

NIMCRUT Basics: When and How to Use the Net-Income with Make-up Charitable Remainder Unitrust

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NIMCRUT Basics

When and How to Use the Net-Income with Make-up Charitable Remainder Unitrust

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Agenda

- CRT refresher
- NIMCRUT defined
- Net income defined
 - Trust Accounting Income (TAI)
 - Uniform Principal and Income Act
 - Treasury Regulation limitations



Agenda (continued)

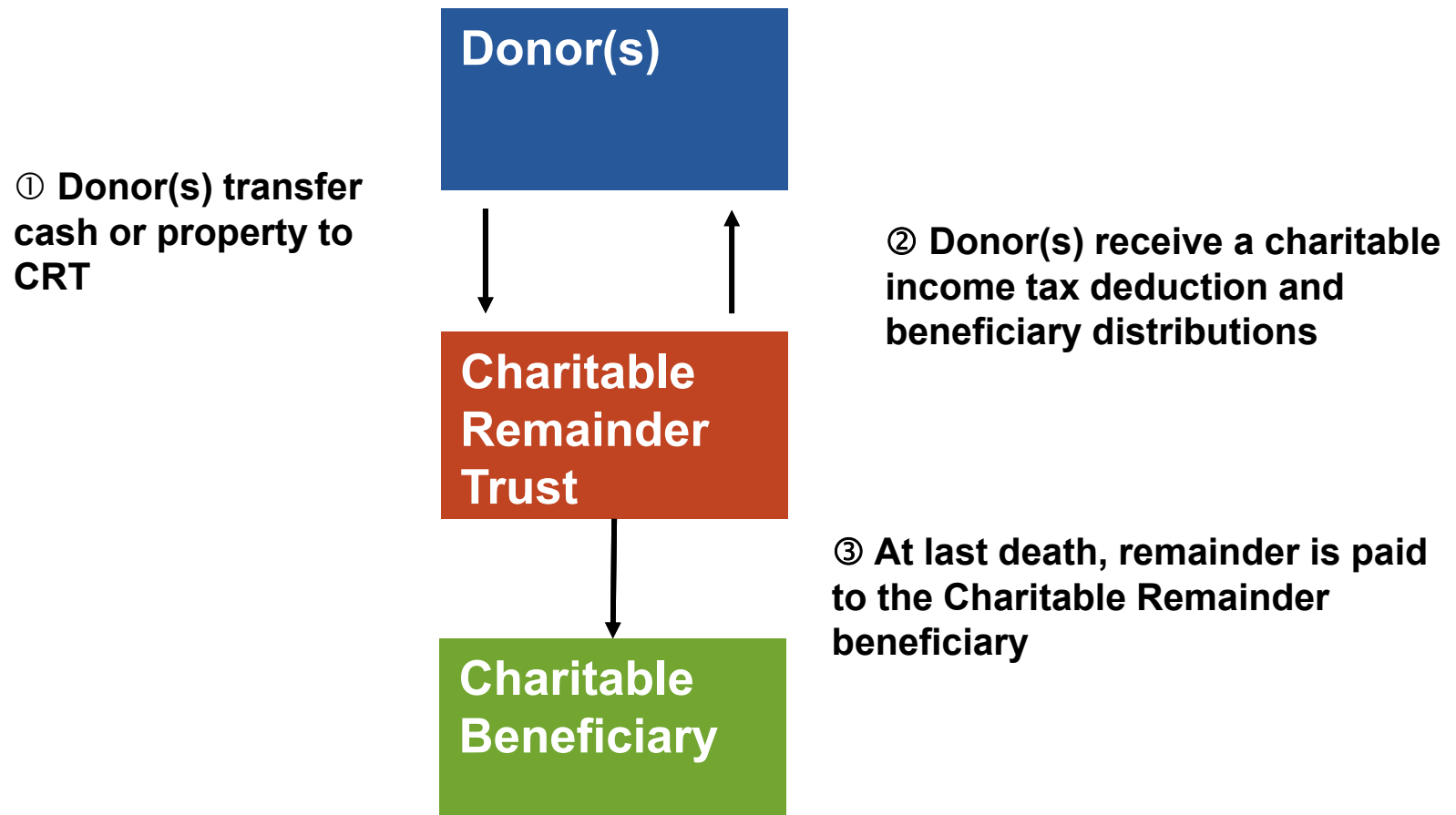
- Interaction of the unitrust amount and net income
- Make-up amount defined
- Principal reasons to use a NIMCRUT
- Flip-CRUT alternative
- Taxation of CRTs
- Using a NIMCRUT to defer distributions



Agenda (continued)

- Using zero coupon bonds to defer distributions
- Deferring distributions via realized capital gains
- Using annuities to defer distributions
- Using partnerships and SMLLCs to defer distributions
- Grantor trust considerations
 - Use of Independent Special Trustee
- Flip-CRUT vs. NIMCRUT as a deferral technique

CRT Refresher: Basic CRT Flow



CRT Refresher

A CRT is a trust with the following characteristics:

- Irrevocable
- At least one noncharitable income beneficiary
- All remainder beneficiaries are charities described in IRC § 501(c)(3)
- Created for the life or live(s) in being or a term certain not to exceed 20 years
- In the case of an annuity trust, it pays a sum certain equal to no less than 5% and no more than 50% of the value of the assets initially transferred to the trust

CRT Refresher (continued)

A CRT is a trust with the following characteristics (continued):

- In the case of a unitrust, it pays a fixed percentage of not less than 5% and not more than 50% of the value of the trust assets as revalued annually
- The present value of the charitable remainder of assets contributed must be no less than 10% of the value of the assets contributed (10% Remainder Test)
- For unitrusts, additional contributions are permitted
- Flexibility in naming charitable remainder beneficiaries



CRT Refresher (continued)

CRT benefits include:

- Avoidance of gain recognition on transfers to the trust
- A CRT donor is allowed a charitable income tax deduction equal to the present value of the remainder interest
 - A charitable gift tax or estate tax charitable deduction is also permitted
 - A marital deduction is permitted so long as there are no income beneficiaries other than the donor and the donor's spouse



CRT Refresher (continued)

CRT benefits (continued):

- Tax-free accumulations in the trust
 - Unless there is unrelated business taxable income (UBTI)
- Beneficiary distributions

NIMCRUT Defined

Internal Revenue Code (IRC) section 664(d)(3):

Exception. Notwithstanding the provisions of paragraphs (2)(A) and (B), the trust instrument may provide that the trustee shall pay the income beneficiary for any year—

- The amount of the **trust income**, if such amount is less than the amount required to be distributed under paragraph (2)(A), and
- Any amount of the trust income which is in excess of the amount required to be distributed under paragraph (2)(A), to the extent that (by reason of subparagraph (A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts

NIMCRUT Defined (continued)

Payment of Unitrust Amount. In each taxable year of the trust during the unitrust period, the Trustee shall pay to [permissible recipient] (hereinafter “the Recipient”) a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to [a number no less than 5 and no more than 50] percent of the net fair market value of the assets of the trust valued as of the valuation date (hereinafter “the fixed percentage amount described in (a) of paragraph 2”) or (b) the trust income for the taxable year as defined in § 643(b) of the Code and the applicable regulations. The unitrust amount for a taxable year shall also include **any amount of trust income for the year that is in excess of [the fixed percentage amount determined under (a) of this paragraph for the year], but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph and (a) of paragraph 5.**

Net Income Defined

IRC section 643(b):

Income. For purposes of this subpart and subparts B, C, and D, the term “income”, when not preceded by the words “taxable”, “distri-butable net”, “undistributed net”, or “gross”, means the amount of income of the estate or trust for the taxable year determined **under the terms of the governing instrument and applicable local law**. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

- Applicable local law is the Uniform Principal and Income Act of the governing law state
- Common term is “trust accounting income”



Uniform Principal and Income Act

- Published by the National Conference of Commissioners on Uniform State Laws (NCCUSL)
- Versions published in 1931, 1962, and [1997](#)
 - The 1997 version was further revised in 2000 and 2008
 - Adopted in 41 states

Uniform Principal and Income Act (continued)

- In 2018, NCCUSL introduced the “[Uniform Fiduciary Income and Principal Act](#)”
 - Continues the emphasis on “total return investing”
 - Has been adopted in Arkansas, Colorado, Kansas, Nevada, Virginia, and Washington

Uniform Principal and Income Act (continued)

- Key provisions of 1997 act
 - Section 103(a)(1)
 - “a fiduciary: (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act]”
 - Section 103(a)(3)
 - “a fiduciary: (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration”

Uniform Principal and Income Act (continued)

- Treasury Regulations do provide some constraints on the flexibility permitted by state law deference to trust agreement provisions
- Treas. Reg. 1.643(b)-1:
Trust provisions that **depart fundamentally from traditional principles** of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as **dividends, interest, and rents are generally allocated to income** and **proceeds from the sale or exchange of trust assets are generally allocated to principal**.

Uniform Principal and Income Act (continued)

- Treasury Regulations constraints (continued)
- Treas. Reg. 1.643(b)-1:

[A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation.

Uniform Principal and Income Act (continued)

- Treasury Regulations constraints (continued)
- Treas. Reg. § 1.664-3(a)(1)(i)(b)(3):

Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income **at least to the extent of the fair market value of those assets on the date of their contribution to the trust.**

Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income **at least to the extent of the trust's purchase price of those assets.**

Except as provided in the two preceding sentences, **proceeds from the sale or exchange of any assets** contributed to the trust by the donor or purchased by the trust **may be allocated to income**, pursuant to the terms of the governing instrument, if not prohibited by applicable local law.

Uniform Principal and Income Act (continued)

- Treasury Regulations constraints (continued)

- Treas. Reg. § 1.664-3(a)(1)(i)(b)(3):

“[T]rust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law.”

“A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially”



Interaction of Unitrust Amount and Net Income

- Beneficiary distributions are the lesser of:
 - The fixed percentage unitrust amount; and
 - Trust accounting income

Interaction of Unitrust Amount and Net Income (continued)

- Example:
 - Unitrust amount
 - \$1,000,000 trust value on the first business day of the year
 - 5% unitrust percentage
 - \$50,000 fixed percentage unitrust amount
 - Trust accounting income
 - Dividends and interest of \$17,500
 - Amount payable to beneficiary: \$17,500

Make-up Amount Defined

- The make-up amount is the cumulative shortfall (deficiency) between annual net income and the annual unitrust amount
- Example
 - Assume these facts:

• Year 1 Unitrust Amount:	\$45,000
• Year 1 Net Income:	\$27,000
• Change in make-up amount	\$18,000
• Cumulative make-up amount	\$18,000

Make-up Amount Defined (continued)

- Example (continued)

- Assume these facts:

- Year 2 Unitrust Amount: \$42,000
 - Year 2 Net Income: \$23,000
 - Change in make-up amount \$19,000
 - Cumulative make-up amount \$37,000

Make-up Amount Defined (continued)

- Example (continued)

- Assume these facts:

- Year 3 Unitrust Amount: \$47,000
 - Year 3 Net Income: \$58,000
 - Change in make-up amount (\$11,000)
 - Cumulative make-up amount \$26,000

Make-up Amount Defined (continued)

- This math is all the subject of Form 5227, Part VI, Lines 4-8
- The make-up amount is a contingent sum that may only be paid in a future year in which net income for that future year exceeds the unitrust amount of that future year



Principal Reasons To Use a NIMCRUT

- There are two principal reasons to use a NIMCRUT:
 - To receive illiquid assets
 - To defer beneficiary distributions (more on this later)

Principal Reasons To Use a NIMCRUT (continued)

- Receiving illiquid assets
 - *Illiquid assets* refers to real property, closely held stock, partnership interests, and other similar assets
 - A CRAT or standard CRUT must make distributions no less frequently than annually
 - If a CRT is funded with illiquid assets that may not be liquidated quickly, then the lack of liquidity will complicate making a distribution
 - Since a NIMCRUT is only required to distribute net income, and net income should be liquid (under trust accounting rules), then a NIMCRUT avoids this complication

Flip-CRUT Alternative

- A Flip-CRUT is a CRT characterized by two distinct distribution phases:
 - Phase 1: The trust's distribution scheme is that of a NICRUT or NIMCRUT
 - Phase 2: The trust's distribution scheme is that of a standard CRUT

Flip-CRUT Alternative (continued)

- Phase 2 begins upon the happening of a “triggering event” specified in the trust agreement (see next slide for list of triggering events)
- Phase 2 must begin on the first day of the taxable year succeeding the happening of the triggering event (Treas. Reg. § 1.664-3(a)(1)(i)(c)(2))

Flip-CRUT Alternative (continued)

- Seven permissible triggering events (Treas. Reg. § 1.664-3(a)(1)(i)(c)(1), (d)):
 - Birth
 - Death
 - Marriage
 - Divorce
 - Sale of an unmarketable asset
 - Date certain
 - An event outside the discretion or control of any person
 - Could this include disability?
- You can flip, but you cannot flop

Flip-CRUT Alternative (continued)

Conversion to fixed percentage method of determining unitrust amount. Notwithstanding paragraph 2(i), upon the occurrence of [permissible triggering event as described in § 1.664-3(a)(1)(i)(c) and (d) of the Income Tax Regulations] (hereinafter “the triggering event”) and effective as of the first day of the taxable year that immediately follows the triggering event (hereinafter “the effective date of the triggering event”), the Trustee shall pay to the Recipient in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to [same percentage used in (a) of paragraph 2(i)] percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the Trustee shall no longer pay the amount equal to the lesser of (a) or (b) in paragraph 2(i).



Flip-CRUT Alternative (continued)

- Benefits of a Flip-CRUT
 - Suitable for receiving illiquid assets
 - Can control the timing of the triggering event at the time of drafting
 - Distribution certainty following the triggering event

Taxation of CRTs

- CRTs are themselves exempt from income tax
- Distributions to noncharitable beneficiaries are taxable
- Unique “four-tier” accumulation schedule is used in lieu of DNI

Taxation of CRTs (continued)

- Tiers are ordered from highest tax rate to lowest tax rate in the following four tiers:
 - Ordinary income (e.g., interest, dividends (including qualified dividends), rents, royalties)
 - Capital gains (including short-term, collectibles, unrecaptured section 1250 gains, regular gains)
 - Tax-free income (e.g., municipal bonds)
 - Corpus (or trust principal)

Taxation of CRTs (continued)

- Tiers are populated according to normal tax rules
 - Including tax timing rules
- Tiers are relieved from highest tier to lowest tier
 - Not pro rata across tiers
 - But pro rata within income classes subject to the same tax rate within a tier
 - e.g., interest, net rents, royalties, and ordinary dividends are relieved on a pro rata basis
- Beneficiaries receive a Schedule K-1



Using a NIMCRUT to Defer Distributions

- Not achievable by direct deferral provisions in the trust agreement
- Deferral is achieved by taking advantage of trust accounting income recognition timing rules
- Four examples:
 - Zero coupon bonds
 - Realized capital gains
 - Variable annuity contracts
 - Partnership and single-member LLCs

Using Zero Coupon Bonds to Defer Distributions

- Not supported directly by UPIA
 - UPIA section 406(b):

(b) A trustee **shall allocate to principal** an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee **more than one year** after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation **matures within one year** after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust **must be allocated to income**.
 - Note that realized appreciation of T-bills and other issues with maturities of one year or less is allocable to income.
 - Realized appreciation from longer maturity issues is allocable to principal

Using Zero Coupon Bonds to Defer Distributions (continued)

- State law can overcome this issue
- Indiana's UPIA:
 - Notwithstanding any other provision of this section, when an obligation described in this section is held as an asset of a **charitable remainder trust**, an increase in the value of the obligation over the value of the obligation at the time of acquisition by the trust is distributable as income. For purposes of this subsection, the increase in value is available for distribution only when the trustee receives cash on account of the obligation.
 - IC § 30-2-14-28(c)
- The trust agreement can overcome this issue by an express provision

Using Zero Coupon Bonds to Defer Distributions (continued)

- **Pros** to this approach:
 - Will defer timing of income subject to distribution
- **Cons** to this approach:
 - There is limited control over the amount and timing of income recognition
 - If a bond issue is called, then a distribution will be forced without regard to the overall plan

Deferring Distributions via Realized Capital Gains

- Not supported directly by UPIA
 - UPIA section 413(b):

“[P]roceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.”
- Specific trust language can overcome this UPIA allocation rule

Deferring Distributions via Realized Capital Gains (continued)

- Sample language:

Net Realized Capital Gains Allocated to Income

Subject to the conditions on the computation of capital gains set forth below, the trustee shall allocate to income the net realized capital gain from the sale of trust assets.

Computation of Capital Gains

Assets Contributed to the Trust. For purposes of this paragraph, net realized capital gains are allocable to income solely to the extent such gains exceed the fair market value of the assets sold or exchanged on the date of their contribution to the trust.

Assets Purchased by the Trust. For the purposes of this paragraph, net realized capital gains are allocable to income solely to the extent such gains exceed the trust's purchase price of the assets sold or exchanged.

Deferring Distributions via Realized Capital Gains (continued)

- **Pros:**

- Deferral is achievable
- Control over the timing of realization
- Limited control over the amount of gain realized (must pay attention to which issues and lots are sold)

- **Cons:**

- Complicates portfolio rebalancing because there is no distinction between sales for the purpose of investment management and sales for the purpose of income generation



Using Annuities to Defer Distributions

- Not supported directly by UPIA
 - UPIA section 409(b) speaks to payments or parts of payments from a “separate fund” (which term includes commercial annuities) that are characterized as interest, a dividend, or a payment made in lieu of interest or a dividend as allocable to income
 - UPIA section 409(c) requires the allocation to income of 10% of uncharacterized payments that are “required to be made” with the balance to principal

Using Annuities to Defer Distributions (continued)

- Not supported directly by UPIA (continued)
 - Characterizing discretionary withdrawals from a commercial deferred annuity
 - UPIA section 409(c) states “a payment is not ‘required to be made’ to the extent that it is made because the trustee exercises a right of withdrawal”
 - Payments not ‘required to be made’ must be allocated to principal

Using Annuities to Defer Distributions (continued)

- Can be supported by state law
- Indiana Code section 30-2-14-31(g):

Notwithstanding any other provision of this section, when a private or commercial deferred annuity is held as an asset of a **charitable remainder trust**, an increase in the value of the obligation over the value of the obligation at the time of the acquisition by the trust is distributable as income. For purposes of this subsection, the increase in value is available for distribution only when the trustee exercises a right of withdrawal or otherwise receives cash on account of the obligation. If the obligation is surrendered wholly or partially before annuitization, the cash available shall be attributed first to the increase. The increase is distributable to the income beneficiary who is the income beneficiary at the time the cash is received.



Using Annuities to Defer Distributions (continued)

- **Pros** to the use of annuities to defer income:
 - Very discrete control over the timing and amount of withdrawals from the annuity and thereby distributions to beneficiaries
- **Cons** to the use of annuities to defer income:
 - Cost (commissions paid to brokers)
 - Can be controlled by choice of vendor

Using Annuities to Defer Distributions (continued)

- **Cons** to the use of annuities to defer income (continued):
 - Subaccounts must be managed and frequently are not
 - Underwater annuity must recover to investment amount before amounts will be available for distribution
 - Investment options are limited: appreciation withdrawn for investment elsewhere must first be included in beneficiary distributions, at least to the extent of the make-up amount
 - Independent special trustee advisable to avoid grantor trust

Key IRS Pronouncements Regarding NIMCRUTs and Annuities

- Rev. Proc. 2024-3 No ruling matters
 - Sec. 4 (39) Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient

Using Annuities to Defer Distributions (continued)

- Rev. Proc. 2024-3 No ruling matters (continued)
 - First introduced in Rev. Proc. 1997-23 in which the Service stated that it would “study whether creating or using income exception charitable remainder unitrusts to control the timing of the trust’s receipt of trust income for the benefit of the unitrust recipient causes the trust to fail to function exclusively as a charitable remainder trust”
- TAM 9825001
 - Favorable ruling regarding the use of a variable annuity contract to control the timing and amount of trust accounting income in a NIMCRUT

Using Partnerships and SMLLCs to Defer Distributions

- UPIA section 104 discussed the treatment of disbursements from “entities”*
- “Entities” for this purpose include corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, “or any other organization in which a trustee has an interest other than a trust or estate”

*This is now embodied in Sec. 401 of the [Uniform Fiduciary Income and Principal Act](#) introduced in 2018 by the National Conference of Commissioners on Uniform State Laws.

Using Partnerships and SMLLCs to Defer Distributions (continued)

- Such disbursements are “income” when received by the trustee (UPIA § 104(b))
 - This ignores the passthrough tax reporting rules applicable to partnerships
 - Deferral is achieved by controlling the timing of disbursements from the entity
- Partnerships and SMLLCs are used so that the tax effect passes through to the trust

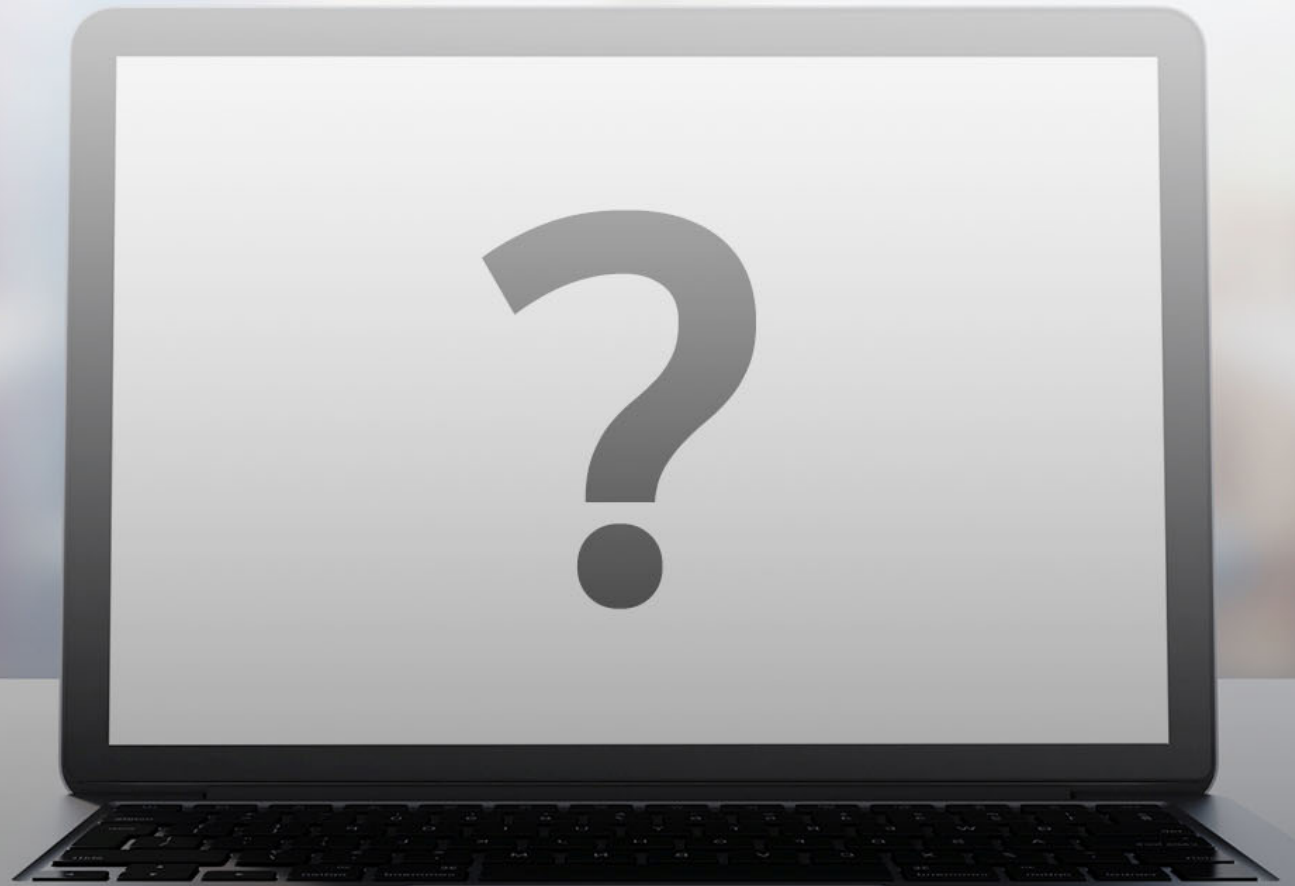
Grantor Trust Considerations

- Because deferral is based on discretionary decisions of a trustee, if the trustee is a beneficiary or donor, due consideration must be given whether this discretion is a “power to control beneficial enjoyment” as that term is used in section 674(a)
- For this reason, the trustee making these decisions should be independent
 - If the trustee is a beneficiary or donor, then the power to make these decisions should be an “independent special trustee”
- Where an entity is used, the general partner or LLC manager should similarly be independent of the donor and/or beneficiary

Flip-CRUT vs NIMCRUT as a Deferral Technique

- Where a date certain or the sale of an unmarketable asset is the triggering event, a Flip-CRUT is generally preferable because it allows for more certainty:
 - That distributions will occur
 - As to the amount of those distributions

Questions?





Thank you.

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