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Subject: Jonathan G. Blattmachr, Matthew D. Blattmachr, Richard L. Fox & Martin M. Shenkman - Charitable Remainder Trust Economics, and Deciding Whether to Use a CRT, Including for Plan and IRA Distributions

"Charitable remainder trusts (CRTs) are probably the most common type of trust where interests are divided or split between individuals and charity. With a CRT, non-charities (such as individuals) benefit first from the trust, and then later what remains after the payment to the individuals (the remainder) passes to or for charity. For several reasons, the use of such trusts has declined since the basic current provisions governing them came into the Internal Revenue Code by the Tax Reform Act of 1969, but that may change as explained below, particularly in the context of their use as beneficiaries of retirement plans.

There seem to be two primary reasons for the decline in CRT use. One is because rates of tax on capital gains have been reduced since 1969, so that the income tax exemption CRT provide may be less beneficial for the person who creates the trust and who contributes appreciated property to the trust, where it is anticipated that the trustee will sell that property. Second, Code provisions governing CRTs have been amended to make them less beneficial than they used to be. Probably, the major adverse change is the requirement that the actuarial tax value of the remainder to pass to charity, determined when the trust is created, must be at least 10% of the value of the assets contributed to the trust. A third adverse change, made by regulation rather than by statute, is the limitation of the ability to generate fiduciary accounting income (FAI) that may be distributed as a make-up provision in an income only with make-up charitable remainder trust (commonly called a NIMCRUT). Net income CRTs (NICRUTs) and NICRUTs with a make-up provision (NIMCRUTs) will both be explained below.

Nonetheless, a CRT may be useful in some situations especially if the asset contributed to the trust represents ordinary taxable income, such as

payments from an IRA or qualified retirement plan, as discussed in more detail later."

Jonathan G. Blattmachr, **Matthew D. Blattmachr**, **Richard L. Fox** and **Martin M. Shenkman** provide members with commentary that examines the economics of Charitable Remainder Trusts and the questions of deciding whether to use a CRT, particularly in the context of their use as beneficiaries of retirement plans and IRAs. Portions of their newsletter are derived from other articles the authors have written.

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Here is their commentary:

EXECUTIVE SUMMARY:

Charitable remainder trusts (CRTs) are probably the most common type of trust where interests are divided or split between individuals and charity. With a CRT, non-charities (such as individuals) benefit first from the trust, and then later what remains after the payment to the individuals (the remainder) passes to or for charity. For several reasons, the use of such trusts has declined since the basic current provisions governing them came into the Internal Revenue Code by the Tax Reform Act of 1969, but that may change as explained below, particularly in the context of their use as beneficiaries of retirement plans.

There seem to be two primary reasons for the decline in CRT use. One is because rates of tax on capital gains have been reduced since 1969, so that the income tax exemption CRT provide may be less beneficial for the person who creates the trust and who contributes appreciated property to the trust, where it is anticipated that the trustee will sell that property. Second, Code provisions governing CRTs have been amended to make them less beneficial than they used to be. Probably, the major adverse change is the requirement that the actuarial tax value of the remainder to pass to charity, determined when the trust is created, must be at least 10% of the value of the assets contributed to the trust. A third adverse change, made by regulation rather than by statute, is the limitation of the ability to generate fiduciary accounting income (FAI) that may be distributed as a make-up provision in an income only with make-up charitable remainder trust (commonly called a NIMCRUT). Net income CRTs (NICRUTs) and NICRUTs with a make-up provision (NIMCRUTs) will both be explained below.

Nonetheless, a CRT may be useful in some situations especially if the asset contributed to the trust represents ordinary taxable income, such as

payments from an IRA or qualified retirement plan, as discussed in more detail later.

COMMENT:

Three Types of CRTs

Although a charitable remainder trust is created under state law, the tax provisions relating to them are primarily described in Section 664.[i] The section describes three types of CRTs: a charitable remainder annuity trust (CRAT), charitable remainder unitrust (CRUT) or an net income only CRUT (NICRUT).[ii]

- A CRAT must provide each year for an annuity payment, to and for the life or lives of identified living individuals or to or for a an individual or a groups of persons (including charity although at least one person must not be a charity) for a fixed-term of not more than 20 years, of a minimum of five percent (5%) and a maximum payment of fifty percent (50%) of the value of the assets contributed to the trust. The value of the assets is determined at the time of their contribution.
- A CRUT must provide each year for an annual payment to and for the life or lives of identified living individuals or to or for a an individual or a groups of persons (including charity although at least one person must not be a charity) for a fixed-term of not more than 20 years, of a minimum of five percent (5%) and a maximum payment of fifty percent (50%) of the value of the assets then held by the trust. With a CRUT the value of the assets is determined annually, not as with a CRAT only at the time of contribution. As will explained below this is critical to planning as it permits the individual beneficiaries to share in the increase in the value of assets contributed.
- A net income only CRUT may also provide for the annual payment of the lesser of: (i) the 5% minimum/50% maximum unitrust amount; or (ii) the trust's fiduciary accounting income (FAI), described in Section 643(b) and its regulations. If the governing instrument does not provide for the make-up of the short fall, as discussed in the next paragraph , the trust is typically called a "net income charitable remainder unitrust" or a "NICRUT."
- A NICRUT may provide that, if the FAI is less than the unitrust amount for any year, that "short fall" may be made up in a later year if and to the extent the FAI in that subsequent year exceeds the unitrust amount for that year. This latter type of unitrust is commonly called a

"net income with make-up charitable remainder unitrust" or "NIMCRUT."

- For all CRUTs, in addition to requirements noted above, the actuarial value of the remainder, which will pass ultimately to or for charity, must be at least ten percent (10%) of the actuarial value of the assets at the time of their contribution to the trust.[iii] Moreover, there cannot be more than a five percent (5%) probability that the trust will be exhausted by the payments[iv] (which as a practical matter cannot happen with a CRUT as the unitrust payments will diminish if the value of the trust declines).[v]

The value of the remainder of a CRT is determined by a number of factors:

- How long the trust is expected to last.
- The required payout. Note that for a CRUT that limits payments to FAI, the calculation will be based upon the unitrust percentage even if that is greater than the assumed rate of FAI to be earned in the trust.[vi]
- For an annuity trust (CRAT), the value will depend on the Section 7520 rate that must be used to value interests in CRTs. Contrast this with a CRUT. Except for the timing during each year when the unitrust will be paid, the value of the remainder in a CRUT will not be affected by the Section 7520 rate.[vii]
- Also, the probability of exhaustion of the trust by payments cannot be greater than five percent.[viii] This may occur for a CRAT but probably not a CRUT as previously stated.

Whenever the Section 7520 (which is the assumed annual rate of growth the CRAT will experience) is less than the annuity percentage used (which as mentioned earlier cannot be less than 5%), the trust may exhaust, depending upon how long it may last. Even if the Section 7520 rate is the same as the annuity rate, the 10% value of the remainder test may not be met. For example, if both the Section 7520 rate and the annuity rate are 5%, the trust will fail the ten percent value of the remainder test if the annuitant (for life) is under age 25. If the annuity is limited to 5% and the Section 7520 rate is at least 5.4%, the test will be met. In fact, the higher the Section 7520 rate, the higher the annuity can be without violating the ten percent value of the remainder test or the 5% probability of exhaustion test. As the Section 7520 rate increases, the value of the remainder increases, all other things being equal.[ix] Unfortunately, this violates the premise of using a CRT: renting the trust's exemption from taxation and

paying the lowest rent (cost) possible, which is the value of the remainder. Ideally, this would be 10% of the value of what is being contributed to the trust and not more.

Benefits of Creating a CRT

In addition to the satisfaction of benefitting charity, there are two potential benefits of creating a CRT. The first is the allowance of a deduction for the value of the remainder for charity. Although a gift or estate tax deduction will be allowed for the value of the remainder[x], an income tax deduction will only be allowed as provided in Section 170. The second provision to consider is the exemption from income taxation that a CRT enjoys under Section 664. This exemption may benefit the individual beneficiaries of the trust to the extent the taxable income the trust receives in any year exceeds the amount required to be distributed to them during that year. That is because the taxable income that is not distributed may remain in the trust and grow income tax free.[xi] Remember, the most powerful force in tax planning is tax free compounding, and the next best result is tax deferred compounding,[xii]which often is the primary reason individuals use qualified retirement plans and individual retirement accounts (IRAs).[xiii]

The Benefit of the Deduction for a CRT

The principal benefit of obtaining a deduction when creating a CRT is that it is allowed even though charity may not receive any property for decades. There is also no guarantee that the charitable remainder beneficiaries will ever receive any property from a CRT. This is the case even if the 10% value of the remainder, and the 5% probability of exhaustion, tests are both met. This is because the investment performance or payment of the annuity year after year may “bust” the trust.

Obtaining a current income tax deduction for the potential delivery of property in the future, which in essence, may occur in only a limited number of situations may be viewed as beneficial, especially if the delivery is after death of the property owner which may occur with a CRT for the grantor of the trust for life.[xiv]

The Benefit to the Individual Beneficiaries of the Trust’s Exemption from Taxation

Although the individual beneficiaries of a CRT do not directly enjoy the exemption from income tax that the trust enjoys, they may indirectly benefit if the trust has taxable income in excess of that it pays to those

beneficiaries, provided that the assets not used to pay the tax grows inside the trust, all things being equal.[xv]

An Example if offered to illustrate the point. Deferral of taxation is beneficial but only if returns are compounded and all other things are equal.

Example: An employee is entitled to $1 million of compensation for 2020. The employee is in a 40% income tax bracket. If the employee is currently taxed in 2020 on that income, he or she will net $600,000, which could be spent or saved in 2020. Assume the employee could and does postpone the receipt of the income until 2021 when it still will be taxed at 40% so he or she would again net $600,000, which could be spent or saved in 2021. Assuming no earnings on the net (after tax) income, it seems unimportant whether the income is received in 2020 or 2021 although, in the real world, one almost certainly will want income (or any other wealth) as early as possible (again, if all other things are equal). That is either because the receipt of the income in 2020 will reduce expending other resources in 2020 or because it will be invested.

Example Continued: As assumed above, the employee is entitled to $1 million of compensation. Again, it is assumed that the employee is in a 40% income tax bracket. If the employee is currently taxed on that income, he or she will net $600,000. If that $600,000 is invested and earned six percent (6%) over the next year, it will earn $36,000 which it is assumed also may be subject to a 40% income tax, meaning that the employee will have $621,600 net after the year $600,000 + ($36,000 x {1-.4}). If the taxation of the $1 million of compensation income were deferred for a year and during that year the entire amount earned six percent, the taxpayer would be entitled to $1,060,000 after one year [$1,000,000 x 1.06]. If that then also were subject to a 40% income tax, the employee would net $636,000 [$1,060,000 x (1-40% tax rate)] or $14,400 [($636,000 - $621,600)] more than if the taxation had not been deferred. This incremental wealth was earned because the $400,000 that would have otherwise have been paid in income taxes in the first year earned the same six percent return for the year, and after tax at 40% generated $14,400 of additional net income [$400,000 x 6% x (1-.4)].

Essentially, the enhanced wealth is attributable to earning a return on the deferred tax.

Corollary 1: Wealth will be increased, all other things being equal, if the taxation of income may be postponed and a positive return can be obtained on the amount of tax deferred

Corollary 1A: The greater the tax the income would face, the greater the benefit of postponing the tax

Why the Value of the Remainder Should Never Be More than 10%

As will be detailed below, the most valuable attribute for the individual beneficiaries of a CRT is its exemption from income taxation. Although distributions to taxable beneficiaries, such as individuals, are included in their gross income to the extent the trust has experienced any taxable income and that has not previously been deemed distributed, the exemption from taxation for the beneficiaries can be beneficial. Basically, what the individual beneficiaries are doing is renting the income tax exemption from the charity. The price of the rent is the value of the remainder. Economically, it is always better to pay the least rent and for a CRT that is a 10% value of the remainder and not more. That is because the part not going to charity is preserved for the individuals. Where the remainder is 10%, the individual beneficiaries hold 90%. If the remainder is more than 10%, the individuals' interest in the trust drops accordingly.

What about the income tax deduction for the remainder committed to charity? Wouldn't the benefit of that be enhanced if the remainder is greater than 10%? No. The part of the CRT that will not be given to charity is retained for individual beneficiaries which may include or consist exclusively of the trust's grantor. The economic benefit of an individual is never (or almost never) enhanced by giving something more to charity (i.e., a greater remainder). Even though an individual may be entitled to an income tax deduction for a donation to charity, and may avoid gain if the donated property is appreciated, the donor would be better off economically by selling the property and keeping all of the after-tax proceeds for himself or herself. The benefit of a CRT is that the proceeds are kept (at least until distributed to the individual beneficiaries, or the trust ends) for the benefit of the individual beneficiaries. In that sense, a CRT functions similar to an IRA.

Corollary 2: Always structure the CRT so the remainder is equal to the required 10%, and not more[xvi]

However, the benefit of the CRT's exemption from income tax does not, in most cases, benefit the beneficiaries of a CRAT even if the asset

contributed to the trust is appreciated, as long as the asset could have been sold on an installment basis, which is equivalent to selling a portion of the asset each year. For example, suppose a taxpayer has $1 million appreciated stock and wants to receive $60,000 annually for 20 years. Note that unless the property appreciates (or produces income and does not decline in value), that cannot be accomplished. Sixty thousand dollars ($60,000) a year for 20 years would require payments totaling $1.2 million. Now the CRAT might help if the taxpayer anticipates that an alternative investment would produce more income and growth than keeping the appreciated stock. In fact, to pay the taxpayer $60,000 annually for 20 years, the property must grow by a minimum of about 2% each year. But the taxpayer cannot, in most cases, change to a higher yielding investment without experiencing a capital gains tax, leaving less to produce income and growth. If the stock is sold to so the proceeds can be invested for a greater yield, the gains tax will erode what is available for the taxpayer over the 20-year term. If the stock is contributed to a CRAT to pay $60,000 a year, it could be sold by the trust and reinvested for the higher yield. However, in order to avoid violating the 10% minimum value of the remainder requirement, the Section 7520 rate (which is the rate at which it assumed the trust assets will produce each year) must be, in this hypothetical, at least 3%.

For CRUTs, the analysis may be quite different. Unlike an annuitant of a CRAT, a unitrust recipient will receive more if the value of the trust increases. For example, with a 5% unitrust, the recipient will receive more if the trust grows by more than 5% a year. For example, if the trust starts at $1 million and grows to $1,050,000 by year end, when the unitrust amount of $50,000 is paid, the unitrust recipient will receive a $50,000 payment if the 5% unitrust payment is calculated at the beginning of each year. The trust will then drop back to $1 million and the unitrust amount for the second year will also be $50,000. However, if the trust grows at 6% a year, there would be $1,010,000 at the beginning of the second and year producing a $50,500 for the second year. That does not seem like much of a difference, but over time it could grow significantly and that may be especially important in later years when the value of a fixed (annuity) payment may be eroded by inflation. Of course, if the trust assets grow at a much higher rate (as equities historically have[xvii]), the difference will be quite stark.

Effects of Inflation

Over the past 50 years, the rate of inflation in the United States has averaged 3.22% a year meaning that the value of a dollar is worth only about 63% of what it was worth ten years ago and only about 53% of what is was worth 20 years ago. In determining inflation rates, the government is now using what is called “chained” Consumer Pricing Indexing in which it is assumed that, if the price of an item (e.g., beefsteak goes up), customers will substitute another item (such as chicken). The “theory” is that individuals can maintain their lifestyle by such substitutions. However, some may view that such a substitution for items that are not as desirable to a consumer as a decline in lifestyle. In any case, some commentators contend that the government underreports inflation and the actual inflation is much higher. See, e.g., http://www.shadowstats.com/alternate_data/inflation-charts.

This is important is considering a CRAT especially for someone who anticipates a relatively long time to live. (And because the major benefit of CRT is the trust’s exemption from taxation, the longer the CRT lasts the better—hence, CRTs work best for younger rather than older beneficiaries.) As shown, with a 20-year CRAT, the real value of the annuity (which will never go up) will decline over time if inflation occurs. Of course, the taxpayer could create a CRAT to last for a shorter period of time, but there seems to be no advantage to that as one would be forfeiting the benefit of earnings that are tax deferred, as illustrated in the Example below.

Corollary 3: A taxpayer rarely will benefit more from a CRAT than from a CRUT

Corollary 3A: If the taxpayer anticipates minimal growth and income will be generated in a CRT, then the taxpayer should seek better investment performance

Benefit of Exemption from Income Taxation

There seem to be some accepted “truths” about CRTs. First, for many taxpayers, the most significant benefit of a CRT is its exemption from income taxation.[xviii] Although distributions to taxable beneficiaries (*e.g.*, an individual who is the annuitant or unitrust recipient) will be included in the recipient’s gross income to the extent the trust has experienced and is not treated as already having distributed taxable income (with the highest taxed class of income being deemed distributed first unless paid to a charity which is an annuitant or unitrust recipient of the CRT), the CRT itself is not subject to income tax under Section 664(c)(1). When someone c reates a

CRT, he or she (or it) may (indirectly) benefit from the CRT's exemption from taxation to the extent, if any, the trust has taxable income in excess of the amount currently payable to an annuitant or unitrust recipient. That is because the next best thing to avoiding income tax is postponing income taxation, as a general rule.[xix] This often occurs when a taxpayer holds appreciated property that the taxpayer decides to sell (or is compelled to sell). Subject to exceptions,[xx] taxpayer must pay income tax on gain recognized, leaving a smaller base of wealth to generate future earnings. By contributing the appreciated assets to a CRT, the trust may sell them without paying income tax because the trust is exempt from such taxes.[xxi] Thus, the amount in the trust is not eroded by taxes as a result of the sale, even though the sale otherwise would have been subject to income tax if sold outside the protective envelope of a CRTs.

For an annuity trust, that may not be important. For example, a taxpayer holds an asset that produces little current income and is worth $1 million with a zero basis. She anticipates that if she sells it, she will pay a 24% tax on the gain, leaving her only $760,000. Instead, she intends to contribute the asset to a CRT with the hope that the trustee will sell it.[xxii] She wants to receive an annuity of $50,000 each year for her life. Before we even begin to look at the "economics" of that move and consider alternatives, it is appropriate to note that she will violate the five percent probability of exhaustion test if she is under age 72 with a Section 7520 rate of 2%. Even at a 4% Section 7520 rate, she will violate the test if she is under 56. Moreover, at younger ages, she will also violate the 10% value of the remainder requirement. Also, she cannot provide for a payment of less than $50,000 a year so the 10% minimum value of the remainder and 5% probability of exhaustion tests will not be violated as a CRAT must pay an annuity equal to at least 5% (5% of the $1 million is $50,000). Although if the Section 7520 rate is at least 5%, a 5% CRAT can be created without violating the 5% probability of exhaustion test, the grantor who creates a CRAT at death will not be able to know what Section 7520 rate might apply.[xxiii] Note, however, that the remainder value may vastly exceed ten percent so the taxpayer will have paid very high "rent" for the use of trust's exemption from taxation.

Consider that if she sold the asset and paid the 24% tax and there are no earnings on the $760,000, the after-tax wealth will be exhausted before the 16th year. Of course, she will have received the annuity payment of $50,000 for 15 years free of any income tax which, if reinvested, may grow in value. With the CRAT, even if it never grows in value, the $50,000

annual payments will last 20 years, but each annuity payment will be subject to income tax. The same result presumably would occur by simply selling $50,000 of the property each year for 20 years. Perhaps, the CRAT is preferable if the property must be sold and gain recognized. Although an installment sale might be considered, such a sale can be complicated from both a management and tax perspective.[xxiv]

The major advantage of a CRAT is that the same payments continue (unless and until the trust is exhausted) even if the trust diminishes in value each year. With a CRUT, the payments will decline for each year the trust decreases in value. But, as mentioned below, a taxpayer may be better off acquiring a commercial annuity if he or she believes there will be no increase in the value of the funds.

Of course, with a CRAT, an increase in value of the assets in the trust does not benefit the noncharitable beneficiary except to ensure the payments will continue beyond the payment of the amount of the original corpus. For example, if the original corpus is $1 million and the CRAT provides for annual payments of $100,000 for ten years, the payments will cease by the end of tenth (10th) year (and if the Section 7520 rate is less than 2.6%, the trust will not meet the minimum 10% value for the remainder requirement). Even if the Section 7520 rate is above 2.6%, the beneficiary may fail to receive the payments for ten (10) years if the assets decline in value while in the trust.

With a CRUT, the taxpayer participates with growth in the assets and, even if the assets in the trust do not grow in value, the trust should never be exhausted by payments (although it could exhaust if the assets investment performance declines in value to zero, which would also mean a loss of all payments from a CRAT as well). In any case, the beneficiary of a CRUT probably will receive more than a beneficiary of a CRAT, all other things being equal, if the trust increases in value (after making the required annual payments) over the life of the CRT. Note that if the annuity percentage, unitrust percentage and the Section 7520 rate are the same, the tax value of the payments and the remainders will be the same.

Of course, in the real world, the return almost certainly will not remain the same for the life of the trust.[xxv] If the property owner is concerned that value of the trust will not increase, then consideration likely should be given to acquiring a commercial annuity as that likely will provide greater payments[xxvi] than the CRAT would. For example, the taxpayer could buy a commercial annuity[xxvii] to receive an annual payment that would at least

equal the amount to be paid from the CRAT and contribute a smaller amount to the CRAT. However, to buy a commercial annuity the taxpayer would have to sell the assets. Nonetheless, the commercial annuity may well pay more than a CRAT even if the CRAT can pay 5% for life.[xxviii] It might not even be possible to create a $1 million CRAT to pay $50,000 a year, if the Section 7520 rate is below the 5% payout.

For example, the exhaustion test will be violated with a 5% annuity (payable at year end), if the Section 7520 rate is below 3.8%. In fact, even if both the payout and Section 7520 rate are 5%, the ten percent (10%) value of the remainder will not be met if the annuity is to be paid for life for someone under the age of 24 years. In any case, as explained, even if the actuarial tests are not violated, the value of the remainder may exceed ten percent, which means too high of a price has been paid to rent the trust's exemption from income tax.

Historically, stocks do increase in value over time.[xxix] "According to historical records, the average annual return since its inception in 1926 through 2018 is approximately 10%. The average annual return since adopting 500 stocks into the index in 1957 through 2018 is roughly 8% (7.96%)."[xxx]

As explained, a taxpayer seems to benefit very little from the trust's exemption from income tax when creating a CRAT but may receive considerably more with a CRUT, if it increases in value. For example, with a $50,000 a year CRAT payment, the annuitant will receive $1,000,000 over 20 years ($50,000 x 20). With a CRUT, a unitrust recipient entitled to a 5% unitrust payment each year would receive approximately $1,650,000 over the same 20 year period if the assets grow at 5% a year (much lower than then S&P 500 returns for any 20 year period in modern times).

In effect, the taxpayer is "renting" the exemption from taxation of charity and is paying for it by committing the remainder of the CRT to charity. In a CRT, that must be at least 10% percent of the value of the assets donated to the trust (the minimum the law allows). Note if a taxpayer wants charity to get more, the taxpayer probably should limit the value of the remainder of the CRT to ten percent and simply donate more directly to charity.

A NIMCRUT May Be Best

Another option with a unitrust is to make it an "income only with make-up" (a NIMCRUT).[xxxi] By investing, for example, in growth stocks that pay little

(if any) dividends, no significant distributions will need to be made. At the appropriate time, the trustee may be able to change the investments, so receipts do constitute FAI and are well in excess of the unitrust amount for year of the change. For example, the trust may have been invested in growth stocks that pay no dividends. The stock can be sold without income tax (because the NIMCRUT is income tax exempt) and then invest in bonds, for example, with a yield more than the unitrust amount. There are some restrictions, however, imposed by the regulations on converting corpus into FAI for purposes of this strategy. For example, although having gain treated as FAI is permitted in an income-only unitrust, any gain arising from a sale or exchange of assets contributed to the trust may be treated as FAI only to the extent the assets have appreciated in value, such that pre-contribution gain cannot be taken into account in computing FAI.[xxxii] Similarly, gain arising from a sale or exchange of assets later acquired by the trust may be treated as FAI only to the extent they have appreciated after acquisition.[xxxiii]

Some states have statutes which seem to permit significant flexibility in controlling the amount and timing of FAI. For example, the uniform fiduciary income and principal act provides essentially that there is no accounting income merely by the imputation of tax income to a trust. So, a NIMCRUT trust must report all income imputed or allocated to it for income tax purposes, such as where the trust is a partner in a partnership (or a member in a limited liability company or LLC treated as a partnership for income tax purposes). Partnerships are 'flow-through' entities. Flow-through taxation means that the entity does not pay taxes on its income. Instead, the owners of the entity pay tax on their 'distributive share' of the entity's taxable income, even if no funds are distributed by the partnership to the owners."[xxxiv] Hence, if a NIMCRUT is a partner, it will report as its income any income of the partnership properly allocated to it (and pay no income tax on it because the trust is income tax exempt), but if the trust received no FAI from the partnership (e.g. the partnership or LLC made no cash distributions to the trust), none of the partnership (imputed) income will be distributable to or taxed to the unitrust recipient or to the trust. [xxxv]

The Uniform Act, for example, essentially limits FAI from a partnership to distributions only of money (except for reinvested dividends) and then only if the money was: (1) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity, (2) money received in total or partial liquidation of the entity, (3) money received from an entity that is a regulated investment company

or a real estate investment trust if the money distributed is a short-term or long-term capital gain dividend for federal income tax purposes. Money is deemed received in a partial liquidation to the extent, and presumably only to the extent, (1) the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation, or (2) the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt. (There is a further limitation: Money is not received in partial liquidation, and it may be taken into account as a partial liquidation only to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.)

Hence, if a NIMCRUT invests in a limited partnership, for example, nothing will be distributable to the unitrust recipient based purely on imputed income from the partnership. Hence, if the NIMCRUT receives no FAI, the share of income it earns (through the partnership) essentially will accumulate in the NIMCRUT income tax free. If and when the trustee wishes to generate FAI, the trust could seek a distribution in cash from the partnership that is not a not indicated to be of a partial liquidation and is not a distribution as part of a series of related distributions consisting of greater than 20 percent of the entity's gross assets, which would cause the money received to be treated as corpus under the act.[xxxvi]

This can be made more certain by having the trust itself provide that distributions of profits experienced by the entity shall be FAI and that only a distribution that the partnership advises is in partial liquidation of the partnership shall be considered principal. This almost certainly would be respected for tax purposes. Reg. 1.643(b)-1 provides, in part, that FAI "means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." Until the Uniform Income and Principal Act was promulgated (in 1997) there was little, if any, developed law on how distributions from business entities (such as a limited partnership) were to be treated for income and corpus purposes. Indeed, common entities used today, such as LLCs, just did not then exist.[xxxvii] Hence, it is very difficult to see how specific provisions on how receipts from such an entity could depart fundamentally from *traditional* principles of income and principal.

Enter the SECURE Act

Prior to the effective date of the Setting Every Community Up for Retirement Enhancement Act (the SECURE Act),[xxxviii] once the plan participant or IRA owner died, the law required the property in the plan or account to be distributed by the end of the fifth calendar year following the death of the participant or owner (unless the plan or account was left to an identified individual, known as a "Designated Beneficiary" (DBs) or a so-called "see-through" trust, in which case distributions could be taken over the unrecalculated (or fixed at death) life expectancy of the identified individual. (For the surviving spouse of the participant or owner, distributions could be taken over the spouse's recalculated life expectancy in some cases.) There were, and even after the effective date of the SECURE Act, there are two types of "see-through" trusts. One was and is called a "conduit trust" which mandates that all distributions received by the trust from the plan or account be distributed immediately to the Designated Beneficiary; essentially, for required minimum distributions (RDMs), the trust is treated as if it were that individual. The other see-through trust was and is called an "accumulation trust" which, as the name indicates, need not make any distributions to any beneficiary, only has beneficiaries who are identifiable individuals, and may take RMDs over the unrecalculated life expectancy of the oldest individual beneficiary of the trust.

Perhaps, the two most important impacts of such changes made by the SECURE Act are: (1) to shorten the period following the death of the participant or owner of tax-free compounding provided by the use of the plan or IRA; and (2) to shorten the period that the plan or IRA interests may remain free from the claims of creditors, although using a trust may provide significant creditor protection for the beneficiary or beneficiaries.

The five categories of eligible designed beneficiaries (EDBs), who may continue to use their life expectancies for payouts from a plan or IRA, are: (1) the surviving spouse; (2) a minor child of the participant or owner; (3) an individual who is not more than ten years younger than the plan participant; and an individual who at the death of the participant or owner is (4) disabled; or (5) chronically ill within the meaning of Sections 72(m)(7) or 7702B(c)(2), respectively. Note that the life expectancy of a minor child of the participant or owner may be used only until the minor attains the age of majority when the ten-year payout rule then commences. Just as under prior law, if there is no Designated Beneficiary (whether or not also an EDB), the entire plan or account must be distributed under the same five-

year payout regime as under prior law (or, if the participant died after commencing required minimum distributions, over the participant's remaining life expectancy).

Unless the beneficiary is an EDB, the proceeds payable to an individual (or to a conduit or a see-through accumulation trust) must be withdrawn in their entirety by the end of the tenth calendar year following the calendar year of the death of the plan participant or IRA owner, so as to avoid the additional tax (in the nature of a penalty) under Section 4974. There are no annual minimum distributions required for individual beneficiaries (who are not EDBs) as there were under prior law. Rather, a non-EDB individual need take nothing from the plan or IRA, so income tax deferral may continue, until the end of that ten-year period.

Are IRA Beneficiaries Better Off with a CRT?

The answer is: It depends. If the ability to postpone income taxation of the plan or IRA proceeds is desirable (for example, to have tax deferred growth), the answer may well be yes. As demonstrated above, postponement of taxation of the proceeds from a plan or IRA may produce overall greater wealth if the assets grow in value. Due to the fact that, except for EDBs, plan and IRA proceeds must be distributed essentially by the end of the tenth year of the death of the plan participant or IRA owner, a mechanism to postpone their taxation for a longer period may also be beneficial.

For example, a taxpayer may create a CRUT to pay 11% a year to a beneficiary for 20 years (the maximum fixed period for a CRT) without violating the ten percent value of the remainder requirement. If it is assumed that the trust will grow at 6% a year and no unitrust payments are made for the first 19 years because there is no FAI, 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 years and with the unitrust payment for year 20 of $ 4,289,200. The CRT would then be worth $3,207,135. Note that, although the shortfall in unitrust payments is nearly $4,300,000, the CRT is worth only about $3.2 million and, obviously, no more than the trust's value could be transferred to a beneficiary. 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 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 of $4,289,200 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. But that result is not unfair, nor would it constitute "cheating" of the charitable remainder beneficiary, which was to receive a present value interest, at inception, of $100,000 (that is 10% of the $1,000,000 account). Indeed, if the charitable remainder beneficiary received $600,000 at the end of 20 years that would represents a 9% compounded growth for the 20 years on the $100,000 value of the remainder at inception of the trust. So, if $2,607,135 of FAI were received in the 20th year and paid to the unitrust recipient and subjected to a 37% tax, the recipient would have $1,642,495 slightly more than if the CRT were not used.

Even if only part of the increase in value in the trust (from inception) constitutes FAI, the unitrust recipient may receive more if the growth in the trust is greater. For example, if the trust grew not at 6% annually but at 11% a year (the same as the 11% unitrust percentage), the unitrust recipient would receive approximately $4.5 million after income tax compared approximately $3.5 million after tax if the plan or account grows tax free at 11% annually for ten years, is then withdrawn subject to a 37% tax and reinvested at 11% (6.39% after a 37% tax) for another ten years.

Should you wait until the end of the 5th year to make the payment to the CRT? If you have the $1 million IRA that is paid out immediately to the CRT and if the CRT invests in for long term capital gains appreciation then instead of the proceeds being subject to 37% tax it will be taxed only at 23.8% tax. There may be a tax arbitrage by converting immediately and not waiting.

A Non-See Through Trust for 20 Years with a CRT as a Discretionary Beneficiary[xxxix]

If a deduction is allowed for the value of the remainder in the CRT, the "rent" will actually be lower than ten percent. For example, if the taxpayer, who is in the 40% income tax bracket, obtains an income tax deduction for the value of the remainder, the real cost is only six percent. Similarly, for a

transfer at death (such for an IRA or plan), the cost of the remainder is, again, only six percent if the estate is in the 40% estate tax bracket.

However, it may be appropriate to forfeit the estate tax deduction to build in more flexibility in dealing with plan or IRA distributions. If the distributions are made to a non-see through trust that is not a CRT, the entire plan or IRA must be distributed by the end of the fifth calendar year following the death of the plan participant or IRA owner. The plan or IRA distributions will be included in the trust's gross income and will form part of the trust's distributable net income (DNI), defined in Section 643(a), and can be distributed out to and taxed to the trust's beneficiaries under Section 661 which might consist of family members and one or more charitable remainder trusts for family members (or, if authorized in the trust, its gross income can be paid to charity and a Section 642(c) income tax deduction allowed). The trustee can determine whether it is preferable to distribute part or all of the DNI to a family member or to a CRT, provided the trust will last for not more than 20 years. One factor the trustee might consider is whether state income tax can be avoided or reduced by making the distribution to an individual who is not subject to such a state tax. Another factor the trustee might consider is who is in the lowest federal income tax bracket. A CRT will be in a zero-tax bracket and that may be a good choice.

Nonetheless, no estate tax charitable deduction will be allowable for naming the non-see through trust even though its beneficiaries may include a CRT.[xl] For some folks at least that will not matter under the current high exemptions.

NIMCRUT for Life

A NIMCRUT may provide for payments for the life of an individual. However, to avoid violating the 10% minimum value of the remainder, no one younger than someone 23 years of age may be the unitrust recipient (and then only with a 5% unitrust payout and having the percentage applied and paid after 12 months from the funding of the trust). The older the unitrust recipient the higher that unitrust percentage may be for life. For example, an 11% unitrust payout can be provided for life for someone 51 years of age or older, the same maximum percentage for a fixed 20-year term unitrust.

With a unitrust for life of someone relatively young, the tax-free compounding inside a NIMCRUT can also mean more economic value

ultimately for the unitrust recipient. For example, if the beneficiary received the amount in the plan or IRA in ten years (which would be $1,790,847 if it earned 6 percent a year 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 30 more years, the beneficiary would then have $3,434,070. If instead, the beneficiary received no distributions from the NIMCRUT for 40 years and it grew at 6% a year, the unitrust recipient would receive $10.2 million (on account of the shortfalls in FAI during the years), leaving approximately $6.5 million after tax and having the original $1million corpus pass to charity at that time, which represents an approximate 6% compounded growth in the $100,000 value of the remainder for 40 years. An alternative, as discussed below, would be not to make up payments made to the unitrust recipient but to convert the NIMCRUT to a standard CRUT at some time.

Another Option to Build In: A Flip Unitrust

For a variety of reasons, one of which may be that the amount of FAI generated each year is insufficient from what the beneficiary desired and that a "standard" unitrust would have been preferred as payments would not be limited to FAI. Reg. 1.664-3(a)(1)(i)(c) permits the conversion of an income only unitrust to a standard unitrust (one that pays the unitrust amount each year regardless of the amount of FAI the trust receives). Once the conversion occurs, the beneficiary will receive the amount of the unitrust determined without regard to the amount of FAI. The conversion has to occur at a date certain what the regulations call a "triggering event," which the regulations provide is a single event whose occurrence is not discretionary with or within the control of the trusts or any other person. Regulations specifically provide that the sale of unmarketable assets,[xli] or the marriage, divorce, death, or birth of a child with respect to any individual may be such a triggering event.

Conclusion

Because tax deferral generally is beneficial, consideration should be given probably more often than it is to a CRT. Perhaps, the best form of CRT is a NIMCRUT which may permit tax deferral for years or even decades. For most who inherit a qualified plan or IRA interest, a ten-year deferral is the maximum allowable period. But for a NIMCRUT, the period may be much longer. The owner of an IRA or participant in a plan need not make a "whole hog or none" decision. Part of the proceeds could be directed to beneficiaries (or trusts for them) permitting a ten-year period to deferral all

or a portion of the tax on that part. The balance could be made payable to a NIMCRUT.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITATIONS:

[i] Throughout this newsletter, Section refers to a section of the Internal Revenue Code of 1986 as amended. Section 664 describes the principal requirements for a trust to be a “qualified” CRT for which an income, gift or estate tax deduction is permitted for the interest in the trust devoted to charity, under Section 170(f)(2)(A), Section 2522(c)(2)(A) or Section 2055(e)(2)(A).

[ii] For a further discussion of CRATs and CRUTs, including their governing instruments, see Fox, A Guide to the IRS Sample Charitable Remainder Trust Forms (Estate Planning, Jan. 2006).

[iii] Section 664(d)(1)(D) and (d)(2)(D).

[iv] Rev. Rul. 77-374, 1977-2 CB 329.

[v] For a discussion of the 5% probability test, see Fox & Blattmachr, “IRS Provides Guidance to Avoid 5% Probability Test for Charitable Remainder Annuity Trusts”, 94 Journal of Taxation 246 (June 2017).

[vi] Treas. Reg. § 1.664-4. In essence, that regulation requires that the charitable remainder (and the annuity or unitrust interest or interests that precede it) must be determined using the rate in effect under Section 7520. (Section 7520(a) provides that if an income, estate, or gift tax charitable contribution deduction is allowable for any part of the property transferred, the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls.) The Section 7520 rate is equal to 120% of the applicable federal midterm rate (determined under Section 1274) rounded to the nearest even two-tenths of one percent. Since the Section 7520 rate has been in effect (beginning in May 1989), it has reached a high of 11.6 percent and a low of 0.6 percent. http://www.leimberg.com/software/7520rate.

[vii] This is explained in detail in Blattmachr & Hastings, “Valuing Certain Split Interests,” 123 Trusts & Estates 27 (June 1983).

[viii] Rev. Rul. 77-374, supra.

[ix] This also is explained in Blattmachr & Hastings, supra.

[x] Note that in Atkinson v. Commissioner, 309 F.3d 1290 (11th Cir. 2002), it was held that, because the trust did not function exclusively as a CRT described in Section 664 (because the required annuity was not paid as provided in the trust), it failed to qualify for the treatment described in that section, presumably not only resulting in the disallowance of any income tax charitable deduction but also the disallowance of any gift tax deduction and causing the trust to fail for income tax exemption.

[xi] Pure tax postponement normally provides no benefit unless the income upon which the tax is imposed grows while it is being deferred, as a general rule.

[xii] This is explained in detail in Glickman & Blattmachr, "High Returns and Tax-Free Compounding: Important Goals in Building Wealth," 43 Estate Planning 11 (May 2016).

[xiii] See Silvermann, "Traditional IRA Pros and Cons," The Smart Investor (January 22, 2020), available at https://infoforinvestors.com/money/retirement/traditional-ira-pros-cons/

[xiv] This also is permitted for remainder in a pooled income fund described in Section 642(c)(5) and for a remainder in a farm or personal residence described in Section 170(f)(3)(B)(i).

[xv] Things will not be equal. Rates of taxation needs for money; rates of return and other things will be different. One of the things hardest to forecast is the structure and rates of income taxation.

[xvi] On account of rounding, it may not be possible to have the remainder exactly equal 10%. A word formula can be used to determine that value of the remainder and it should provide that, if the remainder cannot be made exactly 10%, it should be greater than 10% but as mathematically as close to 10% as possible. See discussion and sample language in Blattmachr & Heintzberger, "Adventures in Partial Interests," 138 Trusts & Estates Magazine 44 (October 1999).

[xvii] *See* https://www.macrotrends.net/2526/sp-500-historical-annual-returns.

[xviii] A CRT is subject to a 100% excise tax on any unrelated business taxable income attributed to it. Section 664(c)(2). It seems this income will form the pool of taxable income that may be taxed to the trust's annuitant or unitrust recipient which may cause the UBIT to be subject to overall taxation of more than one hundred percent (100%).

[xix] Just Google it. And note that the trillions of dollars that are in qualified retirement plans and individual retirement accounts (IRAs) got there based upon that assumption. *See*, also, Glickman & Blattmachr, supra.
[xx] *See*, *e.g.*, Sections 1033 and 1244.

[xxi] However, a CRT is liable for 100% excise tax on any unrelated business taxable income it has. See Section 664(c)(2).

[xxii] At least in some circumstances, gain experienced by a CRT will be attributed to the trust's grantor. *See* discussion in Blattmachr & Hastings, "Charitable Remainder Trusts," The Chase Review (October 1988).

[xxiii] In valuing the interests in a CRT, the taxpayer may use the Section 7520 rate in effect when created (which will be the date of death for one created at death) or either of the two preceding months. Section 7520(a)(flush material). Hence, for an individual who is known with medical certainty that he or she will die within the next two months, he or she can be legally certain of what type of CRAT will qualify. Also, a formula may be used. See the CRT forms available at InterActive Legal.
[xxiv] The creditworthiness of the buyer must be considered although sometimes an escrow may help eliminate that concerns. And *see* Sections 453, 453A and 453B.

[xxv] Even if the trust purchases a bond that pays each year interest equal to the Section 7520 rate used to value interests in the trust for tax purposes, the value of the bond will change over time and that will affect the unitrust payments in future years.

[xxvi] "According to Fidelity, a $100,000 deferred income annuity today that is purchased by someone at age 60 would generate $671.81 a month ($8,061.72 a year) in income for a woman and $696.89 a month ($8,362.68 a year) in income for a man," available at https://money.usnews.com/money/blogs/the-best-life/2013/07/09/when-to-convert-your-savings-into-an-annuity. For a $1 million payment, that would

be $83,627 a year not $50,000. Charity might be better off as well—for example, giving $100,000 to charity now and using $900,000 for the annuity which based upon the same assumptions would produce an annual payment of $75,264 each year.

[xxvii] There may an income tax advantage to a commercial annuity compared to a CRAT. All ordinary income is first treated as coming out of the CRAT, then long term gain, the tax-free return of basis. With a commercial annuity, the payments will be deemed to consist proportionately of ordinary income (interest), gain and corpus until original basis is exhausted.

[xxviii] For example, if the $1 million is sold, leaving $760,000 and $100,000 is given to charity, a commercial annuity purchased with the remaining $900,000 for the 60 year old male would be about $55,000 a year, more than the $50,000 sought annually from the CRAT.

[xxix] See https://www.macrotrends.net/2526/sp-500-historical-annual-returns.

[xxx] https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp

[xxxi] Although an income only CRUT need not provide for the make-up payments for years when FAI exceeds the unitrust payment for the year (such a trust is commonly called a “net income charitable remainder trust” or “NICRUT”), there seems to be little downside in using the NIMCRUT design. However, it the taxpayer wants to insure no “leaking” out of the trust for the long haul, the NICRUT may be best. The taxpayer may be waiting to convert (or flip) the income only trust to a regular CRUT until a later time.

[xxxii] Reg. 1.664-3(a)(1)(i)(b)(3).

[xxxiii] Id.

[xxxiv] Id.

[xxxv] As mentioned above, a CRT is subject to a 100% excise tax on any unrelated business taxable income attributed to it.

[xxxvi] Although the IRS has, from time to time, expressed some concern about the manipulation of FAI in a NIMCRUT, it seems to the authors that there should be no problem if the trust is structured and administered as suggested in this article. See discussion in Fox, A Guide to the IRS Sample Charitable Remainder Trust Forms (Estate Planning, Jan. 2006) at ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person.

[xxxvii] "In 1977, when the state of Wyoming first passed legislation allowing a new type of company called a Limited Liability Company (LLC), hardly anyone noticed. Today, over two-thirds of all new companies formed are LLCs." Search "How long have LLC been around?" at www.quora.com. What-was-the-first-known-Limited-Company.

[xxxviii] The SECURE Act is part of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94, 12/20/2019), which was signed into law by the President on 12/20/2019. The SECURE Act significantly modifies many requirements for employer-provided retirement plans, IRAs, and other tax-favored savings accounts.

[xxxix] The authors thank Andy Hook of the Hook Law Center for this idea.

[xl] It seems quite certain that a trust may create a charitable remainder trust described in Section 664. See discussion Blattmachr & Zeydel, "Split Interest Trusts Created by Entities (and More)", 2015 Univ. of Miami Heckerling Institute, Chapter 12.

[xli] A related or subordinate person is defined in Section 672(c).