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Charitable Remainder Trusts and The Probability of Exhaustion Test

By Charles T. Parks Jr., William Finestone, and Susan Leahy

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Parks, Finestone, and Leahy argue that current law allows the use of a qualified contingency provision in a charitable remainder annuity trust (CRAT) to ensure that the CRAT will satisfy the probability of exhaustion test, and they suggest that the IRS issue guidance endorsing this approach.

This article is one in a series of proposals sponsored by the California Bar Association and presented to various policymakers and government officials. However, the comments in it reflect the individual views of the authors who prepared them and do not represent the positions of the State Bar of California or the Los Angeles County Bar Association.

A. Background

Charitable remainder annuity trusts (CRATs) are attractive to donors who want to make significant contributions to charities while simultaneously providing consistent income streams to one or more income beneficiaries. Until relatively recently (when interest rates began to fall), donors' advisers and charitable development officers often recommended CRATs as estate planning tools to further the charitable goals of clients who are philanthropically inclined but also require a steady source of income. However, historically low interest rates have made it exceptionally difficult to meet the requirements of a CRAT, with the result that this type of charitable trust has fallen out of favor with both charities and advisers.

Section 664(d)(1) defines a CRAT as a trust from which a sum certain is to be paid, no less often than annually, to one or more persons at least one of which is not an organization described in section 170(c).[1] In the case of individuals, the sum certain must be paid to one or more individuals living at the time of the creation of the CRAT for a term (i) of not more than 20 years or (ii) for the life or lives of such individual or individuals. The sum certain can be no less than 5 percent and no more than 50 percent of the initial net fair market value of all property transferred to the CRAT.[2] When the CRAT terminates, the remainder interest must be transferred to or for the use of a qualified remainder beneficiary — that is, an organization described in section 170(c), or to the extent the remainder interest consists of qualified employer securities, transferred to an employee stock ownership plan in a qualified gratuitous transfer.[3] Other than the payments of the sum certain to the income beneficiary,[4] no payments may be made from the CRAT to any person other than a qualified remainder beneficiary.[5] The value[6] of the remainder interest at the time of funding the CRAT must be at least 10 percent of the initial net FMV of all property transferred to the CRAT.[7]

B. The Probability of Exhaustion Test

In addition to the statutory minimum and maximum payout and remainder value requirements, a CRAT must also meet the "probability of exhaustion" test, which requires that the probability be no more than 5 percent that the qualified remainder beneficiary will not receive any property.

The Tax Reform Act of 1969, which added section 664 and adopted the split interest trust rules set forth in sections 170(f), 2055(e), and 2522(c), makes no mention of the probability of exhaustion test. Long before TRA 1969, however, the regulations provided for a denial of a charitable deduction for a charitable remainder interest in trust that was unlikely to result in a charitable distribution at the

[1]Section 664(d)(1)(A).
[2]*Id.*
[3]Section 664(d)(1)(C). "Qualified employer securities" and "qualified gratuitous transfer" are defined in section 664(g).
[4]An "income beneficiary" refers to the person or persons receiving the annuity or unitrust payments until the termination of the CRAT or charitable remainder unitrust and the distribution of the remaining assets to charity.
[5]Section 664(d)(1)(B).
[6]As determined under section 7520.
[7]Section 664(d)(1)(D).

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termination of the trust. Since 1958, reg. section 20.2055-2(d) has provided as follows:

> If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.[8]

Most cases addressing the probability of exhaustion test for years before 1969 assessed the needs of the beneficiary against a principal invasion standard or contingencies such as the failure of an individual to have children.[9] However, in *Estate of Gooel v. Commissioner*,[10] the Tax Court applied the probability of exhaustion test to a trust that called for a fixed minimum annual payment if income was less than the fixed amount. The Tax Court determined the probability of exhaustion using three factors: the value of the initial trust corpus; the applicable rate of return; and the potential of the beneficiary to survive to an age when the trust corpus would be exhausted. Without setting the maximum probability of exhaustion that would have been permissible, the Tax Court determined that the probability of exhaustion was approximately either 11 percent or 22 percent (depending on which life tables were used) and denied the deduction.

In Rev. Rul. 70-452, 1970-2 C.B. 199, the IRS used a threshold of 5 percent to measure whether the possibility was too high that the charitable transfer would be eliminated. The IRS determined that a probability of exhaustion in excess of 5 percent is not so remote as to be considered negligible. This percentage was used because it is the value at which a reversionary interest is considered significant under sections 2037 and 2042.

In Rev. Rul. 77-374, 1977-2 C.B. 329, the IRS ruled that the probability of exhaustion test applies to CRATs. It reaffirmed the 5 percent standard for determining whether the possibility of exhaustion is so remote as to be negligible. The probability of exhaustion test is not relevant in determining the actuarial value of any interest in the CRAT; it merely measures the likelihood the CRAT will fail to make *any* distribution to a qualified remainder beneficiary.

In *Estate of Moor v. Commissioner*, T.C. Memo. 1982-299, the Tax Court upheld the application of the probability of exhaustion test to a CRAT. However, it *allowed* the deduction in the case, finding that the test was met with a 6.2 percent rate of return (compared with the 6 percent return then in effect under reg. section 20.2031-7) and evidence presented by the estate that the 6 percent rate of return was too low.

In many cases, it is not difficult to meet the statutory 10 percent minimum remainder requirement for a CRAT. However, the 5 percent probability of exhaustion test looms as an insurmountable obstacle in designing a CRAT for the life of many beneficiaries. To address the problem of CRATs not meeting both requirements, the American College of Trust and Estate Counsel proposed amending section 664(d)(1) and (d)(2) to allow for a minimum income payout of the lesser of (i) the current section 7520 rate or (ii) 5 percent.[11] This represents an actuarial approach to satisfying the 5 percent probability of exhaustion test by reducing the annuity payments. However, the authors propose that it is possible to satisfy the probability of exhaustion test within the code and regulations in another, more efficient way.

C. Proposal: Possible Early Termination

The authors propose including a qualified contingency provision in the CRAT that would terminate the trust immediately before any payment to the income beneficiary that would cause the value of the CRAT to fall below 5 percent[12] of its initial value. The qualified contingency provision satisfies the probability of exhaustion test using a factual wait-and-see approach, even for a CRAT that would otherwise fail the test on an actuarial basis without the qualified contingency at creation. If in fact the CRAT approaches exhaustion, the CRAT would terminate and be immediately distributed to the

[8]Reg. section 25.2522(a)-2(b) includes almost identical language for the gift tax charitable deduction. Similar restrictions were included in the regulations under section 812(b) of the 1939 code.

[9]After TRA 1969, an invasion power, even if limited by an ascertainable standard, would result in the loss of the charitable deduction. Likewise, a charitable gift that would take effect only if an individual did not have children would result in the loss of the charitable deduction.

[10]68 T.C. 504 (1977). Elmer Gooel died in 1970 with a will executed in 1967. Under TRA 1969 transition rules, his estate was not subject to the section 2055(e) requirement that the remainder be in a qualified charitable remainder trust. *See also Estate of Moffett v. Commissioner*, 269 F.2d 738 (4th Cir. 1959).

[11]*Available at* http://www.actec.org/public/Governmental_Relations/ACTEC-Proposal-to-Amend-Charitable-Remainder-Trust-Requirements-9-9-2014.asp.

[12]For convenience, the phrase "approaching exhaustion" will refer to the CRAT falling in value to the point that the annuity payment would reduce the value to less than 5 percent of the initial value.

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qualified remainder beneficiary, thereby ensuring that the qualified remainder beneficiary receives a material benefit.

Using a qualified contingency in a charitable remainder trust is not a new concept and is already permitted by section 664(f). The term ''qualified contingency'' is defined as follows:

> any provision of a trust which provides that, upon the happening of a contingency, the payments [to income beneficiaries of a CRAT or a charitable remainder unitrust (CRUT)] will terminate not later than such payments would otherwise terminate under the trust.[13]

The qualified contingency provision allows for a wait-and-see approach that tests the CRAT before each distribution and terminates payments to the income beneficiary if the CRAT approaches exhaustion. Similar to the manner in which a CRUT can never be exhausted because the payments to the income beneficiaries are automatically reduced if it approaches exhaustion, a CRAT with the proposed qualified contingency discontinues the payments to the income beneficiaries and causes the CRAT to terminate immediately if the CRAT approaches exhaustion, thus guaranteeing a distribution to the qualified remainder beneficiary.

D. Advantages of Using a Qualified Contingency

1. Using a qualified contingency expands the universe of donors. Because of historically low section 7520 rates, it is impossible for many donors to use a CRAT for the life of the income beneficiary because the probability of exhaustion test cannot be met using the traditional test. For example, as of February 2015, with a 2 percent section 7520 rate, a life annuitant must be at least 72 years old to be the income beneficiary of a CRAT to meet all of the CRAT requirements. This means that a donor contributing the same amount to the CRAT with the 2 percent section 7520 rate would not be able to designate a 71-year-old income beneficiary for life, even though the value of the charitable remainder interest would be more than 40 percent of the amount contributed to the CRAT.[14] By testing before each payment whether the CRAT is approaching exhaustion, donors will be able to use CRATs as estate planning tools to benefit younger income beneficiaries and satisfy their charitable and consistent income security goals. Donors will know not only that they qualify for the tax deduction but also that the charity will receive a minimum amount.

2. Using a qualified contingency takes into account interest rate volatility. The current approach of testing the probability of exhaustion at the creation of the CRAT assumes that the section 7520 rate in existence at creation will be the rate of growth of CRAT assets throughout its life. However, this has not been the reality. Since August 2007, when the section 7520 rate was 6.2 percent, interest rates have fallen sharply, never once exceeding 5.8 percent. Further, since August 2002 interest rates have exceeded the 5 percent minimum annuity requirement in only 39 of 158 months, or 25 percent of the time. By testing the probability of exhaustion before each income beneficiary payment, charitable individuals currently unable to create CRATs will be able to do so.

For example, by testing the probability of exhaustion at the formation of a CRAT, an individual might be able to contribute to a CRAT in one month and meet the probability of exhaustion test but, because of falling interest rates, not be able to meet the test had the CRAT been created the following month. Using the same figures as above, a 71-year-old could have established a CRAT in January 2015, when the interest rate was 2.2 percent, but would have been unable to do so had he waited one more month. The February 2015 section 7520 rate fell to 2 percent, causing the probability of exhaustion to reach 5.5 percent in February (from 4.05 percent in January). The wait-and-see approach corrects anomalies like these.

Many potential donors do not anticipate that interest rates will remain at their current low levels (and may not be overly concerned that the income beneficiary will survive to the 95th percentile of persons of the income beneficiary's age). The wait-and-see approach allows those donors to create CRATs that will continue for the life of the income beneficiary *unless* investment returns remain at the current low section 7520 rates *and* the income beneficiary survives for an extended period while at the same time guaranteeing at the creation of the CRAT that the qualified remainder beneficiary will receive a material amount.[15]

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[13]Section 664(f)(3). Section 664(f)(2) provides that a qualified contingency shall not be taken into account ''for purposes of determining the amount of any charitable contribution (or the actuarial value of any interest).'' The probability of exhaustion test is not relevant in determining the actuarial value of any interest.

[14]The 71-year-old would be able to create a CRAT for a period of 20 years.

[15]If 100 CRATs were established, each funded with $1 million and each with a single 71-year-old income beneficiary, $100 million would be in trust for charitable organizations. Using the February 2015 rates, 94 of those CRATs would be assumed to terminate with a final distribution to a charity. Yet using only the traditional probability of exhaustion test, none of those CRATs could be created.

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E. Possible Objections and Concerns

At first glance, one objection to the wait-and-see approach might be that a CRAT approaching exhaustion cannot constitute a qualified contingency. However, the tax code broadly defines the term, and nothing forecloses the possibility of using this measure as the qualified contingency. Under the IRC, a qualified contingency can be any provision that does not extend the payments to an income beneficiary. This proposal treats the CRAT approaching exhaustion as a qualified contingency triggered when the income beneficiary lives too long *and* the investment returns do not keep up with the distributions, causing the value of the CRAT to drop below 5 percent of its initial value. This results in a premature termination of payments to the income beneficiary, not an extension. This proposal does not change or eliminate the probability of exhaustion test; it merely provides a different, more logical manner of meeting it.

A second possible objection might be that the CRAT must first meet the statutory requirements of a CRAT — that is, it must satisfy the probability of exhaustion test without regard to the qualified contingency before it can include the qualified contingency. However, this objection is foreclosed by the plain text of section 664(f), which states that if a trust meets the requirements of section 664(d)(1)(A) or 664(d)(2)(A) (that the annuity or unitrust payment must be made for the life or lives of the beneficiaries or for a term of years not to exceed 20), then the inclusion of a qualified contingency provision will not cause the trust to fail those tests.

F. Conclusion and Proposal

CRATs ''were created by Congress to ensure that the amount received by a charitable organization at the end of the trust reflects the amount on which the donor's charitable deduction was based.''[16] Allowing qualified contingencies and subjecting CRATs to a wait-and-see approach is consistent with congressional intent and provides benefits to both the income beneficiary and the qualified remainder beneficiary.[17] It expands the universe of potential income beneficiaries and the number of charities that can benefit from charitable donations without diminishing the remainders that they will receive.

Because the IRC specifically allows qualified contingencies, the authors suggest that it is possible to create a CRAT using a wait-and-see approach that tests whether the CRAT is approaching exhaustion before each income beneficiary payment and that terminates the trust if a payment would cause the CRAT to approach exhaustion. The authors propose that the IRS issue written guidance regarding the use of a CRAT with a qualified contingency providing for termination if its value drops low enough that the annuity payment would reduce its value to less than 5 percent of its initial value. The IRS should rule that this may be a qualified tax-exempt charitable remainder trust whose donors are eligible for a charitable deduction at its creation even though the probability of exhaustion test would not be satisfied without the qualified contingency.[18]

In light of today's historically low interest rates, this is the simplest and best way to modify the CRAT requirements without any new legislation, making CRATs viable again as an estate planning tool for advisers, donors, and charities.

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[16]LTR 9601004.

[17]The IRS 2015-2016 Priority Guidance Plan includes as the first item under Gifts and Estates and Trusts, ''Guidance on Qualified Contingencies of Charitable Remainder Annuity Trusts Under Section 664.''

[18]The pronouncement should include guidance whether 5 percent of initial value is the minimum permissible qualified contingency. If written guidance is not feasible, the authors suggest that oral advice be given in a public forum (*e.g.*, American Bar Association, American Institute of Certified Public Accountants, or ACTEC meeting).

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