NIMCRUTs and FLIPCRUTs

NIMCRUTs

A variation on the CRUT is the NIMCRUT; a net income with makeup charitable remainder unitrust.

This is a CRUT for someone who might not need all the income immediately. The payments are governed to a great extent by the way the assets in the trust are invested, and also on how the word "income" is defined by the trust document. We, therefore, can think of this as a trust divided between an *accumulation period* and a *distribution period*.

The NIMCRUT contains language, which sets the payout amount, for example, at 8%. If during the accumulation period, the trust is invested to produce net income for the payment to the income beneficiary of only 5%, then the beneficiary only gets 5% and a promise to make up the difference of 3% in a year when the trust earns more than 8%. Some type of deferred annuity is useful to accomplish this investment strategy.

At the time the beneficiary may want or need a greater income amount, the trustee re-allocates the asset mix, or in the case of an annuity, turns on the income stream in order to produce more "income" as defined by the trust.

FLIPCRUTs

A FLIP is a CRUT that starts out as a NIMCRUT, paying the lesser of the percentage of the income earned annually, but, at a later date, converts to a standard CRUT, which MUST pay out a specified percentage annually without regard to the actual income earned by the trust in that year. FLIPCRUTs must conform to the following rules to be valid.

- The trust must be funded with at least 90% of unmarketable assets (not cash or cash equivalents or marketable securities).
- The change or "flip" must be triggered by an event that is not within the discretion or control of the trustee.
- The change of methods from a NIMCRUT to a standard CRUT is effective the beginning of the tax year following the tax year in which the triggering event occurred.
- Once the conversion (FLIP) to a standard unitrust has occurred, the trust must pay to the income beneficiaries annually the unitrust amount chosen by the donor.
- No amount can be paid from the makeup account, which is forfeited when the trust switches to a standard unitrust. (But, if some of the post-contribution capital gain is allocated to "income" and then used to satisfy the unitrust amount in the year the non-marketable assets are sold, the make up account would be essentially partially shifted by reallocation of the funds).

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Basic Construction and Tax Issues for Charitable Remainder Trusts

CRATs and CRUTs

Generally, there are two types of CRTs, the Charitable Remainder Annuity Trust (CRAT), and the Charitable Remainder Unitrust (CRUT).

The donor contributes property to an irrevocable trust. The trustee may sell the property and reinvest the proceeds (no capital gains is owed at the time of sale). The income from the trust is paid out annually to the donor or another beneficiary based on the percentage or amount selected. The remainder is transferred to the charity at the end of the trust's term. A CRAT allows a one-time contribution. A CRUT allows ongoing contributions.

The CRAT pays an income to the income beneficiary (who could be the donor—the donor is the person setting up the trust). The payment is based upon a fixed percentage of the initial amount of the gift. For example, if a donor gave $100,000 to a CRAT and set a 7% payout annuity to himself as income beneficiary, he would receive $7,000 each year.

On the other hand, a CRUT pays a fixed percentage of the fair market value of the assets measured as of year end. Using similar facts as the first example, but also assuming the $100,000 grew by 8% by year-end, then the payment the following year would be 7% of $108,000 or $7,560.

Generally, the payment to the donor is made up of interest earnings from within the trust, so the donor pays ordinary income tax on the payment. But a variety of factors, such as sales of assets by the trust, can cause the trust to produce short and long-term capital gains and losses. Depending on these factors, some of the income payable may be characterized as something other than ordinary income, but in most instances and with simple trusts, the person receiving the income will pay ordinary income tax on the payment. In short, payments are made first from ordinary income, then capital gains, then other income, usually tax-exempt income, and last, trust principal.

It is possible to make the payments to someone other than the donor, such as a child, and the payments to the other person is considered a gift. The recipient would still be liable for the income tax on that payment.

Limitations on the Charitable Income Tax Deduction

A donor receives a current income tax deduction for the value of the remainder interest that will be going to the charity. The law requires that the remainder interest be at least 10% of the present value of the gift. So, for example, if a donor made a gift of $100,000 to a CRT, the remainder to the charity must be $10,000. Assuming "no" growth, the maximum income stream the donor could take would be $90,000 either over the donor's life or for a term of years.

There are limitations on how much income one can deduct. Generally speaking, if giving cash "to" a charity, one is entitled to an income tax deduction of up to 50% of adjusted gross income. If giving cash "for the use of" a charity, one is entitled to an income tax deduction of 30% of adjusted gross income. This is an important point to work out with your attorney and accountant when considering whether this technique can work in your legacy planning. If the adjusted gross income isn't sufficient to cover all of the charitable gift in one year, you are entitled to a five-year carry-forward of any charitable deduction of this type on unused amounts.

Estate Tax Issues

Generally, if the donor is the income beneficiary, the value of the contribution will be in the donor's estate at death. However, the corresponding estate tax deduction for the remainder interest at death will offset the inclusion of the gift in the donor's estate.

If someone other than the donor is the income beneficiary, there is a gift from the donor to the beneficiary for the amount of the present value of the contribution. Gift tax may be owed but the donor could use the annual gift tax exclusion and/or unified credit to offset any gift tax owed. The gift is NOT in the donor's estate for estate tax purposes.

This information is for general education of producers and contains references to concepts that have significant legal, accounting and tax implications. It is not intended as legal, accounting or tax advice. Clients should consult with their own tax advisor regarding the application of these concepts to any particular situation.

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