Rev. Proc. 2016-42

SECTION 1. PURPOSE

This revenue procedure contains a sample provision that may be included in the governing instrument of a charitable remainder annuity trust (CRAT) providing for annuity payments payable for one or more measuring lives followed by the distribution of trust assets to one or more charitable remaindermen. The Internal Revenue Service (IRS) will treat the sample provision as a qualified contingency within the meaning of § 664(f) of the Internal Revenue Code. Thus, inclusion of the sample provision in the trust instrument does not cause the trust to fail to qualify as a charitable remainder trust under § 664. Any CRAT containing the sample provision will not be subject to the "probability of exhaustion" test set forth in Rev. Rul. 70-452, 1970-2 C.B. 199, and applied in Rev. Rul. 77-374, 1977-2 C.B. 329. The "probability of exhaustion" test is used to determine whether a CRAT complies with the regulatory requirement applicable to all contingent charitable transfers that only a negligible chance exists that the charity will receive nothing. *See* § 1.170A-1(e) of the Income Tax Regulations, § 20.2055-2(b) of the Estate Tax Regulations, and § 25.2522(c)-3(b)(1) of the Gift Tax Regulations.

SECTION 2. BACKGROUND

To qualify as a charitable remainder trust under § 664, a CRAT must satisfy all of the following requirements of § 664(d)(1): (A) a sum certain (not less than 5 percent and not more than 50 percent of the initial fair market value (FMV) of all property placed in trust) is to be paid at least annually to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not to exceed 20 years) or for the life or lives of such individual or individuals; (B) no amount other than such payments and other than qualified gratuitous transfers described in § 664(d)(1)(C) may be paid to or for the use of any person other than an organization described in § 170(c); (C) following the termination of such payments, the remainder interest in the trust is to be transferred to or for the use of an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (ESOP) (as defined in § 4975(e)(7)) in a qualified gratuitous transfer (as defined by § 664(g)); and (D) the value (determined under § 7520) of the remainder interest is at least 10 percent of the initial FMV of all trust property.

To qualify as a charitable remainder trust under § 664, a CRAT also must satisfy the requirements of § 1.664-1(a)(1)(iii)(*a*). Section 1.664-1(a)(1)(iii)(*a*) defines a charitable remainder trust as a trust with respect to which a deduction is allowable under § 170, § 2055, § 2106, or § 2522. Income or gift tax charitable deductions are not allowable under § 170 or § 2522 if the remainder interest of an *inter vivos* CRAT does not satisfy, *inter alia*, the requirements of § 1.170A-1(e) or § 25.2522(c)-3(b)(1), respectively. Similarly, an estate tax charitable deduction is not allowable under § 2055 or § 2106 if the remainder interest of a testamentary CRAT does not satisfy, *inter alia*, the requirements of § 1.170A-1(e) and

§ 20.2055-2(b)(1). Sections 1.170A-1(e), 20.2055-2(b)(1), and 25.2522(c)-3(b)(1) provide that if, as of the date of a gift (or the date of decedent's death for a testamentary transfer), 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 charitable deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, a charity at the time of the transfer and the estate or interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appeared at the time of the transfer to be so remote as to be negligible, the deduction is allowable.

Rev. Rul. 70-452 applies these rules to a split-interest charitable remainder trust. Rev. Rul. 70-452 holds that, if there is a greater than 5 percent probability that payment of the annuity will defeat the charity's interest by exhausting the trust assets by the end of the trust term, then the possibility that the charitable transfer will not become effective is not so remote as to be negligible. This determination is referred to as the "probability of exhaustion test." Rev. Rul. 77-374 applies the probability of exhaustion test to a CRAT. The probability of exhaustion is calculated first by applying the § 7520 assumed rate of return on CRAT assets (§ 7250 rate) against the amount of the annuity payment to determine when the CRAT assets will be exhausted. Then, a mortality table (Mortality Table 2000CM, found in §2031-7(d)(7)) is used to determine the probability that the income beneficiary or beneficiaries will survive exhaustion of the CRAT assets. If the probability that the life beneficiary or beneficiaries will survive exhaustion of the CRAT assets is greater than 5 percent, then the charitable remainder interest of the CRAT does not qualify for an income, gift, or estate tax charitable deduction and the CRAT is not exempt from income tax under § 664(c). If the § 7520 rate at creation of the trust is equal to or greater than the percentage used to determine the annuity payment, then exhaustion will never occur under this test.

Low interest rates in recent years have greatly limited use of a CRAT as an effective charitable-giving vehicle. For example, in May of 2016, the § 7520 rate was 1.8 percent. At this interest rate, the sole life beneficiary of a CRAT that provides for the payment of the minimum allowable annuity (equal to 5 percent of the initial FMV of the trust assets) must be at least 72 years old at the creation of the trust for the trust to satisfy the probability of exhaustion test. The § 7520 rate has not exceeded the minimum 5 percent annuity payout rate since December of 2007, which has necessitated testing for the probability of exhaustion for every CRAT created since that time.

Section 664(f)(1) provides in general that, if a trust would, but for a qualified contingency, meet the requirements of § 664(d)(1)(A) (relating to CRATs) or § 664(d)(2)(A) (relating to charitable remainder unitrusts), the trust is treated as meeting these requirements. Section 664(f)(2) provides that, for purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency is not taken into account. Section 664(f)(3) defines a qualified contingency for purposes of § 664(f) as any provision of a trust which provides that, upon the happening of a contingency, the payments described in § 664(d)(1)(A) or (d)(2)(A) (as the case may be) will terminate not later than these payments otherwise would terminate under the trust.

SECTION 3. SCOPE

.01 This revenue procedure applies to trusts created after the effective date of this revenue procedure that—

    (1) Meet the requirements of § 664(d)(1);

    (2) Provide for annuity payments payable for one or more measuring lives; and

    (3) Contain in their governing instrument the precise language of the sample provision in section 5 of this revenue procedure.

.02 A CRAT that contains a substantive provision similar but not identical to that provided in section 5 of this revenue procedure will not necessarily be disqualified, but neither will such a provision be assured of treatment as a qualified contingency under § 664(f).

SECTION 4. APPLICATION

.01 The IRS will treat the sample provision contained in section 5 of this revenue procedure as a qualified contingency under § 664(f). Thus, the presence of this provision will not cause the trust to fail to qualify as a charitable remainder trust under § 664.

.02 The sample provision provides an alternative to satisfying the probability of exhaustion test for those CRATs to which this revenue procedure applies. The sample provision causes the early termination of the CRAT, followed by an immediate distribution of the remaining trust assets to the charitable remainder beneficiary. Specifically, this provision provides for early termination of the trust (and thus the end of the ability to make any more annuity payments) on the date immediately before the date on which any annuity payment would be made, if the payment of that annuity amount would result in the value of the trust corpus, when multiplied by a specified discount factor, being less than 10 percent of the value of the initial trust corpus.

.03 The sample provision is designed to ensure that the benefit from the creation of the CRAT will be available only where there is a significant benefit to charity. *See* Staff of the Joint Comm. on Taxation, 105th Cong., General Explanation of Tax Legislation Enacted in the 105th Congress, JCS-23-97 at 289-290 (1997). This provision also is designed to ensure that the charitable remainder beneficiary will receive an amount that accords with the charitable deduction allowed to the donor on creation of the trust. *See* H.R. Rep. No. 91-413, pt. 1, at 59 (1969), 1969-3 C.B. 200, 238, and S. Rep. No. 91-552, 88 and 90 (1969), 1969-3 C.B. 423, 480-81. Finally, this provision is designed to expose the charitable remainderman to some, but not all, of the investment performance risk of the CRAT assets.

SECTION 5. SAMPLE PROVISION

.01 The following language is the sample provision designed to be used in an *inter vivos* CRAT for one measuring life:

"The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus, when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to $[1 / (1 + i)]^t$, where t is the time from inception of the trust to the date of the annuity payment, expressed in years and fractions of a year, and i is the interest rate determined by the Internal Revenue Service for purposes of section 7520 of the Internal Revenue Code of 1986, as amended (section 7250 rate), that was used to determine the value of the charitable remainder at the

inception of the trust. The section 7520 rate used to determine the value of the charitable remainder at the inception of the trust is the section 7520 rate in effect for [insert the month and year], which is [insert the applicable section 7520 rate]."

.02 In a testamentary CRAT, the phrase "the property is transferred to the trust" (the first underlined phrase) in this sample language must be replaced with "of my death".

.03 If the *inter vivos* or testamentary CRAT is created using the sample form provided in Rev. Proc. 2003-53, 2003-2 C.B. 230, or Rev. Proc. 2003-57, 2003-2 C.B. 257, respectively, the insertion of this sample provision in place of the second sentence of paragraph 2 of that sample *inter vivos* form, or in place of the second sentence of paragraph 1 of the sample testamentary form, respectively, will satisfy the requirements of a qualified contingency as described in section 6.03 of each revenue procedure.

.04 If the CRAT annuity is payable consecutively for two measuring lives, the phrase "the Recipient's death" (the second underlined phrase) in the sample provision must be replaced with "the death of the survivor of the Initial Recipient and the Successor Recipient(s)". See Rev. Proc. 2003-55, 2003-2 C.B. 242, and Rev. Proc. 2003-59, 2003-2 C.B. 268. If the CRAT annuity instead is payable concurrently and consecutively for two measuring lives, the second underlined phrase in the sample provision must be replaced with "the Survivor Recipient's death". See Rev. Proc. 2003-56, 2003-2 C.B. 249, and Rev. Proc. 2003-60, 2003-2 C.B. 274.

SECTION 6. EXAMPLE

On January 1, Year 1, Donor transfers property valued at $1,000,000 to Trust, an *inter vivos* trust providing for an annuity payment of $50,000 (5 percent of the value of the initial trust corpus) on December 31 of each year to S for S's life followed by the distribution of trust assets to Charity. Trust includes the precise language of the sample provision in section 5 of this revenue procedure providing for an early termination contingency and specifies the § 7520 rate in effect for January, Year 1, which is 3 percent. But for the early termination provision, Trust meets all of the requirements of § 664(d)(1). In accordance with this revenue procedure, the IRS will treat the early termination contingency as a qualified contingency under § 664(f). Therefore, the early termination provision does not cause Trust to fail to qualify as a CRAT under § 664. In addition, Trust qualifies as a CRAT regardless of whether it passes the probability of exhaustion test on January 1, Year 1.

Each year, prior to payment of the annuity to S, the trustee performs the calculations required to determine if Trust will terminate early in accordance with the terms of the qualified contingency. In each year from Year 1 through Year 17, the trustee determines that the value of the trust corpus, minus the $50,000 annual payment, and then multiplied by the specified discount factor, is greater than 10 percent of the initial trust corpus. The value of the trust corpus as of December 30 in Year 18 is $210,000. Only in Year 18 does the value of the trust corpus as of December 30, when reduced by the annuity payment and multiplied by the specified discount factor, fall below 10 percent of the value of the initial trust corpus. The calculations required to determine if Trust will terminate early in Year 18 are as follows:

1. $1,000,000 x 10 percent = $100,000

2. $(\$210,000 - 50,000) \times [1 / (1 + .03)]^{18}$
   $\$160,000 \times (1/1.03)^{18}$
   $\$160,000 \times 0.970874^{18}$

$160,000 x 0.587397 = $93,984.

Because the value of the trust corpus ($210,000), when reduced by the annuity payment ($50,000) and then multiplied by the specified discount factor (0.587397), is less than 10 percent of the value of the initial trust corpus ($100,000), Trust terminates on December 30, Year 18, and the principal and income remaining in Trust (including the annuity payment for Year 18 that otherwise would have been payable to S) then must be distributed to Charity.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 70-452 and Rev. Rul. 77-374 are modified to provide an exception for CRATs that conform to this revenue procedure.

Rev. Proc. 2003-53, Rev. Proc. 2003-55, Rev. Proc. 2003-56, Rev. Proc. 2003-57, Rev. Proc. 2003-59 and Rev. Proc. 2003-60 are amplified.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective **August 8, 2016** and applies to trusts created on or after that date.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Donna Douglas of the Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this revenue procedure, please contact Donna Douglas at (202) 317-6859 (not a toll-free number).