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Terms of Endearment for CRTs

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What do you do when you run calculations for a charitable remainder annuity trust (CRAT) for one of your loyal donors, only to find that the trust fails the 10% minimum charitable remainder test or 5% probability of exhaustion test? One alternative would be to run similar calculations for a charitable remainder unitrust (CRUT) – because of the self-adjusting payment feature in a CRUT, it rarely fails the 10% minimum remainder test, and you don't have to worry about the likelihood of exhaustion at all. Another alternative would be to suggest using a term of years for the CRAT, rather than establishing it for the lifetimes of one or more individuals. In fact, ***using a term of years in a charitable remainder trust (CRT) can greatly expand the possibilities*** of how the trust will work and how it will benefit all interested parties. Let's take a look at how this might work.

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One of the biggest advantages of charitable remainder trusts over charitable gift annuities is that the trusts offer a ***much wider range of possible terms*** – they can be written for the lives of one or more persons, for a term of years, or for a term of years ***in conjunction with the lifetimes of named beneficiaries.*** Under the IRS rules, the term of years may be up to 20 years. The term for a charitable gift annuity, on the other hand, may only be for the lifetimes of one or two individuals.

A CRT that is written for the lifetimes of one or two persons is fairly easy to understand – the trust pays one person for his or her life; or in some cases, the trust pays the two persons jointly. Upon the death of one of the beneficiaries, the trust continues for the duration of the other person's life. We model trusts like this in ***PG Calc's Planned Giving Manager (PGM)*** simply by including both dates of birth, and the software makes use of applicable mortality tables to determine the charitable deduction and to project the long-term outcome of the trusts.

A CRT that is written for a specific term of years is a very different animal. The trust is typically created for the benefit of one or two persons (but technically, in a CRT, there is no limitation on the number of beneficiaries). A trust written to provide payments to two persons for a period of ten years, for example, will end precisely at the end of those ten years and distribute the remaining principal to the charity. In the ***current environment of Americans living longer and longer*** – especially those individuals who create any kind of life income gift arrangement – the effect can be that the CRT with a term of years will terminate and distribute to the charity much sooner than the CRT written for the lifetimes of one or two individuals.

But what happens if both of the named beneficiaries pass away prior to the end of the term of years? That's actually a very significant problem – the charitable remainder trust must continue for the specific term of years, regardless of when any particular person passes away. If both beneficiaries pass away prior to the end of the term of years, the trust can be disqualified by the IRS. The outcome of the trust could be severely compromised by the re-classification of the trust as a taxable trust.

The way to avoid the possibility of this happening is to create the trust in a way that incorporates ***both a term of years and the lifetimes of individuals***. The most common example is the trust ***written for lifetimes or a term of years, whichever is shorter***. Let's take the CRAT we mentioned above - if you run a CRAT in PGM with a 5% payout rate for a 65-year-old, with the current 2.2% IRS discount rate, you get the following error message:

> ***** WARNING *****
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> **IRS Revenue Ruling 77-374 denies a charitable deduction where an annuity trust has a greater than 5% chance of corpus exhaustion.**

The problem is that the current IRS discount rate predicts the annual investment return will be only 2.2% going forward; that, coupled with the relatively long life expectancy of a 65-year-old renders the trust too likely to run out of money - at least in the opinion of the IRS.

When you add a term of years to the trust on top of the life expectancy, however, the outcome is very different. If we couple the 65-year-old's life expectancy with the maximum term of years (20), the trust comes through with flying colors. The charitable deduction is a very respectable 37% of funding principal ($37,007.00), and the ***probability of corpus exhaustion is 0.00!*** You don't even get a message about the probability of exhaustion test, but the information is at the bottom of the Actuarial Calculations page.

Here's how the trust would actually work: if the named beneficiary lives beyond the term of 20 years, the trust will terminate exactly at the 20-year mark, and the remaining principal will be distributed to the charity then; however, if ***the beneficiary dies before the term of 20 years***, the trust will terminate upon the date of death and will become distributable to the charity at that point. It is important to be sure that your donor(s) are aware that if they outlive the term of their trust it will stop making payments!

There are many other ways to incorporate a term of years into a CRT. We've spoken with gift planners whose donors wanted to create CRTs for their own benefit, but also wanted to include a ***certain period of income for one or more younger family members***. Even a CRUT will fail the 10% remainder test if you put too many named beneficiaries into the mix, especially if they are relatively young. Take the example of the 62-year-old donor who wants to establish a 5% CRUT to benefit herself, but also wants to provide support to her 25-year-old niece who is developmentally disabled. If you run calculations for payments to be made over both lifetimes, the numbers don't work – the estimated remainder is $8,619.00 on a gift of $100,000, which is below the minimum threshold of 10% dictated by the IRS.

The way to make this CRUT work is ***to limit the number of years the niece will receive payments***. If you modify the assumptions to reflect the payments going to the niece only for 20 years after the death of the donor / first beneficiary or the remaining lifetime of the niece, whichever is less, the calculations pass muster with an estimated remainder (the charitable income tax deduction) of $16,447. That means the trust would qualify as a charitable remainder unitrust, the donor would be able to claim the income tax deduction, and the trust would be tax-exempt.[1]

So does this mean it's a good trust for the donor? Is it a good arrangement for her niece? And is it an appropriate trust for the charity? Those questions point to an entirely different discussion. As in all gift planning exercises, the gift planner needs to consider the real-world consequences of the gift arrangement in addition to the numbers calculated in *PGM*. For this example, the projections show that the trust will run for 42 years – that is the average remaining life expectancy of the 62-year-old followed by the 20-year term for the niece. The donor gets the charitable income tax deduction and the stream of income for the rest of her life; the niece gets a stream of income payments for 20 years after her aunt's death (or until she dies if she outlives her aunt by less than 20 years). According to average life expectancies for the population, the donor will get payments for approximately 22 years, which would mean the ***niece will start receiving payments when she is about 47 and the payments will stop when she is about 67***. It's important to point out those considerations to the donor – she may wish to have conversations with other family members to ensure that the 20-year stream of income payments makes sense given the overall financial situation of the niece.

And what about the charity's interest - does the charity want to encourage a trust that won't distribute its residuum until 40 or more years from now? That probably depends on some other considerations, ***the most important of which is the issue of who will serve as trustee***. If the charity is asked to serve as trustee, and especially if the trustee is expected not to levy any management fees, it may be wise to discuss alternatives that project the charity receiving its gift much sooner than 40 or 50 years from now. If the charity is not asked to serve as trustee, however, there shouldn't be any reason to discourage the donor from establishing this trust – after all, it falls well within the parameters allowed by the IRS, and it provides significant benefit to all 3 interested parties: the donor, the donor's niece, and the charity.

Creating effective and worthwhile split-interest gift arrangements is always a delicate balancing act of meeting the donor's philanthropic, tax and financial objectives; complying with all relevant tax codes and laws; and, of course, realizing meaningful benefit for the charity at the end of the term. There is no one-size-fits-all solution, and every potential gift arrangement must be molded to produce the best combination of outcomes for the circumstances. Incorporating terms of years into charitable remainder trusts is an area of considerable possibilities with which the gift planning professional should become familiar. The ***Client Services group at PG Calc is always interested in helping gift planners consider all of the possible variations as part of the gift planning process***. ***We encourage you to contact us as these issues arise – together we'll try to find a way to make the proposed gift arrangement succeed***

[1] Please note that the CRT term cannot be specified as being for one life, then for 20 additional years to someone else; rather, it has to be created for the remainder of one life, then for the remainder of a 2nd life or a term of XX years, whichever is shorter. There is a slight but very important distinction between the two.