CRUT or CRAT? Discount Rate May Affect Choice

Charitable remainder trusts provide an array of options for addressing personal, family, and charitable objectives simultaneously. For the charitably minded a carefully planned CRT can provide a stream of payments to the donor or others while generating a significant income-tax charitable deduction. It also lets the donor choose the most advantageous assets with which to fund the trust and, in some cases, to affect the taxable character of trust distributions.

Within the range of types of CRTs there are a number of common characteristics. All CRTs provide for the payment of an income interest to one or more named beneficiaries, either for life or for a pre-determined term up to 20 years, after which remaining trust assets pass to one or more qualified charitable organizations. There are, however, two primary types of CRTs with their own unique characteristics and uses: charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs).

The primary distinguishing characteristic of a CRAT is that it pays a fixed amount to the income beneficiary or beneficiaries. That payment must be at least 5% and no more than 50% of the value of the assets transferred to the trust. Once a CRAT is established, a donor cannot make additional contributions to that trust.

The primary distinguishing characteristic of a CRUT is that payments to the income beneficiary or beneficiaries are based on a fixed percentage of the trust’s annual value as it changes from year to year. Again, that percentage must be at least 5% and no more than 50%. Unlike a CRAT, a CRUT can accept additional future contributions. Those contributions simply change the value of the CRUT on which future distributions are based.

Often, the choice between a CRAT and a CRUT boils down to the appeal of the guarantee of fixed payments with a CRAT versus the potential for growth of income with a CRUT. Rarely can that choice be made in isolation but must be made in the context of multiple factors affecting the outcome.

One of the most significant factors may prove to be the prevailing applicable federal rate (AFR)—effectively a discount rate prescribed by the Treasury in Internal Revenue Code §7520 for valuing the respective charitable and noncharitable interests in a charitable remainder trust. The exact rate in effect at the time of a gift can have a significant impact on the charitable deduction available for creating a CRT and can even cause a CRAT not to be a viable option.

We will explore the impact of the discount rate in some detail below, but first we will take a look at some of the factors that can influence a donor’s decision about the type of CRT to use.

CRUT Offers Flexibility

There are many variations of a CRUT that allow the donor to do even more fine-tuning. A standard CRUT simply pays the stated percentage of the annual
value of the trust corpus to the designated beneficiary or beneficiaries without regard to the actual investment results of the trust.

On the other hand, there are multiple versions of a CRUT that can direct that the distribution is made only to the extent the trust has “income” as appropriately defined either by state law or, in some cases, within the trust document itself. This kind of “income-only” CRUT may be employed for various reasons. For example, a younger donor who is the beneficiary of a CRUT may not want or need additional current income but may be content to see the trust grow faster. In such a situation the donor is hopeful that the strategy of the trustee will be to choose investments that pay little or no income while the beneficiary is in the high-income stage of his or her life and then switch to investments that produce more income that can be distributed by the CRUT in retirement.

A CRUT can even provide that any deficiency caused by payments that were skipped because of the “income-only” provisions can be made up in later years if the trust produces more income than is necessary to make the current year’s distribution.

A fairly recent development is the approval by the IRS of a type of CRUT that can convert, or “flip,” from an income-only trust to a standard CRUT upon the occurrence of some specific event defined in the trust document. The triggering event must be something that either occurs naturally (such as passage of time) or is something that is not within the complete control of the settlor of the trust or the trustee (such as the sale of an asset).

A flip CRUT can be extremely beneficial in cases in which the donor really wants the trust to make current distributions but the trust is funded with illiquid assets. Unless there are income-only provisions in a trust document, a trustee must make a distribution when due. If there are no liquid assets, the trustee is faced with some difficult choices.

Assume, for example, that a donor funds a CRUT with non-income producing real estate. Generally a trust cannot borrow money without affecting the tax-exempt status of the trust. If the real estate has not sold by the time a distribution is due, the trustee may have little option other than to make a distribution of a fractional interest in the real estate to the beneficiary.

All that can be avoided if the trust document includes income-only and flip provisions. Until the real estate is sold, the trust will have no income and the trustee will not be required to make a distribution. After the sale, the income-only provisions go away and the trustee makes future distributions as if the trust is a standard CRUT.

Each different component of income retains its character and is accounted for as such when it is distributed to the beneficiary. Under the four-tier distribution rules of IRC §664(b), a CRT must first distribute all its current and accumulated ordinary income, followed by current and accumulated capital gain, current and accumulated other (tax-exempt) income, and, finally, principal.

As such, in any year in which current and accumulated ordinary income is less than the annual distribution amount, the balance of the distribution will be capital gain to the extent of current and accumulated capital gain absent an income-only provision. Even though some or all of the gain eventually may be recognized by the beneficiary under these rules, this still is far more beneficial than having to recognize all of the gain upon contribution to the trust.

### Impact of AFR on Deduction

The current AFR is reflective of the prevailing interest rate environment which sees rates at or near record low levels. Generally speaking, a lower AFR results in a lower income-tax charitable deduction for a CRT.

However, CRATS are significantly more discount-rate sensitive than CRUTs. A spike in the AFR may result in a major increase in the deduction for a CRAT yet have minimal impact on a CRUT deduction.

In addition, there is one discount rate-related consideration that is unique to CRATS. Revenue Ruling 77-374 provides that no deduction is available upon creation of a CRAT if there is greater than a 5% probability that the principal of the trust will be depleted by payment of the
annuity interest during the term of the trust. Because a lower AFR assumes the trust principal will be able to generate less return than a higher AFR, the chances of failing the 5% probability test are greater when the AFR is low. **Note:** Because a CRUT pays a portion of the annual value of the trust corpus rather than a fixed amount, a CRUT cannot by definition be depleted by payment of the annual unitrust amount.

The following charts demonstrate the impact of the AFR on deductions for CRUTs and CRATs under the 2.2% rate effective throughout the summer of 2014, a 4.2% rate in effect in the summer of 2008 just before the Great Recession, a 6.2% rate in effect in August of 2007 at the height of the bull market, and an 8.2% rate in effect in March of 2000 at the height of the previous bull market.

First, note that at a discount rate of 2.2% a 6% CRAT fails to pass the 5% probability test. Low discount rates make it challenging to create a CRAT that passes the test, particularly at younger ages. For instance, the youngest age at which a 6% CRAT passes the 5% probability test is 78 at a 2.2% AFR. If the payout rate is 5%, a CRAT does pass the 5% probability test with an AFR of 2.2% and generates a deduction of $46,098. That is still considerably less than the $55,434 deduction produced by a CRUT. But the deduction for the CRAT goes up substantially at each point as the discount rate rises, reaching $63,600 at 8.2%—an increase of about 38%. Conversely, the deduction for a CRUT changes little, increasing by only about 2% from the lowest to the highest AFR.

Does this mean that a donor should always choose whichever type of CRT produces the highest deduction? No, but it does point out that the deduction can be one more important factor to consider when making the choice. A donor who places high value on the certainty of fixed payments may be swayed by the availability of a higher deduction for a CRUT when the discount rate is low. On the other hand, the donor who values the flexibility and growth potential of a CRUT may be drawn to a CRAT when discount rates are high.

### Letter Ruling Approves Transfer of Assets from Charitable Trust to Private Foundation

The family of a founder of both a private foundation and a charitable trust has continued the founder’s philanthropic work through ongoing operation of both entities. Each of the entities has its own trustees, all of whom are lineal descendants of the founder or spouses of the lineal descendants.

Members of the family believe there would be multiple benefits from consolidating the two entities into one and are proposing to transfer the assets of the charitable trust to the private foundation. They believe a uniform governance structure would be more efficient and that joining the entities would improve investment opportunities, including the ability to achieve greater diversification. They also see benefits in consolidating matters such as tax reporting, accounting, grant applications, grant making, and coordination of staff activities.

They sought a ruling from the IRS on the ramifications of such a proposed transfer. Among other issues, they are seeking assurance that the transfer will not terminate the trust’s treatment as a private foundation, that the private foundation will not be treated as a newly created entity after the transfer, and that the transfer will not be an act of self-dealing within the meaning of Internal Revenue Code §4941 by the trust, the private foundation, or any foundation managers of either entity.

They also want to be sure that transfer of assets of the private foundation to a Trustee of the trust pursuant to provisions for
Indemnification Obligations in the transactions would not be self-dealing. In addition, they want to be sure that the private foundation can take into account the qualifying excess distribution carryover of the trust in calculating its distribution obligation.

The IRS issued favorable rulings on all counts (Ltr. Rul. 201418060). The Service ruled that the transfer alone would not cause a termination of the trust’s treatment as a private foundation. It also determined that when a private foundation makes a transfer described in IRC §507(b)(2), the transferee foundation is not treated as a newly created organization.

The ruling also found that the activity contemplated generally would not constitute an act of self-dealing within the meaning of IRC §494 nor would transfers pursuant to the Indemnification Obligations be an act of self-dealing because the transferee Trustee is neither a trustee nor a foundation manager of the private foundation. Finally, the IRS ruled that the private foundation could use the excess distribution carryover of the trust to offset its distribution obligation.

**BRIEFLY…**

**IRS Releases Draft of Short-Form Application for Charitable Tax-Exempt Status.**

The IRS has released a draft of a proposed new Form 1023-EZ that would substantially reduce the paperwork required to submit an application for tax exemption under IRC §501(c)(3). The current version of Form 1023 requires multiple schedules and is composed of 26 pages. A recent online version, Form 1023-I, reduces that to 13 pages.

Now the Service is proposing a three-page form that can be used by organizations which meet certain guidelines. The organization cannot have assets exceeding $500,000, and it generally cannot expect to generate annual gross receipts of more than $200,000. If adopted, the new form could allow many smaller organizations to follow a much more expeditious path to receiving 501(c)(3) tax-exempt status.

**Appraisers Given 5-Year Bans.**

The IRS has barred a group of appraisers from valuing facade easements for federal tax purposes for five years for what it deemed to be a pattern of failing to conduct appraisals pursuant to due diligence (IR-2014-31).

According to the IRS release, “In valuing the facade easements, the appraisers applied a flat percentage diminution, generally 15 percent, to the fair-market values of the underlying properties prior to the easement’s donation.”

Specifically, the appraisers admitted violating Circular 230, §10.22(a)(1), for failing to exercise due diligence in the preparation of documents relating to IRS matters, and §10.22(a)(2), for failing to determine the correctness of written representations made to the Department of the Treasury.”

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