Charitable Remainder Annuity Trust

A Charitable Remainder Annuity Trust (CRAT) is an irrevocable trust which pays a fixed dollar amount each year to a beneficiary, such as the donor of the trust assets, his or her spouse, child, etc. This fixed dollar amount is calculated by applying the stated payout rate, e.g. 5%, 6%, etc., to the value [1] of the assets at the time they are transferred into the trust by the donor.

After the death of the income beneficiaries, or at the end of a set number of years (no more than 20), whatever assets remain in the trust are distributed to the charities named in the trust. If additional contributions are desired in later years, new trusts must be established.

Income Tax Considerations

The charitable income tax deduction[2] is based on the current value of the charity's right to receive the trust assets at some time in the future (a remainder interest). There are several factors in determining this value:

- First is the length of time which the charity must wait; for example, a term of years (like 10, 15, 20, etc.) or for the donor's or other person's lifetime.
- A second factor is the fixed dollar amount payable to the income beneficiaries each year and how frequently it is paid, e.g. annually, monthly, etc. Obviously, the higher the payment, the less there will be for the charity and, therefore, the smaller the charitable deduction.
- The current rate of return on investments, using the IRC Sec. 7520 rate, which is subject to change monthly.

These factors are then applied to government tables to determine the current value of the charitable deduction. If the charitable deduction amount exceeds a certain percentage of the donor's adjusted gross income for the year, the excess is carried over to future years.

---

[1] In cases of hard to value assets like real estate, a qualified appraisal is required to support the values.

[2] The discussion here concerns federal income tax law. For individual taxpayers, the deduction for charitable gifts discussed here is one of a number of itemized deductions listed on Schedule A, Form 1040. In calculating taxable income, a taxpayer may choose to deduct from adjusted gross income either the standard deduction or the total allowable deductions from Schedule A. State or local income tax law may vary.

Gift Tax Considerations

If the income from the CRAT is payable to someone other than the donor, it may be subject to federal gift taxation. If certain requirements are met, the income gift can be made to qualify for the annual gift tax exclusion of $15,000 (in 2020) per beneficiary. Also, the marital deduction will usually eliminate any gift tax on payments to the donor's spouse.

Estate Tax Considerations

The value of the interest passing to the charity is deductible from the gross estate. If there are income beneficiaries other than the donor and his or her spouse, there may be an estate tax on the value of this income interest.

Some states allow a surviving spouse to "elect" to receive a portion of the deceased spouse's estate. Such laws are designed to prevent the surviving spouse from being completely disinherited. If state law allows assets in a CRAT to be used to satisfy the surviving spouse's election, the CRAT could cease to qualify as a charitable trust under federal law. As a result, previous income tax deductions can be lost and the assets in the trust could be added back to the deceased spouse's estate. The IRS originally provided a "safe harbor" for this situation in Revenue Procedure 2005-24, with a grandfather date of June 28, 2005. In Notice 2006-15, however, the federal government extended the June 28, 2005 date until "further guidance is issued by the Internal Revenue Service."

Almost Everyone Benefits

A taxpayer can contribute an asset (often highly appreciated and low income producing) to a CRAT and receive a current income tax deduction. The trustee can sell the appreciated asset without the trust paying any capital gains tax and then reinvest the entire proceeds.

The trust will often pay out a higher rate of return than the donor previously received. This higher return, coupled with the federal charitable income tax deduction, can provide a substantial increase in cash flow. The cash payments received by the income beneficiaries are taxed under a four-tier system. Generally, ordinary income is paid first, followed by capital gain, other income, and trust principal.

Thus far, the only ones to lose are the donor's heirs. To solve this problem, many taxpayers use a portion of the increased cash flow to purchase a life insurance policy (outside of the estate) to replace all or part of the value of the asset placed in the trust. This arrangement lets almost everyone benefit.

Party	Benefit
Donor (and spouse)	Increased cash flow during retirement years
Children/heirs	Same size or larger inheritance (with insurance)
Favorite charity	Receives remaining assets after donor's death
Internal Revenue Service	Receives less income and estate tax

Seek Professional Guidance

Because of the complexities involved, the advice and guidance of trained, experienced tax, legal, and other financial professionals is highly recommended.