



**SECURE Act and CRTs, BDITs and QSSTs: Good Opportunities for Some**

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**Some Fundamentals of Financial Planning** 

- **Tax Free Compounding is the Most Significant Factor in Successful Financial Planning**
- **That Includes Income Tax Planning & Estate Tax Planning**
- **Avoiding Tax is the Same as Building Wealth**  
*("A Penny Saved is a Penny Earned" - Benjamin Franklin)*
- **The Next Best Thing to Avoiding Tax is Postponing Tax**

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**Importance of Avoiding Income Tax** 

- **Seeking to Reduce or Avoid Income Tax Is Sensible Only If There Is Positive Taxable Income or Gain**
- **Returns Need to be More than De Minimis**
- **Higher the Return the More Important the Reduction of Avoidance of Income Tax Becomes**
- **Risks and Consistency Once High Returns Are Achieved**

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**Importance of Compounding** 

- **Importance of Compounding:**
  - *Albert Einstein's First Theorem:* Compounding is the most powerful force in the universe
  - My family has 2 descendants per generation (2 children, 4 grandchildren, 8 great grandchildren and so on)
  - Your family has 3 descendants per generation (3 children, 9 grandchildren, 27 great grandchildren and so on)
  - In 20 generations, I have 1 million descendants living
  - In 20 generations, you have 3.5 billion descendants living and your attributes overwhelm and wipe out mine

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**Compounding & Returns** 

- **Importance of Compounding and Level of Returns**
  - Which Return Would You Prefer: 5% Compounded or 10% Simple (Non-Compounded)?
  - Simple vs Compounding return – Exhibit 1



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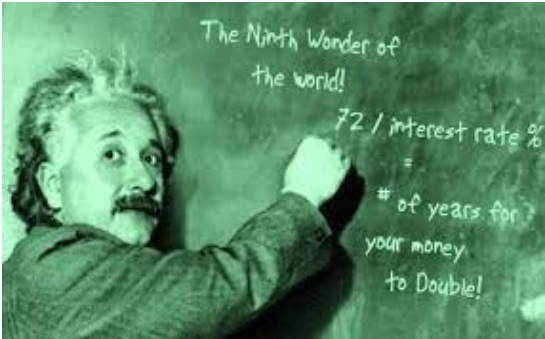
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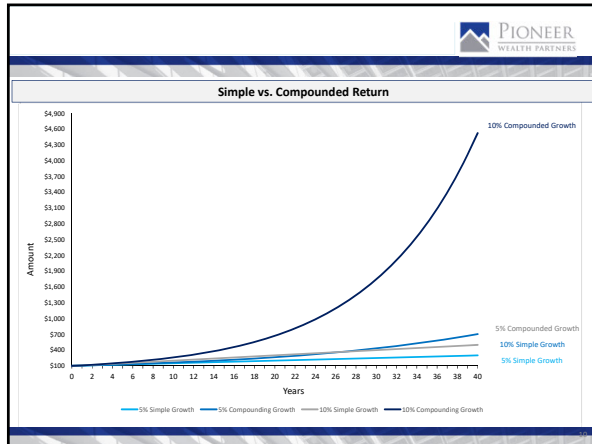
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### Corollaries in Compounding

- Again, the Importance of Compounding: Some Corollaries
  - The Longer the term, the greater the effect of compounding
  - The Higher the annual return, the greater the relative increase in wealth from Compounding

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- Albert Einstein's Other Theorem: The hardest thing in the world to understand is the income tax
  - Which Leads US to Consider the Effects of Taxation on Compounded Returns After 20 years – Exhibit 2

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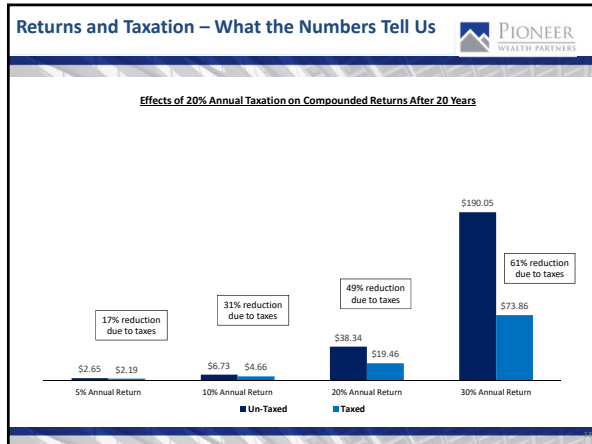
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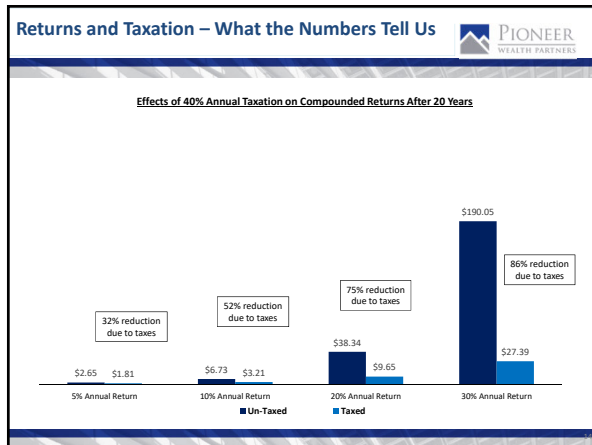
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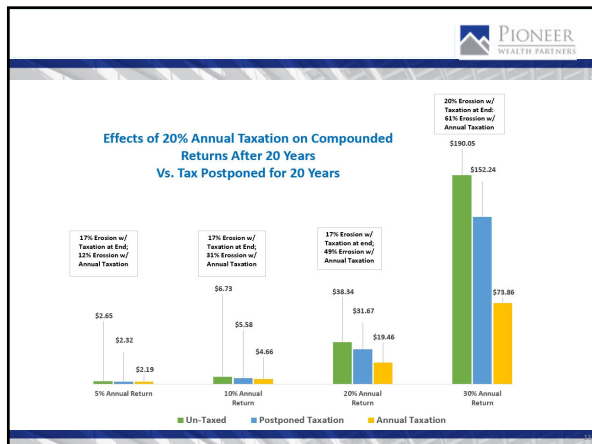
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**Observations about Taxation** 

- **The higher the effective rate of annual taxation, the greater the erosion of wealth**
- **The higher the return, the more the return is eroded by current income tax**
- **Blattmachr’s Corollary: The Most Important Thing in Financial Planning Is Tax Free Compounded Returns**

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**Conclusions** 

- **Conclusions**
  - **High Compounded Returns and Low Taxation are the Key to Building Wealth**
  - **The Greater the Return the More Important Is Compounding**
  - **The Greater the Return the Greater the Erosion from Taxation**
  - **Which Method Is Best to Avoid/Reduce Tax is Dependent Upon Several Variables**

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**Impact of the SECURE Act** 

- The SECURE Act eliminated of the ability of most beneficiaries (upon the death of the plan participant/IRA owner) to take distribution over the beneficiary’s life.
- If the beneficiary is a Designated Beneficiary (an individual) or a Conduit Trust or an Accumulation Trust for one, distributions must be taken by the end of the tenth calendar year following the year of the death of the Participant. If the beneficiary is not a Designated Beneficiary (e.g., a corporation or a trust that is neither a Conduit nor an Accumulation Trust), distributions must be taken by the end of the fifth calendar year following the year of the death of the Participant, although if the Plan Holder has reached the RBD, successor must use Ghost Life Expectancy ratable under the Uniform Life Table of Reg. 1.401(a)(9)-9 (the “at least as rapidly” rule), which will be longer than five year unless Plan Holder was above 91 years old.
- However, if the beneficiary is an *Eligible Designated Beneficiary* (EDB), life expectancy payout is permitted. An EDB consists of (1) surviving spouse of the Participant, (2) minor child of the Participant (not other minors like grandkids), (3) a disabled person, (4) a chronically ill person, or (5) a person not more than ten years younger than the Participant. A minor child of the Participant can use life expectancy only until majority when the ten year rule must be used.

\*Note that the combined federal and state estate and income taxes on Plans/IRAs can be over 85% (e.g., Washington state estate tax plus California income tax as the proceeds are IRD)

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**Why Trusts Must (Almost) Always be Used** 

- ✓ Asset Protection
- ✓ Asset Management
- ✓ Preventing the Foolish/Wasteful Dissipation of Wealth
- ✓ Avoid Loss of Governmental Benefits (such as Medicaid)
- ✓ Trusts and IRAs/Plans Are A Complicated Mixture
- A Conduit Trust permits the life expectancy payout to be used for an EDB (partial only for a minor) but all Plan/IRA distributions the trust receives must be immediately distributed to the EDB. **Good News:** Taxation at individual rates. **Bad News:** Creditor protection lost (including potential loss of government benefits like Medicaid)
- An Accumulation Trust will not permit life expectancy payout for an EDB other than a Disabled or Chronically Ill Person. **Good News:** Distributions may be accumulated so creditor protection and governmental benefits may be maintained. **Bad News:** Distributions taxed at the trust compressed rates

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**Individual Rates vs. Trust Rates (Federal Only)** 

- Trusts hit the top rate (37%) for taxable income over \$12,950 and enjoy only a \$100 or \$300 “standard” deduction (other than for Qualified Disability Trusts)
- Individuals hit the 37% rate only when taxable income exceeds \$500,000 and enjoy a standard deduction of somewhere between \$12,000 and \$24,000

**Examples (income not subject to NIIT):**

Tax due on \$25,000 of income by  
 Single Individual (\$1,342) Married Couple (\$60) Trust (\$7,551)

Tax due on \$100,000 of income by  
 Single Individual (\$15,247) Married Couple (\$8,684) Trust (\$35,301)

Tax due on \$200,000 of income by  
 Single Individual (\$41,413) Married Couple (\$30,493) Trust (\$72,301)

Over the years, this could make a huge difference in the level of wealth

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**How to Postpone Taxation But Is It Worth It** 

- All DBs (individual beneficiaries) can postpone receipts until the end of the tenth calendar year (but if they do the “bunched” may be exposed to higher rates).
- Alternatively, a DB can take distributions in any manner during the ten years.
- An EDB (or a Conduit Trust for an EDB) must take annual payments over his or her life expectancy beginning the year after the Participant dies (LE annual payouts until minor reaches majority when the ten year regime kicks in).
- How do you distribute to a minor? Can’t use an Accumulation Trust for a minor EDB or lose the life expectancy payout (unless Disabled or Chronically Ill) so the ten-year payout regime will apply.
- Conduit Trust requires immediate distribution to the EDB upon receipt by the trust. A distribution to a custodian under UTMA for a minor beneficiary (whether or not an EDB) may not be treated as a distribution to the beneficiary. We just don’t know. A guardianship? How else could it be done?
- Non-Conduit Trust/non-Accumulation will mean all must be withdrawn within five years (or if RBD has been reached, ghost life expectancy rule applies) and, unless distributed to the minor (or a Custodian under a UTMA law), and will be taxed at the trust’s compressed rates. Hence, double trouble: five year payout and trust income tax rates.

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**What about a Charitable Remainder Trust?** 

- Three Types: annuity trusts, unitrusts and income only unitrusts (NIMCRUTs).
- All are required to pay out at least of 5% annually except a NIMCRUT which must pay the lesser of unitrust percent or FAI. To the extent FAI is less than unitrust percent this can be made up when and if FAI exceeds unitrust amount in future years)
- Can't violate the 5% probability of exhaustion test (only applicable to annuity trusts) or the 10% minimum value of the remainder requirement
- Bad News: Plan/IRA must be distributed within five years (or ghost life rule)
- Good News: No income tax due upon receipt of Plan/IRA distributions as CRTs are income tax exempt. Distributions from the CRT will be included in income.
- The additional time the trust is exempt from income taxation inside the CRT may not always offset the cost to individuals of the loss of the value of the remainder interest passing to charity upon the termination of the CRT
- It is always desirable for the remainder to be 10% and no greater--that is the price you pay for renting charity's exemption from taxation (and you always want to pay the lowest rent)

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**Which Type of CRT to Consider in General (1)** 

- Charitable Remainder Annuity Trusts (CRATs):
- Good News: Annuity is paid regardless of investment performance>
- Bad News: No participation in growth inside the trust. Keep in mind that, over time, stocks have, in general, grown in value. The value of the (fixed) annuity will be eroded, overtime, by inflation. At 3% annual inflation, a dollar is worth only 73 cents in ten years.
- The 5% probability of exhaustion and the 10% minimum value of the remainder tests are determined by the size of the annuity and the Section 7520 rate. The lower that rate, the greater the risk these tests will be violated. A CRAT for life cannot be used if the rate is 2% or less and cannot be used for someone younger than 57 if the rate is 4% or less.
- We cannot know ahead of time what the Section 7520 rate will be at death. Hence, a deathtime CRAT for life is risky. (Can use a formula to switch to a term of year CRAT if one for life would violate one of the tests.)
- Conclusion: Don't plan on naming a deathtime CRAT for life to be a Plan/IRA beneficiary.

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**Which Type of CRT to Consider in General (2)** 

- Charitable Remainder Unitrusts (CRUTs):
- Bad News: Unitrust payments will decline if value of trust declines.
- Good News: Direct participation in growth occurring inside the trust, which means there is an inflation hedge. No real concern about 5% probability of exhaustion test with a CRUT. 10% minimum value of the remainder will be met (regardless of Section 7520 rate) if the trust is to pay an 11% unitrust amount each year for 20 years. Can pay 5% a year for life for anyone at least 28 years old.
- Question: If you anticipate that the investments inside the CRUT will decline, what should you do?
- Answer: Get a new investment adviser.
- Bottom Line: The CRUT will "work" well whenever the annual taxable income earned inside the trust exceeds the current payout: tax free (deferred) compounded will be experienced.

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**Which Type of CRT to Consider in General (3)** 

- Charitable Remainder Income Only Unitrusts (NIMCRUTs):
- **Bad News:** Again, unitrust payments will decline if value of trust declines. Beneficiary will receive less if FAI is lower than the unitrust amount. Can be made up in later years to the extent FAI exceeds unitrust payment then due.
- **Good News:** By keeping FAI to a minimum, the trust will grow income tax free. Tax character (e.g., long-term gains) is retained for later payouts. (For Plans/IRAs it is all ordinary income). Hence, tax-deferred compounding continues, perhaps until just before the trust ends and the make-up amounts are paid—e.g., 20 year end of the NIMCRUT vs. end of 10 years for the Plan/IRA.
- **How to control amount and timing of receipt of FAI:** Invest through an entity (such as a limited partnership). Note the person controlling distributions from the entity should not be the grantor, the beneficiary, the trustee or anyone related or subordinate to any of them. Rev. Proc. 97-23. Consider adding a FLIP provision to switch to a straight CRUT.
- The NIMCRUT seems to be the best of all three for maximum wealth build up.

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**Are Individuals Better Off Using a CRT?** 

- It depends.
- Consider anticipated needs of the beneficiary; anticipated growth; anticipated income taxation; consider when the trust will end. A necessary question: Is giving the remainder to charity worth the additional stretch, etc.? Perhaps, consider a wealth replacement trust (life insurance) but how long will the beneficiary live? Is the beneficiary uninsurable?
- A CRT is less likely to be better for an EDB who can use life expectancy payout (limited for a minor child of the Participant until majority but then 10 more years).
- Run the numbers. Disclaimer might be considered to switch over to a CRT. Consider a conditional disposition (“If the transfer to the following CRT for my daughter, Jacqueline, would not violate the 5% probability of exhaustion test or the 10% minimum value of the remainder trust, then... If it would, then...”).
- Consider a conversion just before death to a Roth IRA.

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- **NIMCRUT Example - 1**
- \$1 million IRA payable to a NIMCRUT to pay the lesser of FAI or 11% for 20 years.
- Assume the trust will grow at 6% a year and no unitrust payments are made for the first 19 years because there is no FAI and the NIMCRUT will be worth \$3,207,135.
- If instead, the beneficiary received the amount in the plan or IRA in ten years (which would be \$1,790,847 or \$1,128,234 after a 37% income tax) and that were invested at 6% taxable each year (or 3.78% after a 37% tax) for another ten years, the beneficiary would then have \$1,635,068.
- With the NIMCRUT if no unitrust payments were made until the end of 20 years, the recipient would have faced total shortfalls for the first 19.
- The CRT in 20 years at 6% annually would then be worth \$3,207,135.

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**NIMCRUT Example - 2**

- The increase in value from the inception would be \$2,207,135 and if that entire amount were paid out at the end of the 20-year term and all of it was FAI, the beneficiary would net \$1,390,495 after a 37% income tax. Perhaps, it would be possible for the trust to pay more of the shortfall to the unitrust recipient (although, again, never more than the \$3,201,135 in the trust), so that, after a 37% income tax, the recipient would have more than \$1,635,068. That obviously would mean charity would get after 20 years less than \$1,000,000.
- Indeed, if the charitable remainder beneficiary received \$150,000 at the end of 20 years that would represent a 2% compounded growth for the 20 years on the \$100,000 value of the remainder at inception of the trust.
- So, if \$3,057,000 FAI were received in the 20<sup>th</sup> year and paid to the unitrust recipient and subjected to a 37% tax, the recipient would have \$1,926,000 significantly more than if the NIMCRUT were not used.

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**Integrate LLC/LP into CRT Plan**

**How to integrate LP or LLC into the NIMCRUT?**

- The IRA would fund the NIMCRUT (although it could be formed before death) and the trustee would add it to a partnership or LLC. Alternatively, it could be made payable to a single member LLC which the NIMCRUT owns—in that case, the estate would still get the estate tax charitable deduction for 10% of the IRA. I didn't factor that in.
- But of course, if it is factored in, the "cost" of giving the remainder to charity would be 6% rather than 10 percent of the \$1million IRA. Actually, it would be more than 6% because there would be more in the trust. For example, if the \$1 million IRA is subject to a 40% estate tax, there would be only \$600,000 of the IRA left. But with a 10% charitable deduction, only about \$360,000 rather than \$400,000 of estate tax would be due so there would be about \$640,000 would be in the CRT (net of the estate tax).
- So that would be a \$64,000 charitable interest in the NIMCRUT at inception which would grow at, say 3% a year, for 20 years, so charity should receive \$115,600 after 20 years, which is when I've assumed the NIMCRUT would end.
- Bottom line: a NIMCRUT may produce more wealth at the end of the day. Of course, this assumes the beneficiary can wait. By the way, the trustee could be given discretion as to whom the unitrust payments could be made from any class you want, such a regular trust or any descendants, if the CRT must end in 20 years.

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**What About a Sale of the Interest in a CRT?**

- Does the sale of the unitrust/annuity interest result in long term capital gain as per Rev. Rul. 72-243.**
- Or does the substitution of ordinary income doctrine apply? See, e.g., Lettera v. Commissioner, 437 F.3d 399 (3d. Cir. 2006) (proceeds of sale of winning lottery ticket is ordinary income, which the lottery winner would have received, and not capital gain).**
- Would the result be different if the CRT sold off the right to the IRD?**
- Even if there is conversion into capital gain, compare the delay of ordinary income to up front capital gain?**
- This probably should be viewed as an aggressive strategy.**

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**Could Section 678 Trust Help Compared to Others?** 

- Only consider this if a trust will help accomplish important goals, such as asset protection, maintenance of entitlement to government benefits, better asset management, avoiding foolish/unwise dissipation of wealth or some other goal.
- How could a Section 678 Trust (aka BDIT) help?
  - A Section 678 Trust is one of the deemed owner trusts under the so-called “grantor trust” rules of subpart E (Sections 671 to 679). Under Section 678, the beneficiary with a right to withdraw everything from a trust is essentially treated as though she were the trust’s grantor for grantor trust purposes. So all income, deductions and credits are directly attributed to the beneficiary.
  - But first, why doesn’t a Conduit or Accumulation Trust produce great results?
    - A Conduit Trust must distribute all Plan distributions to the trust beneficiary of a trust causing a loss of trust benefits although distributions are taxed at individual rates.
    - An Accumulation Trust can preserve the benefits of a trust but the distributions will be taxed at the compressed trust rates (e.g., 37% for income above \$12,950).

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**Could a Section 678 Trust Be Better?** 

- Under Section 678, the beneficiary will be taxed on all Plan/IRA distributions at the individual rates (but state income tax may be avoided with a trust).
- Creditor protection will be lost in many states (so create the trust elsewhere—e.g., Alaska or South Carolina).
- The Section 678 Trust likely will be included in the beneficiary’s gross estate.
- The withdraw power could be partially released or modified but retain Section 678 status. (PLR 200944002, not precedent). But even in that case, a five year period of ineligibility for government benefits (e.g., Medicaid) will arise.
- Is a Section 678 Trust a type of “see through” trust? To ensure the ten year payout (rather than five), the Section 678 Trust should be structured as a ten year payout Accumulation Trust. If is unclear how, if at all, the “at least as rapidly” rule applies to the ten-year payout rule.
- A lifetime payout Accumulation Trust which is a Section 678 Trust may be used for a Disabled/Chronically Ill person (but with a likely five year ineligibility).
- A lifetime Accumulation Trust may not be appropriate for surviving spouse or minor as it likely will trigger the ten years of payout regime. So the critical issue is whether taxation at individual rates more than offsets a more rapid payout and other detriments (like loss of govt benefits, such as Medicaid).

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**A Totally Crazy Idea: Name an S Corp as the Recipient of the Plan/IRA if a QSSTs Is a Shareholder** 

- Income of an S corporation is taxed to the shareholders. Flavor of the income generally remains the same so NIT is avoided on Plan/IRA distributions paid to the corporation.
- Only US individual taxpayers, their estates and certain trusts can be S shareholders.
- A QSST is one where the beneficiary (who is not the grantor) elects to be taxed under Section 678 on the S corporation income as though she were the shareholder. The trust can have only one taxpayer (a US individual income taxpayer) as the beneficiary and must be required to pay or does, in fact, pay all of its FAI to the beneficiary. It is likely distributions must be taken by the S corporation under the five-year rule (or if RBD has been each, ratably under the Uniform Life Expectancy rule).
- There will be no FAI unless the S corporation pays a dividend.
- No requirement for the S corporation to have a business purpose and no risk of PHC or Accumulated Earnings tax and needs no business purpose.
- Trustee can use dividends to pay the beneficiary’s income tax liability so the dividend is protected from creditor claims and any such payment is not treated as a resource for govt benefits such as Medicaid.

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**Summary & Conclusions on Payout After SECURE** 

- The elimination for most beneficiaries of the lifetime stretch means greater income taxation of Plan/IRA proceeds.
- Most will face a ten year payout regime. They can wait until the tenth year but that will bunch income into one year, probably meaning a higher tax rate. It may be difficult to determine if that is better. ("A tax dollar delayed may never be paid").
- A NIMCRUT, a Section 678 Trust or a QSST may provide opportunities to delay income taxation. But, in effect, each comes with a price.
- For a NIMCRUT, the price is the value of the remainder passing to charity.
- For a Section 678 Trust, the price is the potential loss of creditor protection (but not if created in some jurisdictions) and there will likely be at least a five year loss of govt benefit (e.g., Medicaid). Also, the five year payout rule (or ghost payout rule) may apply.
- A QSST may be a good choice for some although the five year payout regime (or if RBD has been each the Ghost Life Expectancy rule) likely must be used, which makes the comparison more difficult.
- Consider "running the numbers" but the future tax system (including rates) is an uncertainty.

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