

Making a Charitable Remainder Trust Act Like a Pension

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Charitable remainder trust (CRTs) have been popular for many years because they provide a current income tax deduction, retained cash flow, and may be used to convert appreciated assets to income-producing assets without capital gains tax. One of the "hot" topics in recent years has been the use of a CRT as a retirement planning vehicle.

Basic CRT Rules

A charitable remainder trust (CRT) is an irrevocable tax-exempt trust making annual or more frequent payments to the donor and/or other designated individuals for life, or for a fixed number of years (not more than 20), after which time a charity gets the trust balance. The annual payments to the noncharitable beneficiaries must be at least 5% of the value of the trust's assets (except for the NIMCRUT, described below), they cannot exceed 50% of the value, and the present value of the interest passing to charity must be at least 10% of the contributed amount. The donor gets an immediate tax deduction for the actuarial present value of the interest ultimately passing to charity. As a tax-exempt entity, the CRT may sell appreciated assets without capital gains tax.

The client's private foundation may be the charitable beneficiary of a CRT. However, if appreciated property is contributed to such a CRT, the income tax deduction may be significantly reduced as it will be based on the property's purchase price, rather than its fair market value, unless long-term publicly traded stock is contributed. This is in marked contrast to a gift to a CRT whose charitable beneficiary is limited to a public charity, in which case the gift of any long-term capital gain property results in a deduction based on fair market value.

There are three types of CRTs. The first is an annuity trust (CRAT), which pays a fixed dollar amount each year. The second is a unitrust (CRUT), which generally pays a fixed percentage of the trust's assets, revalued annually. From a practitioner's perspective, a more interesting difference between a CRAT and a CRUT is the subtype of CRUT that contains a "net income with makeup" provision. This trust is commonly known as a "NIMCRUT."

NIMCRUT as Tax Deferral Device

A NIMCRUT pays only trust income if it is less than the percentage amount stated in the trust document. Deficiencies in distributions (i.e., where the income earned for the year is less than the percentage amount) are accrued for future makeup payments, that will be made in any year in which trust income exceeds the specified percentage.

A NIMCRUT permits a client to control the timing of trust distributions and to benefit from the tax free buildup of trust income. For example, in the client's high earning years, the trustee may invest for growth and generate little or no income. With no income, a large deficit would be created during the client's preretirement years. After the client retires, or otherwise wants income, the trustee might sell the growth assets and invest for a high income exceeding the percentage amount. The client then would be paid both the percentage amount and the excess income to make up for the period of time when the client received no income. For example, if, in the first ten

years, the percentage payments totaled \$500,000 but the client received nothing because the trustee invested for growth and there was not income, the NIMCRUT would accrue the obligation to pay the \$500,000 in missed payments. If, in the eleventh year when the client retires, the trustee reverses the investment strategy and invests for income rather than growth and earns \$150,000 in that year when the percentage amount is \$70,000, the entire \$150,000 will be paid to the client: \$70,000 is paid as the percentage amount for the current (eleventh) year and \$80,000 is paid as part of the makeup of the \$500,000 for the first ten years when no payments were made. The remaining \$420,000 due (\$500,000 - \$80,000) would continue to be paid to the client until a "make-up" of all unpaid percentage amounts is achieved by the trustee.

NIMCRUT Investment Strategies to Control Timing of Trust Distributions

Several investment techniques are available to control the timing of NIMCRUT distributions. The timing of distributions is controlled by controlling when the NIMCRUT has trust accounting income that it is required to distribute. Trust accounting income is different than taxable income. A NIMCRUT does not have a trust accounting income unless it has cash receipts. Thus, by controlling the timing of trust receipts, the timing of distributions to the client may be controlled.

The traditional NIMCRUT funding approach is to invest in growth assets and then, on retirement or when the client wants income, sell the assets and invest for a very high income. This control over trust distributions is achieved at the cost of some loss of investment flexibility.

Zero coupon bonds sometimes are held by NIMCRUTs to control distributions. Since zero coupon bonds pay interest only at maturity, a NIMCRUT that holds a zero coupon bond receives no trust accounting income during the term of the bond and thus is not required to make distributions during this period.

When the bonds mature, income is available to make up prior deficits. A drawback to the zero coupon bond is that it does not provide good long-term investment opportunity and, once purchased, the maturity date and time for receipt of NIMCRUT income has been established.

Another potential investment vehicle in the NIMCRUT is a variable annuity. Since a variable annuity may be invested in a variety of funds, it may defer income without restricting investments. A NIMCRUT does not receive accounting income until the trustee actually withdraws money from the annuity. When the trustee does withdraw money from the appreciated annuity, it is all income (not partly income and partly a return of principal as would be the case if an individual owned the annuity). This can provide large infusions of income to make up prior deficits. Whenever the client wants cash flow, the trustee withdraws amounts from the annuity and the entire withdrawal is trust accounting income (assuming the fund as grown in value) and may be immediately distributed to the client -- up to the percentage amount for that year plus an accumulated deficit. The variable annuity thus effectively turns the NIMCRUT into a "spigot trust," where the trustee turns the income flow on and off as needed by the client. The tradeoff is that, under the annuity taxation rules, all distributions are taxable as ordinary income.

Using a Partnership to Control Timing of Trust Distributions

To avoid the investment limitations of the growth stock or zero coupon bonds strategies and the ordinary income tax rate of a variable annuity, a NIMCRUT may hold its assets in a partnership. Taxable income of the partnership flows through to the NIMCRUT so the partnership's investing is done through the trust's tax-exempt environment. Until a distribution is made from the partnership, the NIMCRUT has no trust accounting income and is not obligated to make distributions to the

client. When the client wants cash flow, the partnership makes a distribution to the NIMCRUT, which is characterized as income and distributed to the client.

Capital Gain NIMCRUT to Create Boost in Income

The most frequently contributed property to a NIMCRUT is appreciated property because it may be sold by the trust without capital gains tax. The noncharitable beneficiary thus may be assured of a lifetime income that would be much higher than by personally selling the asset and investing the after-tax proceeds. Usually, capital gains are treated as trust principal and thus sale proceeds will stay in the NIMCRUT. In many states, however, it is possible to define "income" in the trust instrument to include capital gains from a sale. If the sale occurs several years after funding the NIMCRUT (i.e., after substantial distribution deficits are incurred), then the capital gains classified as "income" might be distributed to the client as a "makeup" payment, rather than accruing to trust principal for ultimate distribution to the charity. However, recent IRS regulations prohibit allocating pre-contribution appreciation to trust income. If permitted under local law, the trust instrument may allow post-contribution capital gain to be allocated to income for possible distribution to the client.

Note that a sale will create a boost in "income" only in the year the asset is sold. If the full gain cannot be distributed because it exceeds the percentage amount for that year plus accumulated deficits, the undistributed gain is not part of trust "income" for later years. In later years, the trustee must maintain the high investment return to make up prior deficits.

Allocating post-contribution gain to income will allow more trust return to be distributed to a client. However, if the growth stock strategy is employed to defer income, a blanket allocation in the trust document may conflict with the goal of deferral. Each time the trustee sells an appreciated asset to adjust the trust's portfolio, the trustee creates income required to be distributed to the client. A more flexible approach, approved by the IRS in a recent letter ruling, is to allow the trustee discretion to allocate post-contribution gain to income on a case by case basis, assuming this is permitted under local law.

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