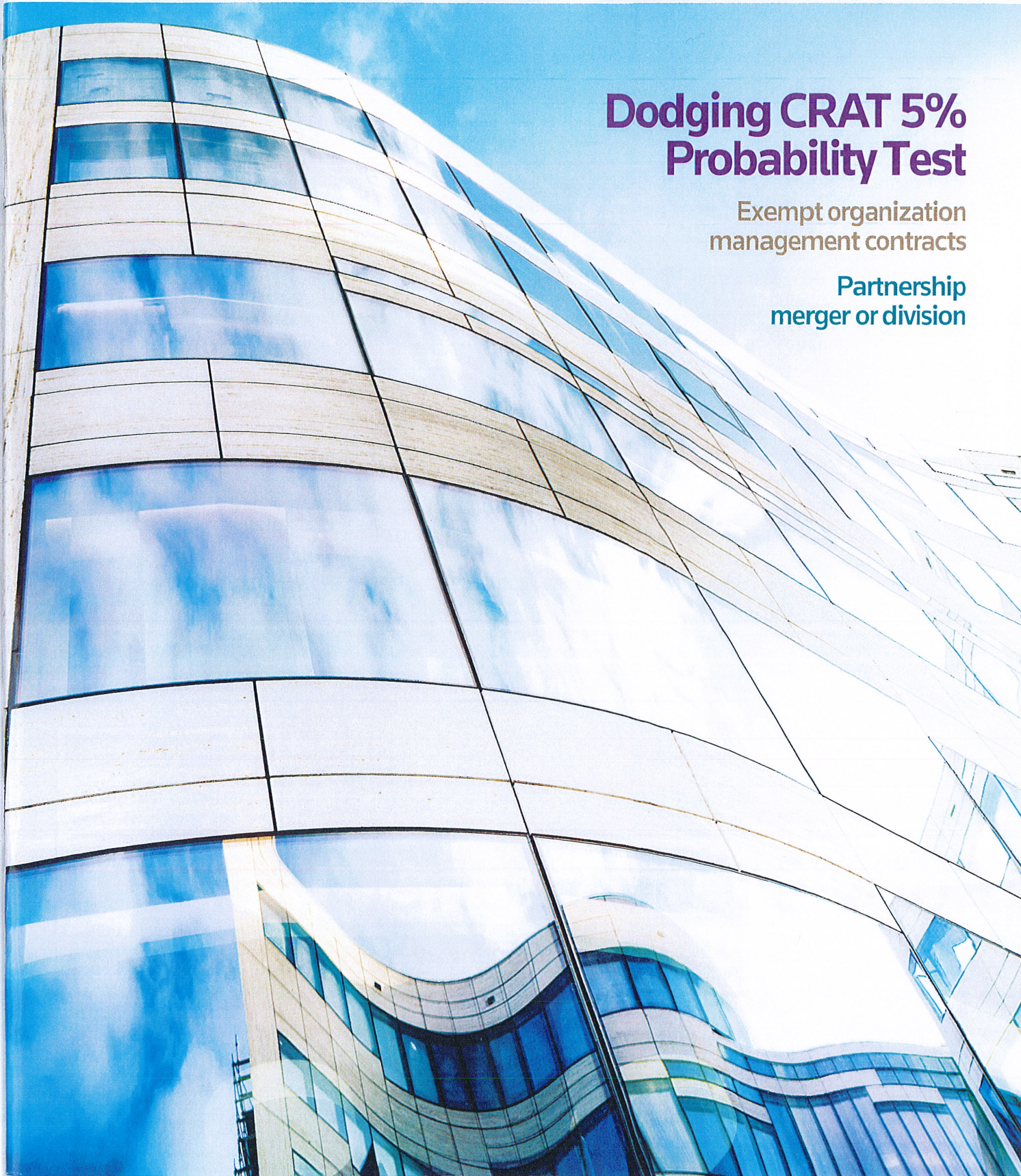


# Journal of Taxation

## **Dodging CRAT 5% Probability Test**

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# IRS Provides Guidance to Avoid 5% Probability Test for Charitable Remainder Annuity Trusts

RICHARD L. FOX AND JONATHAN G. BLATTMACHR

**In order to allow a CRAT to qualify under Section 664 when it would otherwise fail the 5% probability of exhaustion test, the IRS has issued Rev. Proc. 2016-42, which includes a sample provision containing specified "qualified contingency" language that, if included in the governing instrument, will not subject the CRAT to the test.**

Today's historically low interest rate environment presents substantial obstacles in meeting the requirements of a charitable remainder annuity trust (CRAT) when the governing instrument provides for annuity payments payable for one or more measuring lives as opposed to a term of years.<sup>1</sup> The culprits are the 10% remainder interest requirement, which is also applicable to a charitable remainder unitrust (CRUT), and the 5% probability of exhaustion test that is applied exclusively to a CRAT.<sup>2</sup> Even when a CRAT meets the 10% remainder interest requirement, it may still fail to meet the 5% probability of exhaustion test, thereby causing the disallowance of any charitable estate, gift, or income tax deduction and precluding the CRAT from qualifying as a charitable remainder trust (CRT) under Section 664. Indeed, under the current low in-

terest rate environment, it is not possible in many cases to meet the 5% probability of exhaustion test applicable to a CRAT payable over one or more measuring lives, thereby precluding its use.

In response to those situations where the 5% probability of exhaustion test cannot be met, the IRS has issued Rev. Proc. 2016-42, 2016-34 IRB 269, which provides a sample provision containing specified "qualified contingency" language that, if included in the governing instrument of a CRAT, will not subject the CRAT to the 5% probability of exhaustion test. Therefore, assuming the CRAT would otherwise qualify under Section 664, including this special provision in a CRAT governing instrument will allow qualification under Section 664 even when the 5% probability test would not be met and the CRAT



would therefore not otherwise qualify under Section 664.<sup>3</sup>

The sample qualified contingency provision provides for the early termination of the CRAT on the date immediately before the date on which any annuity payment would be made if such payment would cause the value of the corpus of the CRAT, when multiplied by a specified discount, to be less than 10% of the value of the initial trust corpus. Upon such early termination, annuity payments otherwise required to be paid to a noncharitable beneficiary or beneficiaries are discontinued, a distressing prospect for a noncharitable beneficiary who presumably was relying upon the continuation of such payments. Rev. Proc. 2016-42 applies an alternative only to meeting the 5% probability of exhaustion test and has no application to the statutorily prescribed 10% remainder interest requirement. The sample provision contained in Rev. Proc. 2016-42 supplements the sample forms that the IRS had previously issued for CRATs.<sup>4</sup>

#### **BACKGROUND ON 5% PROBABILITY OF EXHAUSTION TEST FOR CRATS**

Unlike payments made under a CRUT, which are reduced when the value of the CRUT assets decrease, payments under a CRAT are fixed, exposing the assets of a CRAT to exhaustion when the value of the CRAT assets decline and the annuity payments continue to be made for one or more measuring lives as opposed to a term of years. When a transfer for a charitable purpose is dependent on performing some act or the happening of an event, an estate, gift, and income tax charitable deduction is not allowed "unless the possibility that the charitable transfer will not become effective is so remote as to be negligi-

ble."<sup>5</sup> In Rev. Rul. 70-452, 1970-2 CB 199, involving a CRT established under the law before the Tax Reform Act of 1969,<sup>6</sup> the IRS ruled that a charitable estate and gift tax deduction are "not allowable where the probability exceeds 5 percent that the noncharitable income beneficiary will survive the exhaustion of the fund in which charity has a remainder interest. Any possibility in excess of 5 percent that the contingency will occur and defeat charity's interest is not considered so remote as to be negligible." The 5% benchmark in Rev. Rul. 70-452 was derived from Sections 2037 and 2042, which specify that 5% is the value at which a reversionary interest will be considered significant.

Based on these principles, the IRS ruled in Rev. Rul. 77-374, 1972-2 CB 329, that in the context of a CRAT established after the Tax Reform Act of 1969, a charitable estate tax deduction is not allowed where the probability exceeds 5% that the noncharitable beneficiaries will survive the exhaustion of the trust corpus in which the charity has a remainder interest. Although Rev. Rul. 77-374 did not address the income tax charitable deduction, as indicated above, a charitable income tax deduction under Section 170 is also not allowed "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible," thereby presumably invoking the 5% probability of exhaustion test in determining whether a contribution to a CRAT is deductible for income tax purposes. Interestingly, the annotations to the sample CRAT forms previously issued by the IRS provide only that "no deduction will be allowable under § 2055 or § 2522 if the probability that the trust corpus will be exhausted before the death of the recipient exceeds 5 percent," making no reference to disqualification of the deduction under

Section 170 or the trust as a whole under Section 664 when the 5% probability of exhaustion test is not met.<sup>7</sup> Rev. Proc. 2016-42, however, indicates that the probability of exhaustion test applies equally to the charitable income tax deduction.

A trust cannot qualify as a CRT under Section 664 unless a deduction for a transfer to the trust "is allowable under IRC §§ 170, 2055, 2106, or 2522."<sup>8</sup> Therefore, when no charitable deduction is allowable for a transfer to a CRAT, including as a result of the failure to meet the 5% probability of exhaustion test, the trust will not qualify as a CRT or achieve tax-exempt status under Section 664.

Interestingly, unlike the 10% remainder interest requirement, which is statutorily proscribed by Congress,<sup>9</sup> the 5% probability of exhaustion test is basically a creation of the IRS, based on its own interpretation of when a charity's interest is not considered so remote as to be negligible. In *Moor Estate*, TCM 1982-299,<sup>10</sup> although the Tax Court upheld the application of the probability of exhaustion test to a CRAT, it found the probability of exhaustion to be negligible in a case where the CRAT was in fact earning more than the 7520 rate, and stated that "[c]onsidering all the facts present in this case, there is doubt as to whether even the 7.63 and 7.09 percent possibilities should not be considered to be negligible. We have found no case holding percentages this low not to be negligible." The court cited Rev. Rul. 77-374 in a footnote (fn. 8) in its decision, but only in support of the "position [of the IRS] that a chance of more than 5 percent that the charity will not take is not sufficiently remote to be considered negligible."

The 5% probability of exhaustion test must be evaluated independently of the 10% minimum remainder interest requirement. This is the case because it is possible to meet the 5% probability of exhaustion test and fail the 10% minimum remainder interest requirement, and it is possible to fail the 5% probability of exhaustion test and meet the 10% minimum remainder interest requirement. The proba-

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bility of exhaustion test is not relevant in determining the actuarial value of the charitable remainder interest in the CRAT, as it is only a measurement of the likelihood that the CRAT will ultimately fail to make any distribution to the charitable remainder beneficiary because of the exhaustion of the trust corpus prior to its termination.

## APPLICATION OF AN EXHAUSTION TEST TO CHARITABLE REMAINDER UNITRUSTS

In Rev. Rul. 77-374, the IRS applied the 5% probability test only in the context of a CRAT. Unlike in the case of an annuity trust, it is extremely difficult to determine at what point the trust corpus of a unitrust will be completely exhausted.<sup>11</sup> Theoretically, because a CRUT pays only a specified

percentage of the value of the assets of the trust, the corpus of the trust will never be exhausted, no matter how high the payout percentage. This is because, unlike in the case of a CRAT where the payments are fixed, as the value of the corpus of a CRUT decreases, the payments will get smaller. The IRS has indicated, however, that under certain circumstances, a CRUT's assets may become exhausted at a time when the projected value of the corpus will be below either a de minimis amount or an amount approximating the annual cost of administering the unitrust.<sup>12</sup> Thus, the IRS has stated that the determination of whether to apply the "so remote as to be negligible" test to CRUTs "should be decided on a case-by-case basis by taking into account not only the adjusted payout rate, the age of the life beneficiary, and the initial value of the

corpus, but also the type of trustee nominated to manage the unitrust and the anticipated cost of administering the trust."<sup>13</sup> The IRS has ruled that the 5% exhaustion test does not apply in the case of a CRUT with a net income limitation, where the payment to the noncharitable beneficiaries is limited to the lesser of the trust income or the fixed percentage unitrust payout.<sup>14</sup>

## EFFECT OF LOW INTEREST RATE ENVIRONMENT ON 5% PROBABILITY OF EXHAUSTION TEST

Low interest rates in recent years have greatly limited use of a CRAT as an effective charitable-giving vehicle, which work best in a high interest rate environment.<sup>15</sup> Unlike CRATs that are highly sensitive to interest rate

<sup>1</sup> In Rev. Proc. 2016-42, 2016-34 IRB 269, the IRS stated: "Low interest rates in recent years have greatly limited use of a CRAT as an effective charitable-giving vehicle." The 5% probability of exhaustion test does not apply to a CRAT having a set term of years that, under the governing rules, cannot exceed 20 years. Section 664(d)(1)(A). However, there would be a 100% probability that a fixed term CRAT would be exhausted if, for example, it was to pay an annuity equal to 30% of the initial trust value for ten years even if the Section 7520 rate were 20%. Such a trust would fail to qualify under Section 664 because it would fail the 10% minimum value of the remainder requirement under Section 664(d)(1)(D).

<sup>2</sup> For background on charitable remainder trusts and their general requirements, see Fox and Blattmachr, "New Valuation Rules for NIMCRUT/NIMCRUT Early Termination," 43 Estate Planning Journal 3 (July 2016), and "Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trust," 121 JTAX 100 (September 2014). For a complete discussion of CRTs, including the tax issues associated with the use of these vehicles, see Fox, *Charitable Giving: Taxation, Planning, and Strategies*, 2nd Ed. (Thomson Reuters, 2014), Volume 2, Chapter 25. For an article discussing the tax benefits of CRTs, see Rogers, Blattmachr, and Rivlin, "Charitable Trusts Can Avoid Loss of Benefits," 18 Estate Planning Journal 292 (September/October 1991). As discussed further below, theoretically, because a CRUT pays only a specified percentage of the value of the assets of the trust, the corpus of the trust will never be exhausted, no matter how high the payout percentage. The IRS has indicated, however, as further discussed below, that under certain circumstances, a CRUT's assets may become exhausted at a time when the projected value of the corpus will be below either a de minimis amount or an amount approximating the annual cost of administering the unitrust.

<sup>3</sup> This alternative to the 5% probability of exhaustion test was proposed in Parks, Finestone, and Leahy, "Charitable Remainder Trusts and The Probability of Exhaustion Test," Tax Notes (9/7/15).

<sup>4</sup> For a complete discussion of the previously issued sample IRS forms issued for both CRATs and CRUTs, see Fox, "A Guide to the IRS Sample Charitable Re-

mainder Trust Forms," 33 Estate Planning Journal 13 (January 2006). For sample CRUTs providing for annuity payments payable for one measuring life, see Rev. Procs. 2003-53, 2003-2 CB 230 (inter vivos CRAT), and 2003-57, 2003-2 CB 257 (testamentary CRAT). For sample CRATs providing for annuity payments payable for two measuring lives, see Rev. Procs. 2003-55, 2003-2 CB 242 (inter vivos CRAT) and 2003-59, 2003-2 CB 268 (testamentary CRAT).

<sup>5</sup> Regs. 20.2055-2(b)(1) (estate tax), 25.2522(c)-3(b) (gift tax), and 1.170A-1(e) (income tax).

<sup>6</sup> Section 664, which established the legislative regime for a CRAT and a CRUT, was enacted under the Tax Reform Act of 1969, P.L. 91-172. Under the Tax Reform Act of 1969, Congress made certain fundamental changes to the tax rules governing charitable giving, including limiting the availability of charitable tax deductions for transfers of property to a CRT. Before the Tax Reform Act of 1969, a CRT could be established to provide simply for the payment of all of the trust income to the donor or other designated noncharitable beneficiary for life or a term of years and for the principal remaining on the termination of the trust to be paid to the charitable remainderman. An income, gift, and estate tax charitable deduction was allowed for the value of a remainder interest in a CRT if it was "presently ascertainable" and the possibility that the charitable transfer would not become effective was "so remote as to be negligible." This standard led to case-by-case litigation over trust instruments containing contingencies. See, e.g., *Provident Trust Co.*, 291 US 272, 13 AFTR 861 (1934) (deduction allowed for charitable remainder, which was contingent on the life tenant's death without issue, because evidence indicated that it was plainly impossible for her to have children because of age and health issues); *Hamilton Nat'l Bank of Chattanooga*, 236 F. Supp. 1005, 15 AFTR2d 1373 (DC Tenn., 1965), *aff'd per curiam* 367 F.2d 554, 18 AFTR2d 6290 (CA-6, 1966); *Merchants Nat'l Bank of Boston*, 320 US 256, 31 AFTR 753 (1943); *Henslee v. Union Planters Nat'l Bank & Trust Co.*, 335 US 595, 37 AFTR 826 (1949); *Estate of Stewart*, 436 F.2d 1281, 27 AFTR2d 711614 (CA-3, 1971). The trust instrument could also authorize the invasion of trust principal for noncharitable beneficiaries if it was governed by an ascertainable standard, also determined

on a case-by-case basis, depending on the facts of each particular case. See, e.g., Rev. Rul. 54-285, 1954-2 CB 302 ("In view of the foregoing it is held that a charitable deduction under section 812(d) of the Internal Revenue Code may be allowed on account of bequests or gifts of remainder interests to charity in cases where the will or instrument authorizes invasion of corpus for the comfortable maintenance and support of life beneficiaries if (1) there is an ascertainable standard covering comfort and support, which may be either express or implied, and (2) the probability of invasion is remote or the extent of the invasion is calculable in accordance with some ascertainable standard"); Rev. Rul. 70-450, 1970-2 CB 195 ("[i]n order for a charitable remainder interest to be ascertainable, and hence severable, a power to vary that interest by invasion of corpus must be limited by a fixed, objective standard calculable in money"); *Merchants Nat'l Bank of Boston*, 320 US 256, 31 AFTR 753 (1943); and *Estate of Sternberger*, 348 U.S. 187 (1955).

<sup>7</sup> Rev. Proc. 2003-53, section 502(2), 2003-2 CB 230.

<sup>8</sup> Reg. 1.664-1(a)(1)(iii)(a).

<sup>9</sup> Sections 664(d)(1)(D) (CRAT) and 664(d)(2)(D) (CRUT).

<sup>10</sup> See also Ltr. Rul. 7908038.

<sup>11</sup> GCM 37770 (11/30/78).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> Ltr. Rul. 7915038.

<sup>15</sup> Unlike a charitable lead annuity trust, which works best in a low interest rate environment, a CRAT works best in a high interest rate environment because the higher the Section 7520 rate, the lower the discounted present value of the annuity payments and the greater the discounted present value of interest of the charitable remainder beneficiary, thereby maximizing the charitable income tax deduction for contributions to a CRAT. In addition, the higher the Section 7520 rate, the more likely it is that the 10% remainder interest requirement and the 5% probability of exhaustion test will be met. For a discussion of charitable lead annuity and unitrusts, see Fox, "A Guide to the IRS Sample Charitable Lead Trust Forms, Parts 1 and 2," Part 1: 36 Estate Planning Journal 7 (April 2009); Part 2: 36 Estate Planning Journal 13 (May 2009).



changes, a CRUT has virtually no sensitivity to fluctuations interest rates.

The 5% probability of exhaustion test will never disqualify a CRAT if the applicable Section 7520 rate is greater than or equal to the percentage used to calculate the annuity payments to the noncharitable income beneficiary (assuming the annuity payments are made at the end of each year), which, at a minimum, must be equal to 5% of the value of the assets contributed to the CRAT, and cannot exceed 50% of the value of such assets.<sup>16</sup> The Section 7520 rate has not exceeded the minimum 5% annuity payout rate since December of 2007, which has necessitated testing for the probability of exhaustion test for every CRAT created since that time, often resulting in the failure of a CRAT to qualify under

case even though the trust in such a case easily satisfies the 10% minimum remainder interest requirement. This is a harsh consequence because it is assumed that the CRAT will earn only the Section 7520 rate in effect upon its creation during its entire term, a conservative assumption that may never ultimately result.

#### QUALIFIED CONTINGENCY

Section 664(f) provides a special rule for a CRT, including a CRAT, otherwise qualifying under Section 664 that allows for the annuity or unitrust payments to terminate upon the occurrence of a "qualified contingency." Before the enactment of this provision, the IRS had ruled that a trust did not qualify under Section 664 when

as it does not extend the trust term. Therefore, a CRAT could provide that the first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the noncharitable income beneficiary's death or, if earlier, the date on which the noncharitable beneficiary obtains a Ph.D. in Mathematics.

While a CRT cannot pay a beneficiary an annuity or unitrust interest over the lifetime of another person, it may be possible to provide for payments to be made over a noncharitable beneficiary's lifetime with a contingency, however, that if the donor should die before the noncharitable beneficiary, the payments shall terminate on the donor's death at which time the trust assets are distributed to the charitable remainderman.<sup>20</sup>

**Today's historically low interest rate environment presents substantial obstacles in meeting the requirements of a charitable remainder annuity trust (CRAT) when the governing instrument provides for annuity payments payable for one or more measuring lives as opposed to a term of years.**

Section 664.<sup>17</sup> At a Section 7520 rate of 1.80%, for example, the sole life beneficiary of a CRAT that provides for the payment of the minimum 5% allowable annuity must be at least 72 years old at the creation of the trust for the trust to satisfy the 5% probability of exhaustion test.<sup>18</sup> This is the

the governing instrument provided that the annuity or unitrust payment would terminate on the happening of a contingency, notwithstanding the result of the charitable remainder beneficiary receiving the remainder interest at an earlier time.

A qualified contingency is broadly defined as "any provision of a trust which provides that, on the happening of a contingency," the annuity or unitrust payments will terminate not later than when such payments would otherwise terminate under the trust.<sup>19</sup> This means that a CRT can provide for early termination and acceleration of the remainder upon the happening of any event specified in the instrument. The value of the charitable deduction is determined without regard to the contingency, even when the contingency may be capable of valuation. A qualified contingency can be any contingency as long

#### REV. PROC. 2016-42 PROVIDES RELIEF BY USING SPECIFIED QUALIFIED CONTINGENCY LANGUAGE

Rev. Proc. 2016-42 provides a remedy where the 5% probability of exhaustion test would not otherwise be met through the use of a "qualified contingency." The Revenue Procedure contains a sample provision for a qualified contingency that would cause the trust to terminate early, and provides that any CRAT containing this provision will not be subject to the 5% probability of exhaustion test of Rev. Proc. 77-374.<sup>21</sup>

Therefore, the sample provision of Rev. Proc. 2016-42 provides an alternative to satisfying the probability of exhaustion test for CRATs. Specifically, this provision provides for early termination of the trust, and, therefore, the discontinuation of any further annuity payments, on the date immediately before the date on which any annuity payment would be made, if the payment of that annuity amount would result in the value of the corpus of the CRAT at that time, when multiplied by a specified discount factor taking into account the number of years that have elapsed since the CRAT's creation, to be less than 10% of the value of the initial trust corpus.

#### NOTES

<sup>16</sup> Section 664(d)(1)(A).

<sup>17</sup> Rev. Proc. 2016-42.

<sup>18</sup> *Id.*

<sup>19</sup> Section 664(f)(3).

<sup>20</sup> See Ltr. Rul. 9322031 (holding that a provision, which provides for the early termination of the payments of the unitrust amount to B on the death of C, constitutes a qualified contingency within the meaning of Section 664(f)(3). Similarly, an in terrorem clause providing for the termination of annuity or unitrust payments to a noncharitable beneficiary on such person contesting the donor's will should be considered a qualified contingency. The IRS has also ruled that a provision in a trust document, which causes the termination of the interest of the grantor's spouse in a charitable remainder interest due to a divorce will not disqualify the trust under Section 664, although reference was not made to Section 664(f)(3). See Ltr. Rul. 9511029.

<sup>21</sup> Rev. Proc. 2016-42, section I.



The trust ends, therefore, when the value of the CRAT (after subtracting the next annuity payment), *as discounted*, has declined to 10% of the initial value of the trust. Therefore, the fact that the value of the CRAT (after subtracting the next annuity payment) substantially exceeds the initial trust value, the termination provision may be triggered after applying the requisite discount factor.

To bring a CRAT within the scope of Rev. Proc. 2016-42, the trust document must contain the following language:

The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's

death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus, when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to  $[1/(1+i)]^t$ , 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 interest rate determined by Section 7520 that was used to determine the value of the charitable remainder at the inception of the trust. The Section 7520 rate used to determine the value of the charitable remainder at the inception of the trust is the Section 7520 rate in effect for [insert the month and year], which is [insert the applicable Section 7520 rate].

The Revenue Procedure illustrates the necessary calculation with this example:

On January 1, Year 1, Donor transfers property valued at \$1,000,000 to Trust, an inter vivos trust providing for an annuity payment of \$50,000 (5 percent of the value of the initial trust corpus) on December 31 of each year to S for S's life followed by the distribution of trust assets to Charity. Trust includes the precise language of the sample provision of Rev. Proc. 2016-42 providing for an early termination contingency and specifies the Section 7520 rate in effect for January, Year 1, which is 3%. But for the early termination provision, Trust meets all of the requirements of § 664.

In accordance with this revenue procedure, the IRS will treat the early termination contingency as a qualified contingency under § 664(f). Therefore, the early

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termination provision does not cause Trust to fail to qualify as a CRAT under § 664. In addition, Trust qualifies as a CRAT regardless of whether it passes the probability of exhaustion test on January 1, Year 1.

Each year, prior to payment of the annuity to S, the trustee performs the calculations required to determine if Trust will terminate early in accordance with the terms of the qualified contingency. In each year from Year 1 through Year 17, the trustee determines that the value of the trust corpus, minus the \$50,000 annual payment, and then multiplied by the specified discount factor, is greater than 10 percent of the initial trust corpus. The value of the trust corpus as of December 30 in Year 18 is \$210,000. Only in Year 18 does the value of the trust corpus as of December 30, when reduced by the annuity payment and multiplied by the specified discount factor, fall below 10 percent of the value of the initial trust corpus. The calculations required to determine if Trust will terminate early in Year 18 are as follows:

1.  $\$1,000,000 \times 10 \text{ percent} = \$100,000$
2.  $(\$210,000 - \$50,000) \times [1 / (1 + .03)]^{18}$
3.  $\$160,000 \times (1/1.03)^{18}$
4.  $\$160,000 \times 0.970874^{18}$
5.  $\$160,000 \times 0.587397 = \$93,984$

Because the value of the trust corpus (\$210,000), when reduced by the annuity payment (\$50,000) and then multiplied by the specified discount factor (0.587397), is equal to \$93,984, which is less than 10% of the value of the initial trust corpus (\$100,000), the trust terminates on December 30, Year 18, and the principal and income remaining in Trust (including the annuity payment for Year 18 that otherwise would have been payable to S) then must be distributed to Charity.

It is important to note that the contingency formula contained in the Revenue Procedure uses the interest rate under Section 7520 that was originally used to determine the value of the charitable remainder interest at the time the CRT was actually created, notwithstanding that such rate may be substantially different at the time of the determination as to whether the contingency has been triggered. This is particularly important if Section 7520 rates subsequently rise because the use of a higher Section 7520 rate in applying the contingency formula would otherwise produce a lower discounted value, thereby increasing the risk of the triggering event occurring.

#### NOTES

<sup>22</sup> Rev. Proc. 2016-42, Par. 4.03.

According to Rev. Proc. 2016-42, the sample provision is designed to meet three objectives.<sup>22</sup> First, it is designed to ensure that the tax benefit from the creation of the CRAT will be available only when there is a significant benefit to charity. Second, it is designed to ensure that the charitable remainder beneficiary will receive an amount that accords with the charitable deduction allowed to the donor on creation of the trust. And, finally, the provision is designed to expose the charitable remainder beneficiary to some, but not all, of the investment performance risk of the CRAT assets.

### CRATS SUBJECT TO REV. PROC. 2016-42

Rev. Proc. 2016-42 applies to a CRAT that:

1. Is created on or after its effective date, which is 8/8/16.
2. Otherwise meets all of the requirements of Section 664(d)(1).
3. Provides for annuity payments that are payable for one or more measuring lives.
4. Contain in its governing instruments the precise language of the sample provisions of the Revenue Procedure.

Rev. Proc. 2016-42 further states that a CRAT that contains a substantive provision that is similar to, but not identical to, the sample provision provided in the Revenue Procedure will not necessarily be disqualified.

### IMPACT OF REV. PROC. 2016-42

The use of the qualified contingency language of Rev. Proc. 2016-42 now permits a CRAT governing instrument to provide for annuity payments to be made over one or more measuring lives even when the trust would otherwise be disqualified under Section 664 because of its failure to meet the 5% probability of exhaustion test.

Noncharitable beneficiaries of a CRAT containing the contingency language of Rev. Proc. 2016-42 face the possibility, however, that their sought-after lifetime annuity payments may be prematurely terminated

due to a downturn in the value of the CRAT assets that triggers the qualified contingency and the early termination of the trust. CRAT governing documents that incorporate the contingency provision will also require trustees to take on additional administrative burdens to determine whether the contingency has been triggered and face liability to the charitable remainder beneficiaries should they inadvertently fail to terminate the CRAT upon the occurrence of the triggering event and, therefore, improperly continue to make the annuity payments.

It should be noted that even when a CRAT does not contain the qualified contingency language of Rev. Proc. 2016-42 because the 5% probability of exhaustion test is met upon inception or does not apply because the CRAT has a fixed term up to the maximum 20 years, the CRAT is still subject to early termination when, as a result of a market downturn and fixed annuity payments being made, the trust assets are, in fact, actually exhausted during the term of the trust. In such a case, even without the qualified contingency language of Rev. Proc. 2016-42, the fixed annuity payments would prematurely terminate because there are simply no more funds available in the CRAT from which to make any further annuity payments.

The sample contingency language of Rev. Proc. 2016-42 (applicable only to a CRAT having a term based on a measuring life or lives), however, causes the termination prior to the complete exhaustion of the CRAT assets if the discounted value of the assets drops to less than 10% of the value of the initial corpus. Although the 5% probability of exhaustion test may be avoided if the CRAT has a fixed term up to 20 years, individuals seeking to have the annuity payments made over a measuring life or lives may be willing to risk the early termination of the CRAT upon the qualified contingency of Rev. Proc. 2016-42 being triggered, particularly given that the trust will terminate in any event if its trust assets are, in fact, fully



exhausted during the term of the trust and, as a result of which, the charitable remainder beneficiary or beneficiaries would receive nothing.

When a CRAT is being considered, consideration should also be given to using a charitable gift annuity, which is subject to substantially lesser requirements as to the governing instrument and administration and is not subject to the 5% probability of exhaustion test. Charitable gift annuities for more than two lives are not permitted, whereas such payout schemes, as well as a multitude of others, are permitted in the context of a CRAT. Also, because the required annuity payments represent a general obligation of the charity issuing the annuity, there is generally little risk that the annuity payments will be discontinued early.

#### **FURTHER CONSIDERATIONS ON USE OF QUALIFIED CONTINGENCY LANGUAGE**

It should be noted that it may not be appropriate to include the qualified contingency language of Rev. Proc. 2016-42 in an inter vivos CRAT or when the Section 7520 rate is equal to or greater than the annuity percentage (that is, the percentage of the initial value of the trust that the annuity represents) at the creation of the CRAT.

In an inter vivos CRAT with a term based on a measuring life or lives, the drafter can calculate at the time the trust is established, using a commercial program such as Tiger Tables or Number Cruncher, whether the 5% probability of exhaustion test has been met. If it is not met, the drafter can lower the annuity percentage (but not lower than 5%) or change the term of the CRAT to a fixed term up to 20 years. However, doing either of those may not be acceptable to the settlor. In fact, in such a case, the settlor may knowingly violate the 5%

probability of exhaustion test and use the contingency language of Rev. Proc. 2016-42 (in which case the 5% probability of exhaustion test does not apply) if the settlor is sufficiently confident that the trust's investment return will be sufficiently above the Section 7520 rate used to value interests in the trust at its inception so that the value of the CRAT, *as discounted*, will not decline to 10% of the initial value of the trust (i.e., the contingency event causing early termination under Rev. Proc. 2016-42).

However, if the settlor is reasonably certain as to such investment returns, a CRUT probably should be considered in lieu of a CRAT. Unlike a CRAT, where the payments are fixed, payments from a CRUT increase based on increases in the underlying value of the CRUT corpus, thereby allowing the noncharitable beneficiary to participate in the investment growth of a CRUT. CRATs also do not have the flexibility offered by CRUTs, which are generally not subject to the 5% probability of exhaustion test<sup>23</sup> and are permitted to be structured as standard CRUTs, net income CRUTs, net income CRUTs with makeup provisions, and flip CRUTs.<sup>24</sup>

Placing the contingent termination language in a testamentary CRAT may well be appropriate as it will not be possible to know what the Section 7520 rate will be at death or what mortality table (which also is used to test for the 5% probability of exhaustion calculation) will then be in use and a formula clause reducing the annuity percentage to meet the 5% exhaustion test may not be effective because of the required 5% minimum annuity percentage. If the annuity rep-

resents a percentage of the initial value of the trust that is equal to or less than the Section 7520 rate in effect upon its creation, the trust will never fail the 5% probability of exhaustion test. Of course, for every month since January 2008, the Section 7520 rate has been less than 5%, which is the minimum percentage that must be paid based on the initial value of the trust. However, it is likely, if not certain, that the Section 7520 rate will rise above 5% in the future and, therefore, the annuity percentage could be set at a rate less than the Section 7520 rate, meaning that the contingent termination language set forth in Rev. Proc. 2016-42 would not be necessary.

#### **CONCLUSION**

Rev. Proc. 2016-42 offers a solution to use a CRAT in today's low interest rate environment where it would otherwise be disqualified under Section 664 because of the inability to meet the 5% probability of exhaustion test. Because the sample provision required to be used by the Revenue Procedure includes a contingency that, if triggered, causes the early termination of the CRAT, noncharitable beneficiaries of a CRAT face the possibility that their sought-after annuity payments may be prematurely terminated due to a downturn in the market. The sample provision of Rev. Proc. 2016-42 also requires trustees to take on additional administrative burdens to determine whether the contingency provision has been triggered and face liability to the charitable remainder beneficiaries should they inadvertently fail to terminate upon the occurrence of the triggering event. ●

<sup>23</sup> As discussed above, only under unusual circumstances would the probability of exhaustion test be applied to a CRUT and any such determination would be made on a case-by-case basis. For all intents and purposes, the 5% probability of exhaustion test does not apply to a CRUT.

<sup>24</sup> For a further discussion of the variations available for a CRUT, see Fox and Blattmachr, "Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trust," 121 JTAX 100 (September 2014).