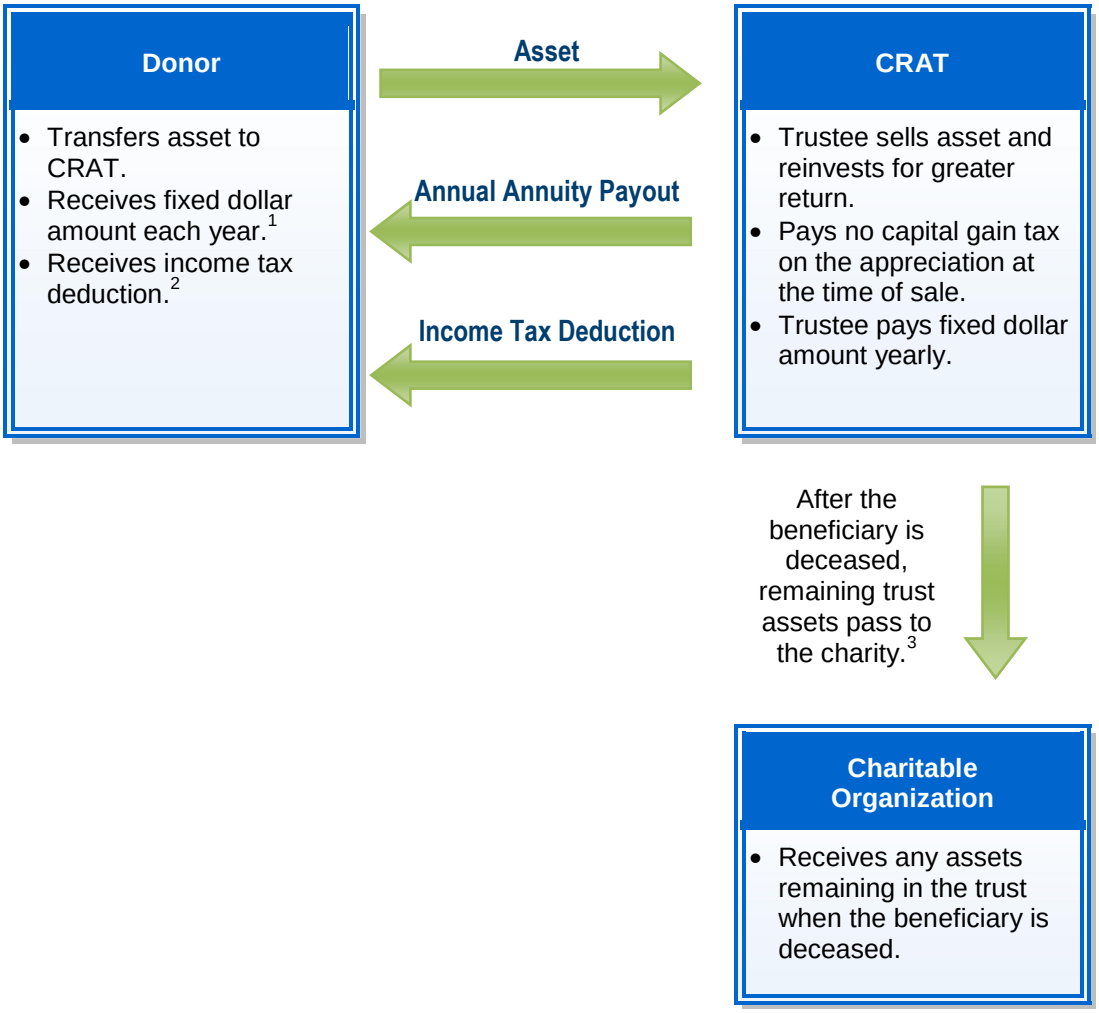
How a Charitable Remainder Annuity Trust Works

CRAT

The donor transfers an asset to the trustee of the charitable remainder annuity trust (CRAT) and receives a fixed dollar amount for each year thereafter. A current income tax deduction is also available.

When the donor or other named beneficiary dies, the remaining trust assets pass to the designated charity.



[1] The annual annuity payout is taxed under a four-tier system. Generally speaking, ordinary income is paid first, followed by capital-gain, other income, and trust principal.
[2] The income tax deduction is based on a government determined applicable federal rate and may have to be spread over more than one year, if it exceeds certain percentage of income limitations.
[3] If a surviving spouse "elects" to claim a part of a deceased spouse's estate, the income and estate tax benefits of a CRAT may be lost.

Charitable Remainder Annuity Trust

CRAT

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 determined by applying the trust's stated percentage payout, e.g., 5%, 6%, etc., to the value[1] of the assets initially transferred by the donor.

After the death of the income beneficiaries or at the end of a set number of years,[2] 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 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.

- The first factor is the estimated 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.
- Another factor is the percentage rate payable to the income beneficiaries each year and how frequently it is paid, e.g., annually, monthly, etc. Obviously, the higher the rate of payout, the less there will be for the charity; and, therefore, the smaller the charitable deduction will be.
- The current rate of return on investments as determined by the applicable federal (midterm) rates (AFR) is also an important factor.[3]

All of these factors are applied to government tables to determine the current value of the charitable deduction. If the charitable deduction exceeds a certain percentage of the donor's adjusted gross income for the year of the gift, that portion must be carried over into future years.

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 $13,000[4] per beneficiary. Also, the marital deduction will usually eliminate any gift tax on payments to the donor's spouse.

[1] In cases of hard to value assets like real estate, a qualified appraisal is required to support the values.
[2] If a set number of years is chosen to determine the term of the trust (instead of the lifetime(s) of one or two beneficiaries), the maximum term is 20 years.
[3] This rate changes monthly.
[4] The annual gift tax exclusion ($13,000 in 2011) is indexed for inflation in increments of $1,000.

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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 (usually highly appreciated and low income producing) to a CRAT and receive a current income tax deduction.

The trustee can sell the appreciated asset without paying any capital gain tax and can then reinvest the entire proceeds at a higher rate of return.

The trust will often pay out a higher return than the donor previously received. This, coupled with the income tax deduction, can create a substantial increase in cash flow.

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