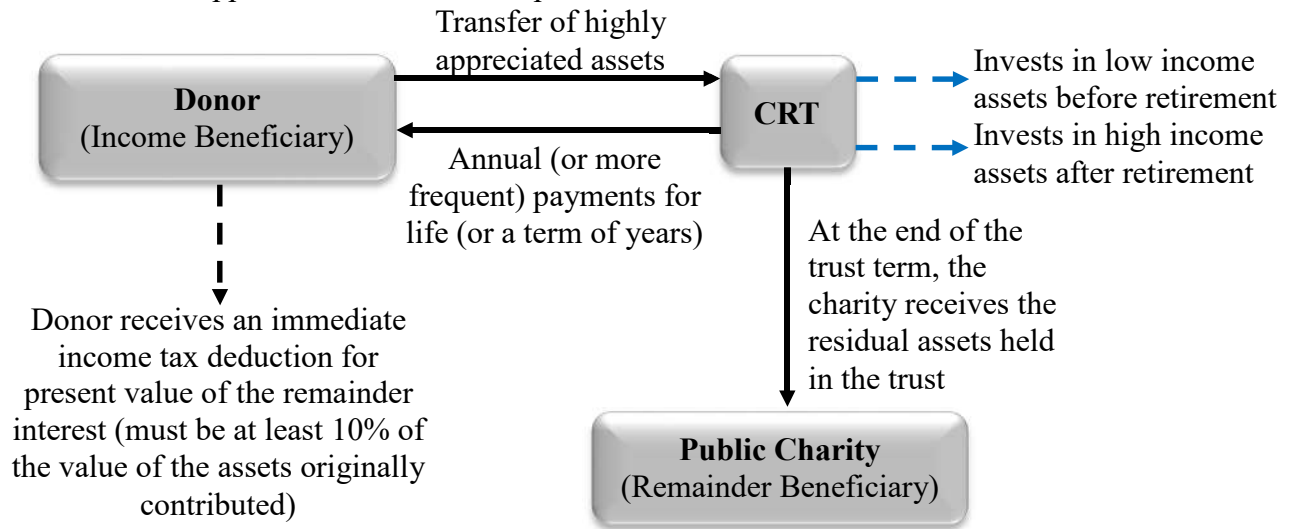


#6: Retirement Charitable Remainder Trust

Other sections of this series describe how a charitable remainder trust (CRT) can be used to smooth out capital gains from a large sale (#12) and how a CRT can be used to shift income to family members in lower tax brackets (#5). A CRT can also be used as an alternative or supplement to a retirement plan.



Recall from the other CRT sections that the lead interest in a CRT can be either an annuity interest (CRAT) or a unitrust interest (CRUT). A retirement CRT is set up using a special kind of CRUT called a net income with make-up CRUT, or NIMCRUT. A NIMCRUT pays the settlor the lesser of a fixed percentage of the trust assets (recalculated annually) or the net trust income. It also includes a make-up provision providing that--“to the extent that trust income is less than the stated fixed percentage, the shortfall goes into a make-up account that can be paid out in later years to the extent the trust income exceeds the fixed percentage.” It should be noted that in a NIMCRUT, the principal can never be invaded; therefore, the shortfalls in the make-up account may only be paid out later if trust income exceeds the fixed percentage.

Example 1. For an illustration of how the make-up provision works, assume that after 5 years a 5% NIMCRUT, with a principal of \$100,000 and a make-up account of \$20,000, has the amounts of trust income shown below:

Trust Income	5% Unitrust Payout¹⁶	Make-Up “Payout”¹⁷	Actual Payout¹⁸	End. Bal. Make-Up Fund¹⁹	End. Bal. Trust
\$ 4,000	\$ 5,000	\$ 0	\$ 4,000	\$ 21,000	\$ 100,000
\$ 5,000	\$ 5,000	\$ 0	\$ 5,000	\$ 20,000	\$ 100,000
\$ 6,000	\$ 5,000	\$ 1,000	\$ 6,000	\$ 19,000	\$ 100,000

The CRT retirement strategy works by minimizing trust distributions before retirement and maximizing trust distributions after retirement. In the years before retirement, the NIMCRUT invests in assets that produce very low income, like growth stock. This activates the make-up provision, i.e., the trust income will be less than the fixed percentage so the shortfall goes into the make-up account to be paid out later when trust income exceeds the fixed percentage. Thus, in these years, the NIMCRUT makes few or no distributions, and accumulates gains tax-free. Then when the donor retires, the NIMCRUT invests in assets that will maximize trust income, like high dividend paying stock or high yield bonds. This will create trust income that exceeds the fixed percentage and will allow for not only the full amount of the fixed percentage to be paid out, but also the amounts in the make-up account. Thus, the retirement CRT allows for deferred growth of retirement funds without the restrictions on qualified retirement plans and relatively high payouts after retirement.

Example 2. Taxpayer is currently 45 years old and plans to retire in 20 years. Before retirement, Taxpayer transfers low basis land to a 40-year NIMCRUT with a 5 percent payout. The NIMCRUT sells the land for \$1,000,000 and invests the proceeds in growth stocks that appreciate in value at 7 percent per year and pay 1 percent in dividends. During these years, the amount of the fixed payout percentage that exceeds the net trust income goes into the make-up account to be paid out later. At the end of 20 years, there is \$1,754,607 in the make-up account and the value of the stock has increased to \$3,869,684. After retirement, the NIMCRUT sells the stocks and reinvests in high-yielding bonds, paying 8 percent interest annually. Taxpayer then begins to receive the full 5 percent annual payout from the NIMCRUT, \$193,484 in Year 21 (.05 x \$3,869,684). Taxpayer also receives a payment from the make-up account equal to the excess of the 8 percent return over the fixed payout percentage. This amount is \$116,091 (.03 x \$3,869,684). This reduces the make-up account to \$1,638,517 (\$1,754,607 - \$116,091). This \$1,638,517 is available for use in future years until it is used up (which happens in year 37). Once the make-up account is used up, the excess of net trust income over

¹⁶ Calculated by taking the 5% interest rate times the \$100,000 of trust principal.

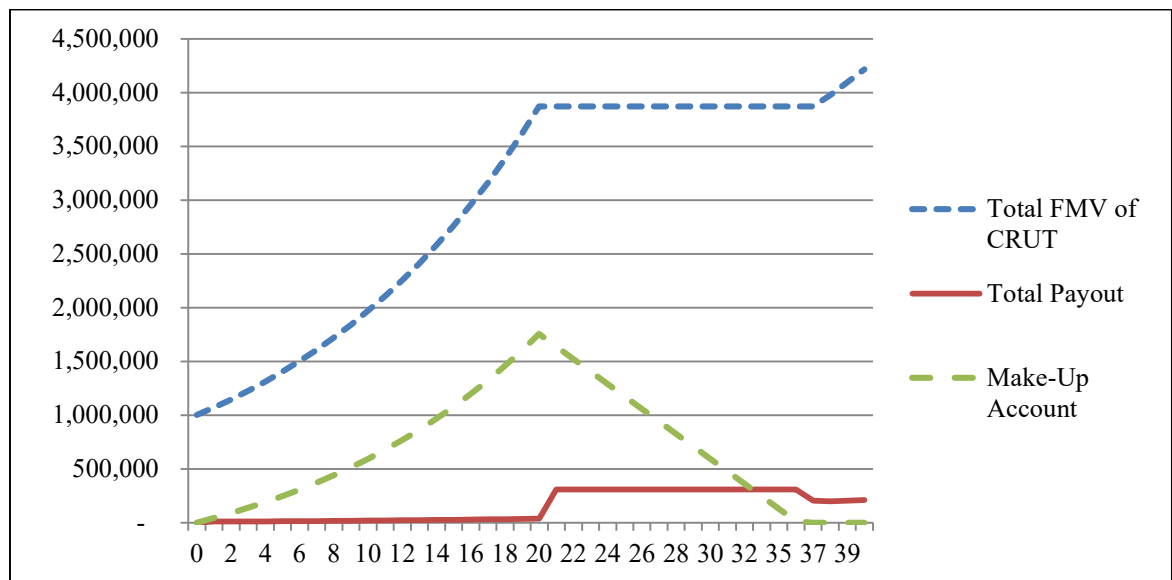
¹⁷ If the trust income exceeds the stated 5% payout and there is an accumulated amount in the Make-Up Fund, then the amount that the trust income exceeds the stated 5% payout will be a Make-Up Payout.

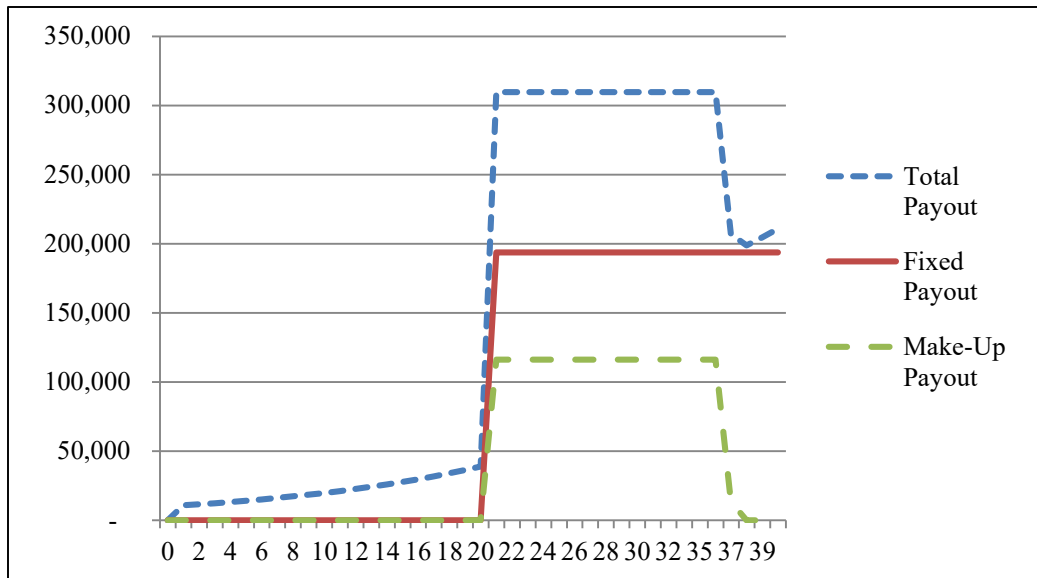
¹⁸ The lesser of trust income or the stated 5% interest rate payout (plus any amount in the Make-Up Fund).

¹⁹ If the trust income is less than the stated 5% interest rate payout, then that amount goes into the Make-Up Fund to be paid out later, when trust income exceeds the stated 5% interest rate payout.

the fixed payout percentage is added to the NIMCRUT. Below is a summary of what the different amounts look like every 5 years.

Year	CRUT FMV	Trust Income	5% Unitrust Payout	Make-Up "Payout"	Total Payout	Make-Up Fund
1	\$1,070,000	\$10,700	\$53,500	\$0	\$10,700	\$42,800
5	\$1,402,552	\$14,026	\$70,128	\$0	\$14,026	\$246,132
10	\$1,967,151	\$19,672	\$98,358	\$0	\$19,672	\$591,344
15	\$2,759,032	\$27,590	\$137,952	\$0	\$27,590	\$1,075,522
20	\$3,869,684	\$38,697	\$193,484	\$0	\$38,697	\$1,754,607
RETIREMENT						
21	\$3,869,684	\$309,575	\$193,484	\$116,091	\$309,575	\$1,638,517
25	\$3,869,684	\$309,575	\$193,484	\$116,091	\$309,575	\$1,174,154
30	\$3,869,684	\$309,575	\$193,484	\$116,091	\$309,575	\$593,702
35	\$3,869,684	\$309,575	\$193,484	\$116,091	\$309,575	\$129,340
40	\$4,214,453	\$337,156	\$210,723	\$0	\$210,723	\$0





Therefore, at the end of the 40-year NIMCRUT, \$4,214,453 goes to the charitable remainder beneficiary. The total payments made to the lead beneficiary over the 40-year NIMCRUT equal \$5,464,289. Therefore, taking the \$1,000,000 investment in the NIMCRUT, over a 40 year period, with a future value of \$5,464,289, that gives Taxpayer a 4.34% return. If you include the charitable gift, the total future value is \$9,739,143, giving Taxpayer a total return of 5.84%.

Not only does the retirement CRT serve as a substitute for or a supplement to a retirement plan, it can also be used to smooth out income to enable the taxpayer to avoid the 3.8% net investment income tax (NIIT) and the higher marginal tax brackets. In the years before retirement, when the taxpayer is in higher tax brackets, the NIMCRUT lead interest beneficiary (i.e., the taxpayer) will receive very small, if any, payments, deferring income and taxes. Then in the years after retirement, when the taxpayer is in lower tax brackets, the NIMCRUT lead interest beneficiary (i.e., the taxpayer) will receive the larger payments taxed at a lower rate; thus, deferring and lowering taxes. Also recall from the CRT sections of this series how the payments from the CRT are characterized when planning a retirement CRT, i.e., the four-tier income ordering rules.

However, careful planning must be done in order to avoid increasing the taxpayer's taxes under the new NIIT during the years of distribution from the NIMCRUT. In the years before retirement, there should be little impact on the taxpayer's net investment income because the payments will be small, if not zero. After retirement though, the payments will be much larger. Careful planning must be done to ensure that a taxpayer who but for the NIMCRUT payment would not have been subjected to the NIIT, still is not; i.e., the taxpayer continues to be under the applicable threshold amount in § 1411.²⁰

In the end, the purpose of this strategy is to harbor net investment income in a tax-exempt environment while at the same time leveling and deferring income over a longer period of time to

²⁰ Also recall and consider the two accounting methods for distributions of NII from a CRT to a non-charitable beneficiary as discussed under the "Substantial Sale CRT" topic in this series.

keep MAGI below the applicable threshold amount under § 1411 and to keep the taxpayer out of the higher tax brackets.

One final note: There are more aggressive variations on the strategy that might produce even more favorable results. For example, a taxpayer could have a NIMCRUT invest in a tax-deferred annuity. No trust income would be produced until the annuity starting date. Thus, by fixing the annuity starting date at the taxpayer's retirement date, the taxpayer could ensure that there was no income before retirement, but a relatively favorable income stream after retirement. But before having a retirement CRT invest in deferred annuities, or even zero-coupon bonds, partnership assets, or life insurance, etc., do more research; there are arguments being made that the IRS could, in certain situations, find that such CRTs violate the CRT or grantor trust rules and, therefore, result in a failure to qualify as a CRT.

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