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Potential Benefit of Paying Qualified Plan Benefits to a CRT

Examination of the tax deferral opportunities of the NIMCRUT.

Jonathan G. Blattmachr, Martin M. Shenkman, and Stephen J. Bigge

INTRODUCTION

Since the passage of the SECURE Act, in most cases, non-spouse beneficiaries (e.g., children) are usually faced with a ten-year payout option for IRAs and other qualified retirement plans (either of which in this article is referred to as a "Plan"). In turn, this results in income tax being paid sooner and more income tax being paid by non-spouse beneficiaries (as opposed to the lifetime "stretch" that was allowed for non-spouse beneficiaries prior to the SECURE Act).

If carefully planned and properly administered, a NIMCRUT can be a useful tool to help defer the recognition of taxable income over a longer period of time. As illustrated in Exhibit 1, if a non-spouse beneficiary opts to delay post-mortem "inherited IRA" distributions over a ten-year period, the beneficiary would have $2,782,644 at the end of Year 20. On the other hand, if the IRA owner names a 20-Year NIMCRUT as beneficiary of the IRA, the non-spouse beneficiary could have $3,172,289 at the end of Year 20. Thus, an additional $389,645 passes to the non-spouse beneficiary at the end of Year 20 by using a 20-Year NIMCRUT (a 14% increase over simply having the IRA paid out over the normal ten-year period). It may be that the remainder passing to charity could be a bit quite smaller than 10%, depending upon several factors, which could mean much more than a 14% increase in what ultimately passes to the individual beneficiaries.

SOME BACKGROUND.

This article discusses making a special type of charitable remainder trust ("CRT"), called a

JONATHAN G. BLATTMACHR is Director of Estate Planning at Peak Trust Company, a Director at Pioneer Wealth Partners, LLC, Editor-in-Chief of InterActive Legal, LLC, and is a member of the editorial board of ESTATE PLANNING.

MARTIN M. SHENKMAN, CPA, MBA, PFS, AEP (distinguished), JD, is an attorney in private practice in Fort Lee, New Jersey and New York City, New York. His practice concentrates on estate planning. Author of 44 books and more than 1,200 articles. Editorial Board Member of Trusts & Estates Magazine, CCH (Wolter's Kluwer) Co-Chair of Professional Advisory Board, and CPA Journal. Active in many charitable and community causes and organizations. Founded ChronicIllnessPlanning.org which educates professional advisers on planning for clients with chronic illness and disability and which has been the subject of more than a score of articles. American Brain Foundation Board, Strategic Planning Committee, and Investment Committee. Bachelor of Science degree from Wharton School, concentration in accounting and economics; MBA from the University of Michigan, concentration in tax and finance; Law degree from Fordham University School of Law. www.shenkmanlaw.com.

STEPHEN J. BIGGE, CPA, Keebler & Associates, LLP in Green Bay, WI.

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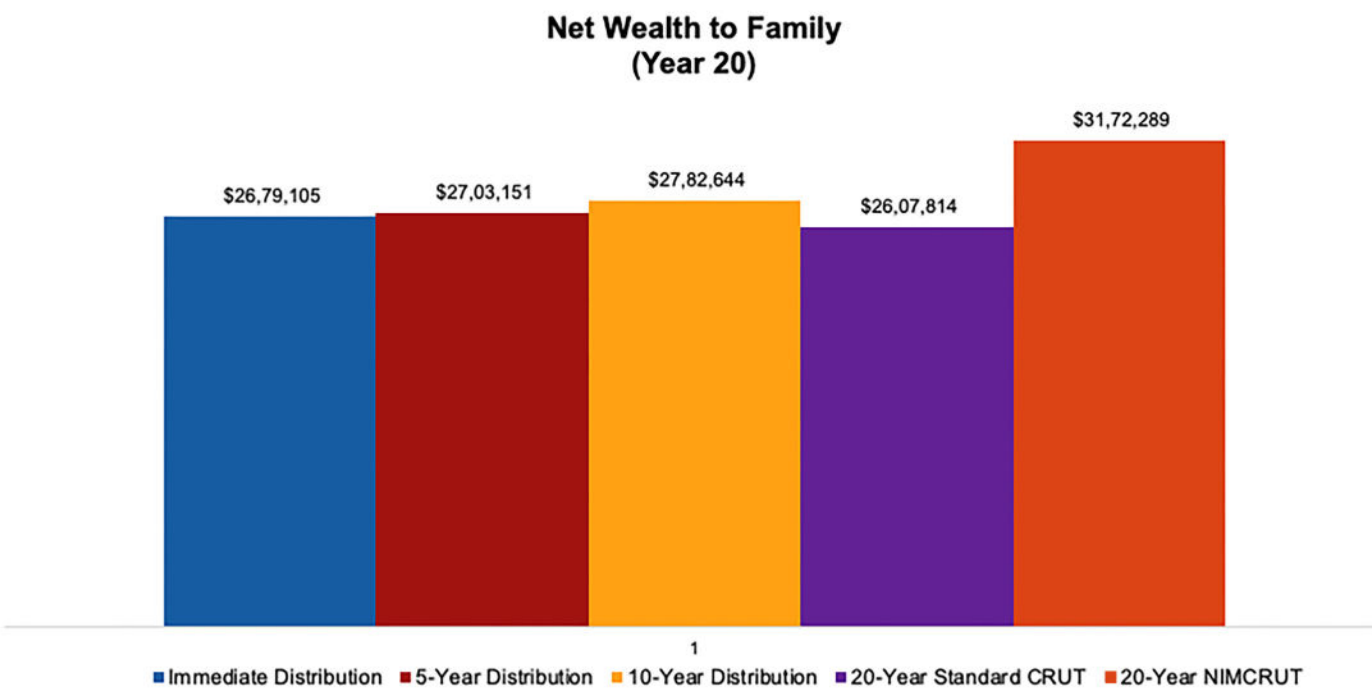
Exhibit 1:



NIMCRUT, the beneficiary of a qualified retirement plan (such as so-called "401 Plan") or a traditional (non-Roth) Individual Retirement Account ("IRA") when the owner of the IRA or employee of the Plan (each of which is referred to as the "owner") dies. This is a complicated matter although the beneficiaries who succeed to the Plan after the death of the owner may ultimately wind up with greater wealth than if a Plan were not used.[1] Of course, there always are offsetting factors.[2] For example, building wealth may mean not expending funds now which for some individuals may be more important than having more wealth in the future.

This article will explain some of the tax benefits of Plans under current law.[3] It will explain why an individual taxpayer may wind up with more wealth by using a Plan than saving some other way. It will make some comparisons making Plan proceeds payable (1) in a single lump sum upon the death of the owner (2) pursuant to the five-year rule,[4] (3) the ten-year rule,[5](4) over the actuarial life expectancy of an eligible designated beneficiary,[6] and (5) to a 20-year NIMCRUT[7] over which the trustee may make payments to and among a class of beneficiaries.[8] The authors conclude that using a NIMCRUT ultimately may produce more overall wealth in many cases. A significant complication is where the Plan will be subject to estate tax when the owner dies and lifetime estate tax planning could have significantly reduced the estate tax on the value that otherwise would be in the Plan, in which case the successors may be better off not using a NIMCRUT.[9]

More Background.

Approximately, 30 trillion dollars are held in Plans in the United States. Taxation of interests in a Plan is complicated.[10] However, for many American taxpayers, the benefits of Plans, including building an enhanced base of wealth on account of the income tax treatment of them, outweigh the complications. Three tax benefits of Plans are that (1) contributions made to a Plan typically are not subject to immediate income taxation, (2) earnings and realized gains in the Plan also are not subject to immediate taxation and (3) distributions from Plans, even if included in the recipient's gross income, are not subject to the 3.8% net investment income tax (NIIT which is sometimes called the Medicare tax). Other forms of income also may not be subject to immediate income taxation, and may not be subject to the NIIT. The tax benefits of a Plan may or may not outweigh other ways of building wealth.

Comparison.

Comparisons in building wealth with a Plan or not are very difficult. There are limitations on what may be held in a Plan. Rights or interests in Plans may be different (such as for a surviving spouse) than for rights or interests in other property. For example, assume that $1 million of compensation income (usually taxed as ordinary income[11]) could be contributed to a Plan and not be subject to immediately income tax. Hence, the entire $1 million would be available to produce additional earnings (or growth), which also may not be subject to immediate income taxation. So, in ten years, if the annual earnings earn 6% each year and are reinvested and also earn 6% each year, the one million dollars would grow to $1,790,848.[12] If the amount in the Plan were then withdrawn from the Plan (at the end of the tenth year) and be subjected to a 37% income tax, the taxpayer would owe $662,614 in tax, leaving the taxpayer with $1,128,234 (that is, $1,790,848 minus $662,614 in tax). Distributions from Plans are not subject, under current law, to the net investment income tax ("NIIT") imposed under Section 1411, as mentioned above.[13] But these are complex matters making comparisons very difficult especially because the tax treatment of interests in Plans and other arrangements will change in the future.

"Tax-free compounding" is earning income on income that is not reduced by income taxes. As is obvious, tax-free compounding income on a greater base, because the base itself is able to avoid or defer a reduction for an assessment of income taxes, leads to greater growth.

So, from the perspective of the worker, the Plan may well result in him or her having greater wealth. Of course, things may not be equal. That is, there likely will be changes in the law relating to taxation of compensation, Plans, and Plan distributions. In any case, the comparison made here did not take into account estate taxation. The owner of the Plan need not be directly concerned with estate tax but the successors to the Plan may well be.

Estate Taxation of Plan Interests.

Until the 1980s, interests in a Plan generally were not included in the gross estate of the person for whose benefit the Plan was held and, accordingly, no estate tax was payable on such interests.[14] Virtually, forever under the United States income tax provisions, distributions from Plans, including distributions after death, were subject to income tax. Now, interests in Plans may be subject to both estate tax and income tax, producing a significant overall tax burden.

There are many ways to eliminate or reduce the estate tax on assets that otherwise would in subject to the tax. These include gifts under the gift tax annual exclusion under Section 2503, gifts using the taxpayer's lifetime gift tax exemption (based on what is called the unified credit) under Section 2505 and other opportunities that may be available for lifetime transfers that are not available at death.[15] And protecting interests in the estate that otherwise would be subject to that tax can completely change the outcome so that using a Plan may not increase but decrease the amount available for those who would be the successor beneficiaries of a Plan.

It is unclear whether or to what extent lifetime planning with respect to Plans can be undertaken without adverse tax effects. It has been suggested that transferring Plan interest to a so-called "grantor trust" (that is, one the income of which is attributed pursuant to Section 671 to the trust's owner, typically the grantor and which, according to the IRS, is disregarded for Federal tax purposes) can provide such an opportunity without significant adverse effects.[16] But that is not at all certain. This article will proceed on the basis that transfers in Plans cannot take place during a Plan owner's life to avoid estate tax.[17] Nonetheless, on account of the extremely large available current estate tax exemptions (based on the unified credit under Section 2010), most taxpayers may be able to proceed without concern that their Plan interests will be subject to estate tax. The risk of an estate tax will increase for many after 2025 when the exemption is reduced by half.

Introduction to Planning for Plans.

As demonstrated above, postponing the income taxation of Plan interests is a principal way to let interests in the Plan grow on a tax deferred basis. Taking distributions as slowly as possible from a Plan often is the primary means of doing that. The SECURE Act[18], unfortunately, eliminated the so-called "stretch IRA" for many successor beneficiaries of IRAs (sometimes, in this article, called "inheritors"). As a result, taxpayers have sought options to regain some of that lost income tax benefit of a stretch IRA for their inheritors. While this article will discuss how to use a CRT dealt with primarily in Section 664 to regain, perhaps, some of that lost tax benefit for certain inheritors (and, in fact, a variation of the CRT known as a NIMCRUT as will be discussed below), the next portion of this article will take a "step back" and discuss some of the conceptual theory underlying this planning. While for some this may seem a distraction, it is intended to provide a foundation to better understand the planning objectives involved and how a NIMCRUT may provide a solution.

Tax-Free Compounding: Fundamental to Wealth Accretion.

Several factors affect how increases in wealth occur. Obviously, investment return is one of the most important. But the income taxation of returns on wealth, and estate tax of wealth, are both also critical factors in determining the level of future wealth. "Compounding" is the earning of income on income. "Tax-free compounding" is earning income on income that is not reduced by income taxes. As is obvious, tax-free compounding income on a greater base, because the base itself is able to avoid or defer a reduction for an assessment of income taxes, leads to greater growth. Based upon two of Albert Einstein's observations,[19] tax free compounding is one of the most important keys in building wealth.[20] Qualified plans and traditional (non-Roth) Individual Retirement Accounts (IRAs) permit income tax free compounding during the life of the employee of the Plan or owner of the IRA.

The effective net income tax rate of 34.632% combined with the 52% effective state and Federal estate tax rate brings the total aggregate tax burden to as high as 86.632%.

This article will discuss Plans paid at the death of the owner to an "income only with make-up" charitable remainder unitrust (commonly called a NIMCRUT) described in Section 664(d)(3). As discussed below, such a trust may allow those who succeed to a Plan ultimately to have much more wealth available from the arrangement than the traditional methods of using a Plan.

The SECURE Act: Curbing Tax-Free Compounding.

The tax free (or tax deferred) compounding for interests in Plans typically declines incrementally as owners withdraw funds from them (e.g., either voluntarily or as mandated under the tax law as required minimum distributions ("RMDs")). But while compounding erodes as withdrawals must be taken (and that any withdrawal results in the recognition of taxable income), compounding essentially comes to a rather abrupt end when the owner dies although, as mentioned earlier, there can be a payout in many cases, over 10 years following the owner's death. For decades, arranging for "stretching" payments from the Plans, not just to the owner over the owner's lifetime but thereafter also to the successor beneficiaries over their actuarial lifetimes, was advice commonly given as it permitted continued tax-free compounding (to the extent distributions were not made). This so-called "stretching" of Plan payments enabled the "spreading" of income over several years, or even decades, following the Plan owner's death. That meant that income might be taxed at lower brackets than if more were distributed and the income compressed into a smaller number of years. This was because the slivers of income the inheritor withdrew might, even if added to the inheritor's other income, be taxed at lower brackets than if the income were withdrawn over a shorter period of time. That often contrasted favorably to a large withdrawal on death which may have run up the progressive tax brackets of the inheritor so as to be taxed as marginally higher rates. The SECURE Act changed that because, in general, it requires the entire amount in the Plan to be paid out by the end of the tenth calendar year following the calendar year in which the owner died ("10th Year").[21] So the challenge to planners is to identify when approaches might be feasible to reduce the tax rates at which that income might be taxed.

Forecasting Income, Tax Rates, Etc.

One solution, which does not require the creation of a CRT or any trust, would be to forecast the income of the successor beneficiary ("inheritor") for future years, and take payments during the years before the end of the 10th Year and the final payment in that 10th Year, in a manner to reduce overall income taxation. For heirs of some clients (not otherwise entitled to a stretch as eligible designated beneficiaries[22]), "smoothing" income over the tax years through and including the 10th Year (when the RMD may be quite large) may possibly provide significant income tax savings. That might be achieved because distributions made in each of those tax years would be taxed at lower than the maximum income tax bracket (or at least at lower brackets) than would be incurred if only RMDs were taken with a lump sum of the balance in the Plan taken at the end of the 10th Year. This calculation is not simple because the time value of money must be considered, projecting income and tax brackets over that time period is also subject to uncertainty, such as changes in tax laws, etc. But for some taxpayers, this may provide a meaningful reduction in overall tax cost.

However, for some Plan inheritors, especially those likely to always be in the maximum tax bracket, the above income smoothing may not provide as much tax benefit as desired, if any. Is there a more advantageous approach? Perhaps. That approach may include having the Plan in whole or part distributed to a NIMCRUT as described in Section 664(d)(3).

> The real tax advantage of a CRT is its exemption from income taxation.

Considering having a Plan distributed to a NIMCRUT will be more complicated and costly than just taking all Plan interests at once or over whichever of the five-year or ten-year payout regime may apply. For example, if the client has three heirs she wishes to make the successor beneficiaries of the Plan, three separate NIMCRUTs might be created thereby multiplying the complexity of administration and costs associated with that. On the other hand, creating one NIMCRUT for all three may reduce overall income taxation if the trust grants the trustee the power to determine which of beneficiaries will receive distributions and, in effect, when they will be made.[23] For example, if one child has a large tax loss, a distribution may be made to that child and in the future "equalizing" distributions might be made to the other beneficiaries. Thus, a single NIMCRUT could offer more planning flexibility, but the client and trustee would have to be comfortable with the implications. For some clients, family "dynamics" might preclude this step.

Thus, the NIMCRUT approach probably should be considered only for relatively large Plans and only for those intended to benefit from the Plan who can reasonably afford to wait for an extended period to receive significant distributions from the Plan. Because only a small or no portion of a Plan will avoid estate tax[24] if a CRT is made the successor beneficiary, it may be preferable for a wealthy family simply to leave the Plan to a charity (such as a private foundation)[25]. Doing that may avoid all estate and income taxes (or at least postpone the payment of income taxes). But obviously, that will not be agreeable to many clients, especially if the Plan represents a significant portion of the family's wealth.

A hybrid of each of the above approaches to handling Plan assets may provide a more desirable outcome for some wealthy clients. This might be facilitated by dividing the Plan into two or more accounts with each having different beneficiary designations to tailor the results to the client's wishes and tax benefits sought by using any combination of the approaches discussed above:

- A portion of Plan assets equal to the amount the Plan owner wishes to transfer to charity at death can be designated to pass directly to charity (or during life using the Qualified Charitable Distributions[26] or "QCDs"), which may reduce the RMD's during lifetime and then leave an appropriate share of the remainder to charity at death.
- A portion of Plan assets paid out using the income smoothing concepts discussed above with any remaining balance paid out at the end of the 10th Year.
- A portion of the Plan assets paid to one or more NIMCRUTs.

Differences in Investing in a Plan to Other Opportunities to Invest.

There are differences in investing in a Plan as opposed to investing in other ways. Of course, earnings inside a Plan grow free of income tax, which tax would otherwise erode wealth.

One of the major disadvantages of investing in a Plan is the loss of the tax-free step-up in basis under Section 1014[27], which does not apply to the right to income in respect of a decedent ("IRD") primarily dealt with in Section 691(a), and everything in the Plan will be IRD[28] or after death taxable income. Of course, the consequence of the interest in the Plan being IRD has no impact on the owner of the Plan, only on those who succeed to the wealth at owner's death (although distributions from the Plan to its owner normally also will be subject to ordinary income tax[29]).

Even if the tax treatment of interests received by the successor beneficiaries being IRD is of great concern to the Plan owner, it may be that using a Plan would nonetheless enhance the wealth available to his or her beneficiaries rather foregoing the use of a Plan. In any case, avoiding tax on Plan interests by the owner is restricted, in part, on account of RMDs that must be made from the Plan.[30] Moreover, it usually is possible to postpone income tax on income contributed to a Plan, thereby providing a larger base of wealth upon which earnings accrue. Also, virtually all distributions from a Plan are considered ordinary income (although not subject to the NIIT under Section 1411).

> In a NIMCRUT, the portion of the unitrust payments not distributed because FAI was less than the unitrust amount of any year shall be paid, or "made up," if and to the extent FAI exceeds the unitrust amount for the year.

Earnings outside of a Plan (including distributions from a charitable remainder trust) retain their tax character or "flavor" which may be taxed at a lower rate than ordinary income is (which almost all Plan distributions do as constituting ordinary income).[31] And, there are some opportunities to reduce or eliminate income tax that will not be available for investments made through Plans.[32]

Life Insurance Investment Considerations.

A similar income tax result might be achieved using permanent life insurance. It is possible to make investments inside a policy of life insurance without the growth and income earned "inside" the policy being subject to income tax provided the so-called "investor control" doctrine is not triggered and other requirements are met.[33] And, in general, proceeds paid upon the death of the insured under the Policy are excluded from gross income.[34] Obviously the costs of permanent insurance, such as commissions, must be factored into the analysis.

Comparing Wealth Accumulated Inside and Outside a Plan.

In general, and ignoring the many distinctions among investments that may be made without adverse effect in a Plan, made in a life insurance contract, made in an annuity contract, or made directly, it will be rare for a Plan not to provide greater wealth accumulation, primarily because income contributed to a Plan usually is income tax deductible and not subject to the net investment income tax under Section 1411 ("NIIT"). Therefore, a larger asset base is available for investment and earnings inside a Plan, even when distributed, are not subject to the NIIT. The issue is when growth in after-tax wealth, reduced by any estate or similar tax, of assets not in a Plan, will be greater than the after-income tax wealth distributed from a Plan.

Ignoring all the algebra and analysis in trying to do a true comparison, one has to make certain assumptions which always will involve unknown future factors, including what investment opportunities will be available, the effective income and estate tax rates, whether an income tax free increase in basis under Section 1014 (or the equivalent) will be available, when if ever and at what rate of annual wealth tax may be imposed, and the impact of state income taxes, among other variables.

Taking Estate and State Income Taxes into Account.

Plan distributions may be taxed at 37%, the highest Federal income tax rate under current law plus any state or local income tax. Hence, for each distribution, 63% (that is 100% minus the 37% income tax rate) of each distributed Plan dollar will be left for investment to produce greater wealth assuming no state or local income tax or other consequence of having more income. However, interests in Plan assets that have not been distributed almost always will be included in the Plan owner's gross estate and may be subject to Federal and state estate tax.[35] There are some "historic" special rules for Plan distributions, which this article does not address.[36]The combination of a 40% estate tax rate (the highest rate currently imposed by the Code) and a 37% income tax rate (imposed whenever the dollars are distributed from the Plan), would bring the combined erosion of the Plan interest down to 37.8% [$1 X (1-.40 estate tax rate) X (1-.37 income tax rate) = $.378]. Also, Section 691(c) permits an income tax deduction for the net federal estate tax paid on IRD which is not subject to the limitation on itemized deduction under Section 67.[37] That deduction could provide a benefit of 14.80% (37% income tax rate X 40% estate tax rate).

Several states impose an independent estate tax (which in Hawaii and Washington States reaches 20%[38]) which has the effect of increasing the tax burden on Plan interests in two ways. It increases the overall estate tax to the extent it exceeds the benefit of the deduction allowed under Section 2058 for state death tax but, in turn, it reduces the net Federal estate tax and, therefore, the deduction allowed under Section 691(c). The recipient of the Plan proceeds may face a state income tax which may not be deductible under current law and can reach, in California, 13.3%.[39]

As stated above, in the states of Hawaii and Washington, the top state estate tax rate is 20% (In several others, it is 16%).[40] State death taxes imposed on property included in the Federal gross estate are deductible, under Section 2058, for purposes of determining the Federal taxable estate meaning for example, where the state rate is 20%, only 80% of what otherwise would be in the taxable estate is exposed to the 40% Federal estate tax rate. 40% of 80% is 32% which then is the effective Federal estate tax rate on the Plan. When that is added to a 20% state estate tax, the combined effective estate tax rate is 52%. The 32% effective Federal estate tax rate is deductible under Section 691(c) for Federal income tax purposes on IRD Assets. But Section 68, which imposes an overall limit on itemized deductions, could reduce the income tax deduction allowed on IRD assets under Section 691(c) by as much as 80%. This could mean that of the 32% effective Federal tax only 20% of it or only 6.4% is effectively deductible for income tax purposes. That would mean 93.6% [100% less 6.4% effective federal income tax deduction after application of the Section 68 limitation] of the distribution may be subject to ordinary federal income tax rate as high as 37%. This results in an effective marginal income tax rate of 34.632% [93.6% X 37% = 34.632%]. Hence, the effective net income tax rate of 34.632% combined with the 52% effective state and Federal estate tax rate brings the total aggregate tax burden to as high as 86.632%. If the distribution is also subject to state and local income tax, the combined tax also could approach 100%.[41] The one bit of good news is that distributions from Plans are not subject to the net investment income tax (also known as the Medicare Surtax) imposed by Section 1411. [42]

The bottom line to all of this discussion of marginal federal and state income and estate tax rates is that most of a Plan's value can be eroded by taxes at the margin. Thus, for wealthy/high income taxpayers, planning that can ameliorate some of this tax burden may be worthwhile. Planning may be worthwhile even if that planning, such as naming a NIMCRUT as beneficiary of an IRA, is both complex and more costly to implement and administer than other methods of dealing with Plan distributions.

CHARITABLE REMAINDER TRUSTS GENERALLY

A variant of a charitable remainder trust ("CRT"), as noted above, may provide a solution to some of the potential tax costs associated with a Plan, more specifically the NIMCRUT. A background discussion on CRTs is provided, as it is important to understand the CRT framework, and then that discussion will be expanded to the CRT variations permitted, to set the stage for the planning opportunities CRTs, and NIMCRUTs in particular, may offer for Plan assets.

As with Plans, CRTs are exempt from income taxation although both Plans and CRTs pay taxes on unrelated business taxable income (commonly called "UBIT") under Section 511. There are some differences in the tax (and state law) treatment of CRTs and Plans. For example, if you have a CRT, the state attorney general may become involved.[43] In any case, as a general rule, it is best to avoid either having a CRT or a Plan receive UBIT.

The real tax advantage of a CRT is its exemption from income taxation. But this is sometimes misunderstood. First, when the settlor funds a CRT during lifetime, the trust takes over the settlor's income tax basis in the assets transferred.[44] If the CRT thereafter sells an appreciated asset, it will realize gain. However, because CRTs are themselves income tax exempt, realized gain will not have to be recognized (that is, no income tax will be payable by the CRT on its earnings). However, that is not equivalent to the tax being avoided. More aptly, the tax on that gain is deferred. This is because distributions from a CRT are generally included in the gross income of the recipient (annuitant or unitrust beneficiary).[45] The tax character (or flavor) of the income realized by the CRT passes through the CRT to the recipient.[46] So, as each annual payment is made to the non-charitable beneficiary, a portion of that payment will be comprised of the proportions of income realized by the CRT. Generally, under the so-called four-tier system under Section 664(b) applicable to CRTs, the most highly taxed income is treated as first distributed. Moreover, Plan distributions made before age 59 $^{1/2}$ years may be subject to a 10% penalty[47] unless falling under an exception while distributions from a CRT although attributable to Plan distributions received before the beneficiary that age are not.[48] If the benefits of a CRT deferring income tax outweighs the value of the remainder that must pass to charity at the end of the CRTs term, that differential may represent the economic benefit of the CRT.

> The real tax and economic benefits of a CRT, from the perspective of the individual beneficiaries, is that the income earned inside the CRT is not presently taxed as long as distributions from the trust do not exceed the trust's taxable income. That means the excess earnings compound tax deferred.

Charitable Remainder Unitrust.

With the above background on CRTs generally, we can now explore a specific type of CRT, the charitable remainder unitrust ("CRUT"), a variation of which will serve as the keystone for tax savings for Plan assets post-SECURE Act. In general, CRUTs must make annual distributions to the beneficiary or beneficiaries which may carry out taxable income that has not already been treated as having been distributed and included in the gross income of a beneficiary who receive a distribution from a trust. However, the trust may be structured as an income only CRUT which is required to pay the lesser a fixed percentage of the trust's annual value, or its fiduciary accounting income ("FAI").[49] This type of CRUT is referred to as a net income CRUT or "NICRUT." To the extent the FAI of a NICRUT is less than the unitrust amount for that tax year, the NICRUT cannot make a distribution. That result may seem adverse for NICRUT's non-charitable beneficiaries. After all, they cannot get the full unitrust payment (or perhaps no payment) in that particular tax year. However, that apparently negative result actually provides the basis for the tax deferral that is the foundation of the arrangement to defer income tax on Plan assets despite the 10-year payout essentially required under the SECURE Act (other than for eligible designated beneficiaries).

Net Income Make-up CRUT ("NIMCRUT").

One further variation of the CRT technique is necessary to create a specific type of CRT for the arrangement necessary to defer Plan income. The NICRUT discussed above may also provide in its governing instrument for a *make-up* provision, hence the name NIMCRUT (where the M stands for "make up"). Specifically, the portion of the unitrust payments not distributed because FAI was less than the unitrust amount of any year shall be paid, or "made up," if and to the extent FAI exceeds the unitrust amount for the year. Hence, to the extent FAI is not received in a particular year, the entitlement to receive the unitrust payments not previously made because FAI for the year was less than the unitrust amount will arise to the extent FAI exceeds the current year's unitrust amount in later years. In other words, the right to receive the portion of a unitrust payments not made, because FAI has been less than the unitrust amounts, will be preserved and will be made-up if and when FAI in a later year exceeds the unitrust payment for that year. In effect, the right to unitrust amounts not made, because FAI was insufficient, accrues and, in effect, compounds if the trust grows in value over time.[50] This is at the heart of the tax deferral for a Plan asset post-SECURE Act.

Comparisons of a NIMCRUT to a Plan Are Difficult.

Although a CRT, like a Plan, is exempt from income tax, the comparisons between the two are difficult to make. If the taxable estate is sufficiently large, the Plan will be subject to estate tax whether payable to a CRT or elsewhere (other than a charitable organization).

An estate tax deduction will be available for the actuarial value of the remainder.[51] The tax allocation clause in the estate plan will affect which bequest, e.g. Plan to CRT, or other assets will actually bear the burden of the tax. For example, if there are adequate other assets and beneficiaries are similar, the tax may expressly be allocated to assets other than the Plan/CRT. However, the value of the remainder devoted to charity must be at least 10%[52] and generally should not be greater than that amount.[53] The payment to charity at the end of the term is the "price" that has to be paid for the ability of the settlor to use the tax deferral envelope a CRT provides (i.e., that the CRT is tax free, but when payments are made to the non-charitable beneficiaries those carry out the prior earned classes of income). So, there is no requirement and no further benefit to paying more to charity than the minimum required 10%. Should a client feel charitably inclined beyond that point more could be calculated to pass to charity, but if that is case, there may be preferable approaches to making gifts to charity outside the CRT, rather than enlarging the charitable remainder interest in a CRT. Note, charity may actually receive significantly less or more than that value when the trust ends despite the initial calculation. However, this does not mean that 10% of the trust, when it ends, must pass to charity. What will ultimately pass to charity depends upon actual growth in the CRT assets and its payouts.[54]

The real tax and economic benefits of a CRT, from the perspective of the individual beneficiaries, is that the income earned inside the CRT is not presently taxed as long as distributions from the trust do not exceed the trust's taxable income. That means the excess earnings compound tax deferred. And, if the FAI of the trust is zero, then distributions will also be zero, and all of the income otherwise subject to income tax can be held within the tax-deferred envelope of the CRT. This benefit is not present with an annuity trust, i.e., a CRAT, because any excess earnings will eventually go to charity upon termination of the CRAT, rather than ultimately passing from trust to individual beneficiaries as they may with a charitable remainder unitrust. In effect, the cost of income tax postponement with a unitrust is the cost of the remainder which will eventually pass to charity. In essence, the beneficiaries of a unitrust are "renting" the trust's exemption from taxation for the cost of the remainder committed to charity. And, of course, a person typically wants to pay the lowest possible rent. With a CRT, that lowest rent amount, as noted above, is 10% of the value of the assets when contributed to the trust. But, it does not mean that 10% of the trust in the end will pass to charity. Rather, 100% of what is in the trust when it terminates will pass to charity. What that amount is depends upon investment returns, payout rates, and, for a NIMCRUT, the amount of FAI the trust receives prior to its termination.[55]

> If the FAI is less than the unitrust amount, the beneficiary of a NIMCRUT essentially accrues the right to the amount of the shortfall (that is, excess of the unitrust amount for the year over that year's FAI) and the amounts to which the beneficiary is entitled will compound (income tax free) but only will be payable to the beneficiary if and when FAI is greater than the unitrust amount for the year.

Another potential advantage of a CRT is that the tax character (or flavor such as long-term capital gain or as qualified dividends which are taxed at rates lower than for other forms of income[56]) is retained within the trust for purposes of determining the character of the income when distributed to a non-charitable beneficiary. However, under the four-tier system of CRT taxation the least favorable categories of income are treated as distributed first.[57]

Further Discussion of CRTs.

Many of the tax results involving property interest which are divided or "split," such as with a CRT, a grantor retained annuity trust,[58] charitable lead trust,[59] personal residence trust,[60] are dependent upon the so-called "Section 7520 rate." That rate, at the time of transfer,[61] is 120% of the Federal mid-term rate (known as the "mid-term AFR") for the month of the transfer under Section 1274(d)(1) rounded to the nearest even two-tenths of 1%. As surprising as it may seem, the Section 7520 rate has no appreciable effect on the value of interests in a unitrust.[62]

A CRT must meet a number of requirements under Section 664 in order to produce certain tax benefits including being exempt from income tax (and to generate a deduction for the charitable component in the trust). These requirements include that the annuity and annual unitrust payments must fall within a 5% and 50% range,[63] that the trust cannot be actuarially subject to exhaustion by the payments,[64] and that the actuarial value of the remainder must be at least 10% of the value of the trust when the trust becomes irrevocable.[65]

Not violating the 10% minimum value for the remainder trust is very important as the trust will not qualify as a CRT under Section 664 if it does not meet that test. It is also appropriate for the remainder value not to exceed 10%. Although some may think that have a remainder in excess of 10% is "just fine," the taxpayer will not have gained any additional benefit of creating the CRT which is to benefit from its exemption from income taxation which will occur whenever the unitrust grows at a rate faster than what it pays out to its beneficiaries.

Perhaps, the most important factor for a beneficiary of a CRT is that income not currently distributed accumulates tax free (or at least tax deferred) essentially just as income in a Plan does.

Again, Postponement of Taxation Is Critical.

The importance of tax postponement is illustrated by the law known as SECURE. It eliminated (subject to certain exceptions) the ability to withdraw distributions from Plans over the beneficiary's life expectancy. SECURE was enacted, in part, to increase receipts by the Federal government by eliminating the so-called "Stretch" for receipt of Plan interests (that is, the ability to take distributions over the designated beneficiary's lifetime[66]). However, other parts of SECURE will reduce Federal receipts such as increasing the age at which withdrawals from Plans must be taken to avoid a penalty.

The exact results for any particular individual are difficult to determine. Tax rates, methods of taxation, returns on investments, and other factors are extremely difficult to forecast. However, here are some guidelines:

- The higher the effective rate of annual taxation, the greater the erosion of wealth.
- The higher the return, the more the return is eroded by current income tax.
- A significant beneficial factor in financial planning is tax free compounding of positive returns (corollary to Einstein's two observations mentioned above).
- The next best thing to tax free compounding is tax deferred compounding.
- Qualified Plans and IRAs – because they grow tax free – are ideal vehicles for wealth building, and should be allowed to grow tax-free as long as possible (and practicable).

Exhibit 2 illustrates by example of some of the foregoing points.

How a NIMCRUT May Help Enhance Plan Wealth.

A NIMCRUT is exempt from income tax. Hence, if a Plan is distributed to such a trust, the NIMCRUT will have gross income on receipt of the Plan distributions (i.e., it will realize income), but no income will be recognized, so no income tax will be payable. Distributions to the NIMCRUT beneficiaries will be included in their gross income (to the extent the trust has received taxable income which has not been distributed or treated as distributed). However, as mentioned earlier, a NICRUT may and must distribute only the lesser of the NICRUTs FAI or the unitrust amount for the year. A NIMCRUT (i.e., a NICRUT with a make-up provision) will also have to distribute unitrust amounts from prior years which were not distributed to a beneficiary because FAI was less than the unitrust amounts otherwise payable for such years if and when FAI in a later year or year FAI is greater than the unitrust amount for such year (or years).

In effect, if the FAI is less than the unitrust amount, the beneficiary of a NIMCRUT essentially accrues the right to the amount of the shortfall (that is, excess of the unitrust amount for the year over that year’s FAI) and the amounts to which the beneficiary is entitled will compound (income tax free) but only will be payable to the beneficiary if and when FAI is greater than the unitrust amount for the year.

Treas. 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 ("UPIA") was promulgated (in 1997) there was little, if any, developed law on how distributions from certain business entities (such as a limited partnership) were to be treated for income and corpus purposes. Indeed, common entities used today, such as limited liability companies ("LLCs"), just did not then exist.

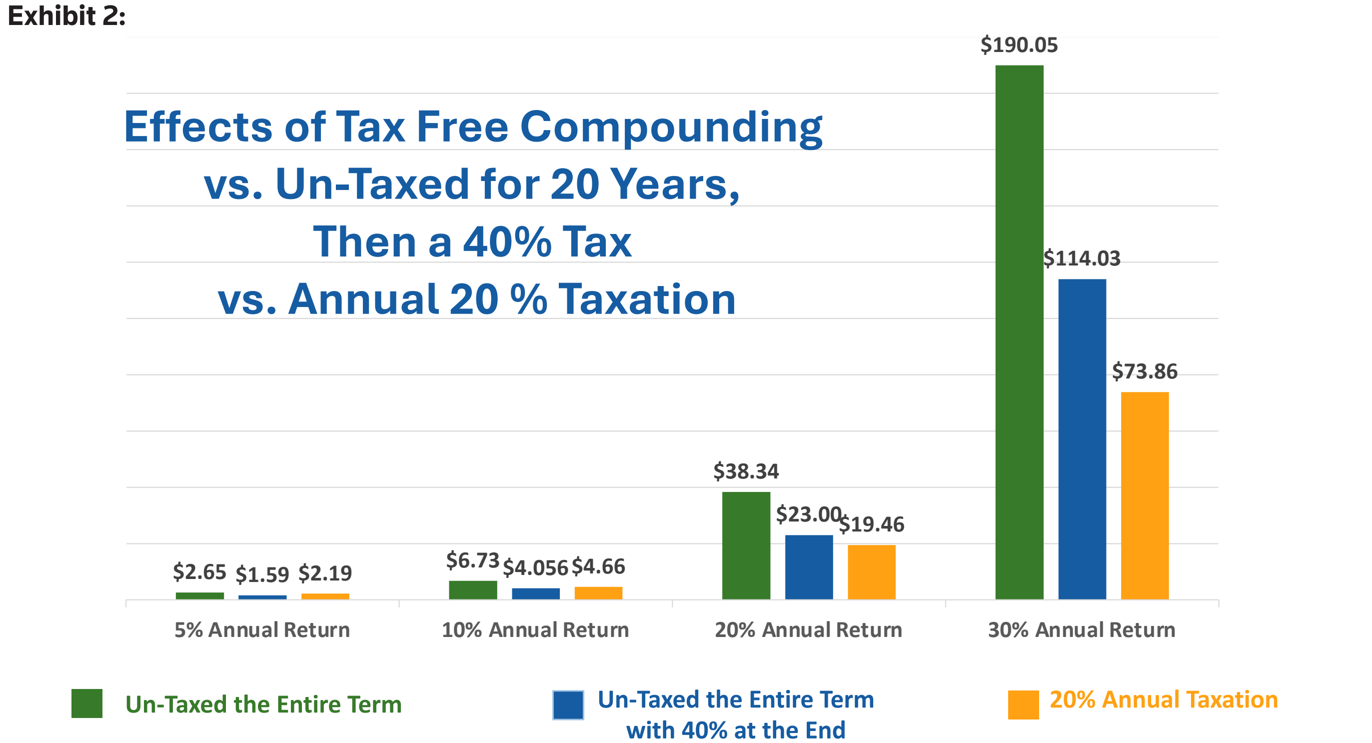
Hence, it is very difficult to see how specific provisions on how receipts from such an entity are treated could depart fundamentally from traditional principles of income and principal.

Wealth Available from a Plan.

Although not an absolute truth, generally, postponing taxation where the property grows in value will increase wealth. This will be true if there are earnings on the income tax that would otherwise be paid.

- For example, if $1,000,000 is subject to a 40% rate, it will be $600,000 after tax which, if invested at 6% income taxable a year, will net the taxpayer $36,000 in the

Exhibit 2:



first year (or $21,600 after 40% income tax), providing the taxpayer with a net of $621,600.

- Conversely, if $1,000,000 is deferred for one year, the taxpayer would have $1,060,000 pre-tax ($1,000,000 X [1 + 6%]) and $636,000 after tax ($1,060,000 X [1 – 40%]). The $14,400 difference ($636,000 vs. $621,600) is attributable to the $400,000 income tax ($1,000,000 X 40%) being deferred one additional year (i.e., $400,000 X 6% X [1 – 40%]).

Hence, postponing tax is beneficial if there are earnings on the tax postponed. And the longer the period of postponement, the greater the benefit. And that is what a Plan can accomplish.

Nonetheless, there may be several reasons why an individual, although armed with that knowledge, will choose not to use a Plan. For example, the individual may have a current need to spend the wealth (where borrowing or sale of other assets is not appropriate or is not available) or the amount involved is so sufficiently small that the postpone-the-tax strategy just is not worthwhile.

How Income Tax Can Be Deferred in a NIMCRUT.

If postponing income taxation is beneficial, a NIMCRUT may provide a solution to make the strategy improve by investing in a manner to minimize current accounting income. For example, investing in growth stocks that pay little (if any) dividends, no significant distributions will be made. The stock can be sold without income tax (because the NIMCRUT is income tax exempt) and then invested in bonds or other investments, for example, for a FAI yield, perhaps, greater than the unitrust amount for the succeeding years. 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.[67]

Some states have statutes which seem to permit significant flexibility in controlling the amount and timing of FAI. For example, the UPIA provides essentially that there is no accounting income merely by the imputation of tax income to a trust (such as where the trust is a partner in a partnership). 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 an 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 partners.

Hence, if a NIMCRUT is a partner, it will report as its income any income of the partnership properly allocated to it, but if the trust received no FAI (because, for example, the partnership made no distribution to the NIMCRUT as a partner), none of the partnership (imputed) income will be distributable to or taxed to the unitrust recipient. Thus, if a partnership or LLC (taxed as a partnership) owned by the NIMCRUT did not make any distribution, the NIMCRUT would neither realize nor recognize any income in that tax year.

The UPIA, adopted by several states, essentially limits FAI from a partnership to distributions only of money (except for reinvested dividends) and then only if the money was not one of the following:

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, or
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% of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

Hence, if a NIMCRUT invests in a limited partnership (or LLC), nothing will be distributable to the unitrust recipient (i.e., the non-charitable beneficiary) based purely on imputed income from the partnership. Hence, if the NIMCRUT receives no actual partnership distribution it will have no FAI, make no distributions to its non-charitable beneficiaries, and no income will be passed out to those beneficiaries. Thus, the share of income the NIMCRUT earns (through the partnership) essentially will accumulate inside the NIMCRUT income tax free.

If and when the trustee wishes to generate FAI, it could seek a distribution in cash from the partnership that is not indicated to be a partial liquidation and is not a distribution as part of related distributions consisting of greater than 20% of the entity's gross assets, which would cause the money received to be treated as corpus under the act. 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 probably will be respected for tax purposes.

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.

Potential Advantage of Spreading Income.

The beneficiary of a Plan may be a discretionary trust (that is, a trust under which the trustee may withhold distributions or make them to one or more individual beneficiaries described in the trust agreement). But it cannot permanently defer paying income tax on Plan interests because, to avoid penalties, distributions must either be all paid out by the end of the fifth calendar year following the calendar year of the death of the owner or during the ten years following the death of the owner if the successor beneficiary is a "designated beneficiary."[68] The distributions under the ten-year regime must begin in the calendar year after the calendar year in which the owner of the Plan dies.[69] Thereafter, they must be distributed annually, pursuant to the actuarial life expectancy of the designated beneficiary and entirely paid out by the end of the tenth calendar year following the owner's death, or pursuant to the remaining actuarial life expectancy of the owner. If the Plan owner died after his or her Required Beginning Date

("RBD") then the payout would be based on the Plan owner's life expectancy which is sometimes called a "ghost life expectancy."[70]

Perhaps, a better solution may be to name a 20-year NIMCRUT as the successor beneficiary of the Plan where the trustee is authorized to pay its tax income to and among a group of beneficiaries which could include all descendants of the Plan owner, trusts for the benefit of them, subchapter S corporations owned by one or more of such descendants (or qualified subchapter S trusts for the benefit of one or more of those descendants), or a charitable lead trust or other entity.[71] That way, income tax may be postponed until the end of the 20-year term (assuming no FAI is generated before then) and the trustee can then determine to whom it should be taxed (which may be those individuals in the lowest income tax brackets).[72]

Steps in the Life of a Plan Payable to a NIMCRUT.

Following is a list of the steps that might be typically found if the Plan/NIMCRUT mechanism is used to defer income tax and endeavor to increase wealth:

1. Create a NIMCRUT during lifetime but make it revocable. The trust instrument would not require any special tailoring as compared to any other NIMCRUT.
2. Form an LLC to be owned 99.99% by the NIMCRUT and .01% by the person who will be the manager of the LLC. On account of Rev. Proc. 97-23[73], the manager should not be the grantor, the trustee, or a beneficiary of the CRT, or anyone related or subordinate to them.[74] This could be the attorney or CPA for the client or an independent corporate fiduciary such as a bank or trust company who is not the trustee.
3. Name the LLC as a beneficiary of the Plan. Do not name the NIMCRUT as the beneficiary, but it is the NIMCRUT which "owns" 99.99% of the LLC.
4. On death of the Plan owner, the Plan assets pass to the LLC by the beneficiary designation and the income from the Plan will be attributed to the NIMCRUT which will report the income but pay no income tax because it is income tax exempt. If the NIMCRUT has no FAI because the income is locked into the LLC, the NIMCRUT will have no FAI to distribute to its beneficiaries. Since all income on the Plan is triggered at this time the NIMCRUT will have realized 99.99% of the value of the Plan as taxable income, but none of that will be subject to income tax by reason of the income tax exemption of the CRT.
5. In any year in which the LLC does not make an actual cash distribution to the NIMCRUT, the NIMCRUT presumably will have no FAI, the NIMCRUT will not have to make a distribution to the non-charitable beneficiaries, and any tax on the income realized on the NIMCRUTs receipt of the Plan assets, will continue to be deferred.
6. If the non-charitable beneficiaries need or want distributions, the manager of the LLC could distribute FAI to the NIMCRUT. Properly structured, that distribution would be FAI and then that amount would have to be distributed to the non-charitable beneficiaries. They would then realize taxable income, based on the four-tier tax system of taxation with respect to CRTs. Thus, ordinary income would be deemed distributed first. Since the full value of the Plan would be deemed ordinary income in the year of the Plan owner's death, there would almost assuredly be a substantial amount of ordinary income for each distribution. Capital gain income could only be realized by the non-charitable beneficiaries of the NIMCRUT after the income of entire value of the Plan on were treated as distributed to them.
7. At the end of the 20th year of the NIMCRUT, all assets would have to be distributed and all income recognized, otherwise everything in the trust will pass to charity. Note that, generally speaking, an additional ten years of income tax deferral may occur versus merely accepting the 10-year payout of the Plan under general post-SECURE Act rules. Recognize that the Proposed Regulations that clarified that RMDs must be paid during the intervening ten years before the final payout could provide a further advantage to the Plan/NIMCRUT approach as that could be avoided.

Which Clients are Potential Candidates for a Plan/NIMCRUT Approach?

Here are some factors that might help identify appropriate clients:

1. The Plan owner has to be willing to incur the cost and endure the complexity of this Plan bearing in mind that the Plan owner will have no benefit from the approach, only the beneficiaries of the Plan owner. Costs will include professional fees, the .01% of the LLC that may be given away to the manager of the LLC, and the remainder interest to charity.
2. The Plan assets have to be valuable enough to warrant the costs of creating a NIMCRUT and the LLC, and administering the complexity of the plan.
3. The heirs who will be named non-charitable beneficiaries of the Plan/NIMCRUT may have to be able to forgo any distributions for 20-years to maximize the wealth accumulation that the approach might provide.
4. The heirs will have to incur some costs and endure the complexity of the administration of the approach.
5. The Plan owner and the heirs will have to accept the risk of the arrangement. These risks may include (a) the failure to properly operate the plan; (b) a challenge by the IRS that the underlying LLC should not be respected as a blocker of FAI, although Rev. Proc. 97-23, 1997-1 CB 654, seems to suggest it would be if properly structured and administered; (c) if the same non-charitable beneficiaries control the .01% and are managers of the LLC, or directly or indirectly can control the LLC, or if the person who does control the LLC acts as the alter-ego of the non-charitable beneficiaries, the approach may not produce the desired result; or (d) the non-charitable beneficiaries have to be willing to stick with the terms of the approach and not receive withdrawal potentially for two decades.

CONCLUSION

Although complicated, creating a NIMCRUT with an LLC or limited partnership underneath (or owned by) the NIMCRUT can facilitate a deferral of income tax on Plan assets for as long as 20-years which may provide a valuable wealth enhancement to the beneficiaries of the Plan owner. However, if the Plan is subject to significant estate taxation, the situation must be more carefully considered.

End Notes

[1] No detailed examples of when beneficiaries will receive more by not using a Plan are offered in this article. However, even if the amount to be invested outside of a Plan were eroded by the top income tax bracket of 37%, all of which could be avoided by contributing it to a Plan, ultimately the amount in the Plan may be subject to both estate and income tax, when the owner dies. As explained later in this article, 86% of the value of the Plan may be lost to estate and income taxes when the owner dies. Even if the amount that could be added to the Plan is subjected to the highest income tax, leaving 63% of the amount for investment outside of a Plan, that net amount might be invested in appreciating assets which are kept until the death of the client which might avoid estate taxation of them and be entitled to a tax-free step-up in basis at death under I.R.C. Section 1014 of the Internal Revenue Code of 1986 as amended. It is unclear whether assets may receive a tax-free step-up in basis at death under I.R.C. Section 1014. See, e.g., Gans and Blattmachr, "Grantor Trust Assets and Section 1014: New IRS Ruling Doesn't Solve the Problem," 139 JTAX 3 (Sept. 2023). But even if it is not possible, more may be available even if the amount outside the Plan is eroded by estate tax as the maximum erosion may be only 40% (of a smaller number) and not 86% of a larger number.

2 Whether to save for the future is an issue all humans face. Instant gratification often wins out over postponing receiving much more at a later time. The comparisons in using a Plan or not is complex dependent upon many factors, such as the structure of the income tax in the future which is impossible to determine.

[3] There are many consequences of using a Plan to build wealth. In general, interests in a Plan are not subject to attachment by the owner's creditors. Moreover, if the owner is married, the spouse of the owner may have rights with respect to the Plan that are different from rights, if any, that the spouse would have as to other assets.

[4] The 5-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the fifth anniversary of the owner's death. For example, if the owner died in 2022, the beneficiary would have to fully distribute the IRA by December 31, 2027. The beneficiary is allowed, but not required, to take distributions prior to that date. The 5-year rule never applies if the owner died on or after his or her Required Beginning Date (RBD).

[5] The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2022, the beneficiary would have to fully distribute the IRA by December 31, 2032 or essentially face penalties. The 10-year rule applies if (1) the beneficiary is an eligible designated beneficiary who elects the 10-year rule, if the owner died before reaching his or her required beginning date; or (2) the beneficiary is a designated beneficiary who is not an eligible designated beneficiary, regardless of whether the owner died before reaching his or her required beginning date. For a beneficiary receiving life expectancy payments who is either an eligible designated beneficiary or a minor child, the 10-year rule also applies to the remaining amounts in the IRA upon the death of the eligible designated beneficiary or upon the minor child beneficiary reaching the age of majority, but in either of those cases, the 10-year period ends on December 31 of the year containing the 10th anniversary of the eligible designated beneficiary's death or the child's attainment of majority.

[6] An eligible designated beneficiary is the surviving spouse of the owner, a minor child of the owner, someone not more than ten years younger than the owner or someone who is chronically ill or disabled.

[7] Payments from a CRT cannot exceed the longer of 20 years or until the death of identified living individuals. On account of the requirement that the actuarial value of the remainder in a CRT be at least 10% of the value of the assets contributed to the trust and the 5% minimum payout, in many cases, the practical time limit for a CRT will be 20 years.

[8] Keebler & Associates LLC of Green Bay, Wisconsin, has a computer program that will generate illustrations, one of which is shown an exhibit to this article.

[9] It is unclear whether interests in a Plan may be transferred during the lifetime of the owner without income recognition and without causing the Plan to be disqualified. See Horvitz, infra. In any event, interests in Plans to do not "enjoy" the tax-free change in basis under I.R.C. Section 1014.

[10] See, generally, Choate, Life and Death Planning for Retirement Benefits, 8th ed. 2019, published by Ataxplan (referred to herein as "Choate"). To order a copy, go to https://ataxplan.com/life-and-death-planning-for-retirement-benefits/order-form/. An electronic (digital) form of the book is available from Interactive Legal at https://retirementbenefitsplanning.us/

[11] Ordinary income means it is subject to the highest rate of Federal income tax. Other forms of income, such as long-term capital gain and qualified dividends, may be subject, under current law, to lower rates of income taxation. See I.R.C. Section 1.

[12] Essentially, this is taking the $1 million and multiplying it by 1.06 ten times.

[13] I.R.C. Section 1411(c)(5).

[14] See, e.g., Tax Reform Act of 1976, Prentice-Hall, Inc., (booklet 202(b)), at pp. 849-850.

[15] The use of the lifetime "exemption" may or may not reduce estate taxes depending upon the growth or decline of the property after the lifetime transfer is made. Use of other arrangements, such as a grantor retained annuity trust (GRAT) described in Treas. Reg. 25.2702-3, also may or may not reduce taxation.

[16] See Horwitz, infra.

[17] *Id.*

[18] 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.

[19] One observation attributed to Professor Einstein is that compounding it the most important factor in the universe. Another is that the income tax is the hardest thing in the world to understand.

[20] See Glickman & Blattmachr, "High Returns and Tax Free Compounding: Keys to Building Wealth," 43 ETPL 11 (May 2016).

[21] The proposed regulations issued under SECURE require, in most cases, that distributions commence the first calendar following the calendar year of the death of the owner and each year thereafter with any balance distributed by the end of the tenth calendar year following year of death of the owner. Some assumed that the beneficiary could wait (without penalty) until that tenth year to take anything from the Plan. Perhaps, the final regulations will permit that but the proposed ones do not. See Prop. Treas. Reg. 1.401(a)(9)-5.

[22] See discussion in Choate, "Estate Planning for Retirement Benefits Under SECURE and Proposed Treasury Regulations," available at https://ataxplan.com/wp-content/uploads/2022/09/Estate_Planning_for_Retirement_Benefits_post_SECURE_and_Prop_Regs.pdf

[23] See Blattmachr and Shenkman, "Preserving the Benefits of Trusts Despite High Income Tax", 50 ETPL 4 (January 2023).

[24] An estate tax deduction will be allowed for the actuarial value of the remainder. See I.R.C. Section 2055(a) and (c)(2)(A). It makes sense to have the remainder be the minimum required percentage of the value of the Plan, which is 10%, meaning that no more than 10% will qualify for the estate tax charitable deduction.

[25] Although contributions by individuals during lifetime to a private foundation defined in I.R.C. Section 509 may not produce as favorable income tax treatment under I.R.C. Section 170 as contributions to so-called public charities may, transfers for estate tax purposes under I.R.C. Section 2055 and for purposes of the income tax deduction allowed to trusts and estates under I.R.C. Section 642(c) to private foundations fare as well as transfers to public charities do.

[26] See I.R.C. Section 408(d)(8)(B). See, generally, Warren, "Qualified Charitable Distribution (QCD): What It Is, How It Lowers Your Taxes," available at https://www.investopedia.com/qualified-charitable-distribution-qcd-5409491

[27] Or exclusion of the proceeds of life insurance from income tax. *Id*.

[28] I.R.C. Section 1014(c).

[29] Ordinary income tax means the tax on taxable income that is not taxed at lower rates as long-term capital gains and qualified dividends are.

[30] Treas. Reg. 1.401(a)(9)-5.

[31] See I.R.C. Section 664(b).

[32] See, e.g., I.R.C. Section 1202. See, generally, e.g., Kenton, "Section 1202 of the IR Code & Tax Breaks for Small Businesses," available at https://www.investopedia.com/terms/s/section-1202.asp

[33] In order for an investment contract to be considered a policy of insurance, certain actuarial and asset diversification tests must be met, including guideline premium requirements of I.R.C. Section 7702(c) and the cash value corridors of I.R.C. Section 7702(d). See discussion in Rev. Rul. 2005-6, 2005-6 IRB 471. Additional costs (such as fees paid to the insurer) may be incurred by investing through a policy

of life insurance. Also, virtually, no control over the investments may be retained by the owner of the policy. There is little developed law with respect to investments in the policy. See discussion in Lipkind and Blattmachr, "Income Tax Aspects of Variable Life Insurance Policies," 122 JTAX 52 (Feb. 2015); Blattmachr and Keenan, "*Webber* and the Investor Control Doctrine," 113 Tax Notes 683 (Aug. 1, 2016). But Plans face restrictions on investments that do not apply to those made "inside" a life insurance policy. Also, Plans cannot make certain investments. See, discussion under Investment at https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras#Investments. The foregoing points make comparisons extremely difficult.

34 I.R.C. Section 101(a)(1).

35 It has been contended that an interest in a Plan may be sold by the owner to a grantor trust prior to death to keep it from forming part of his or her gross estate without causing the Plan to lose it tax favored status. Horwitz and Damicone, "A Decent Proposal," 150 Trusts & Estates 46 (Nov. 2011), referred to in this article as Horwitz. This is based on the IRS position reflected in Rev. Rul. 85-13, 1985-1 CB 182, and Treas. Reg. 1.1001-2(c), Example 5 that the grantor owns for all income tax purposes all assets in the grantor trust. But see Choate, seminar outline, "The 201 Best & Worst Planning Ideas for Your Client's Retirement Benefits," 2014 edition, published electronically as a Special Report by Ataxplan Publications, www.ataxplan.com. See, also, Private Letter Ruling 201129045 (stating without analysis or citation that an IRA will lose its status as such if contributed to a grantor trust); but, cf. CCA 201334021 (which seems critical of the statement in the private letter ruling). Under I.R.C. Section 6110(k)(3), neither a private letter ruling nor a chief counsel advisory (CCA) may be cited or used a precedent. The IRS has told to some practitioners that it will not rule on this issue.

36 For example, special income tax treatment may be available for income averaging for owners born before 1936, no immediate income taxation on net unrealized appreciation of employer stock and no income tax on distributions Roth IRAs, among other special treatments. See, generally, Choate at ¶2.1.06.

37 I.R.C. Section 67(b)(7).

38 See, e.g., RCW 83.100.040.

39 California has one of the most complicated tax systems in the United States. See, generally, https://www.caltax.org/foundation/reports/2023-Tax-Facts.pdf for an explanation and at p.14 for rates.

40 See https://media.mcguirewoods.com/publications/State-Death-Tax-Chart.pdf

41 State and local income taxes probably can be avoided by having the proceeds paid to a trust. Cf. North Carolina v. Kaestner, 588 U.S. __ , 139 S.Ct. 2213 (2019). See, generally, Blattmachr and Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 ETPL 3 (Feb 2019).

42 I.R.C. Section 1411(c)(5). Note that the limit on deducting itemized deductions is to expire at the end of 2025.

43 See, e.g., https://ag.ny.gov/sites/default/files/2022-10/CHAR001-RTi.pdf

44 I.R.C. Section 1015.

45 I.R.C. Section 664(b).

46 *Id.*

47 I.R.C. Section 72(t). The penalty is 25% in some cases. I.R.C. Section 72(t)(6). Although called a penalty, it is actually an additional tax.

48 Choate, Chapter 9.

49 I.R.C. Section 664(d)(3).

50 Although Treas. Reg. 1.664-3(b)(3) limits how much of the proceeds of sale can be allocated to the FAI of a NIMCRUT, there is no limit on how much can be distributed in the trust receives other forms of FAI such as certain distributions from entities. This is discussed in detail in M. Blattmachr, J. Blattmachr, and Fox, "Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests," 47 ETPL 3 (May 2020).

51 The Federal estate tax rate is 40% meaning the 10% deduction, equal to the value of the remainder for charity, saves 4% in estate tax.

52 I.R.C. Section 664(d)(1)(D) and (d)(2)(D).

53 Although the income tax charitable deduction(if the trust is created during lifetime) and the estate tax deduction (if the trust is created at death) may increase the value of the charitable remainder, most of benefit of the increase in the value of the remainder inures to charity and not to the non-charitable trust beneficiaries.

54 This probably is easiest to understand is to look at a CRAT. Suppose a $1million CRAT is to pay 6% of its initial value (or $60,000) each year for 20 years when the Section 7520 used to value interest in the CRAT produces a value of the remainder of $100,000. If the trust earns $60,000 a year, the entire remainder (assumed still to be worth $1million) will pass to charity. However, if the trust earns less than $60,000 a year, charity may well receive less than $100,000. It is possible nothing will pass to charity even if the probability of exhaustion test is not violated.

55 This again is discussed in detail in M. Blattmachr, supra.

56 See I.R.C. Section 1 (especially 1(g) and (h)).

57 See I.R.C. Section 664(b).

58 See Treas. Reg. 25.2702-3.

59 See, e.g., I.R.C. Section 170(f)(2)(B).

60 See I.R.C. Section 2702(a)(3).

61 If an income, estate, or gift tax charitable deduction is allowable for any part of the property transferred in a split interest transfer, as in the case of a CRT, the taxpayer may elect to use the midterm rate for either of the two preceding months. I.R.C. Section 7520(a)(flush material).

62 That is explained in detail in Blattmachr and Hastings, "Valuing Certain Split Interests," 122 Trusts & Estates 27 (June 1983). It is a bit of an overstatement that the Section 7520 rate has no impact on the valuation of interests in a unitrust. On account of the timing differences between the valuation date and the payment date, there can be a slight difference in the value of interest in unitrusts based on the Section 7520 rate used to value interests in the trust. This occurs by changing the so-called "stated payout rate." "If the unitrust makes the annual distributions in the form of installments paid periodically during the year, or if the unitrust makes payments annually at a time during the year other than one year from the annual valuation date, it is necessary to adjust the payout rate to reflect the periodic installments and the period of time between the annual valuation date and the payments. This results in an 'adjusted payout rate,' which is used to find the factors in the actuarial tables." https://www.irs.gov/pub/irs-pdf/p1458.pdf at p. 5.

63 I.R.C. Section 664(d).

64 The exhaustion disqualification can occur as a practical matter only for an annuity trust.

65 These matters are discussed in some detail in M. Blattmachr, supra.

66 A Designed Beneficiary is an individual who succeeds to the interest in the Plan upon the death of the owner of the Plan either directly or through certain types of trusts. See Choate at ¶1.5.

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

68 As mentioned before, special payout rules apply if the successor is an eligible designated beneficiary or "EDB."

69 Although if the Plan owner dies before his or her Required Beginning Date, no annual RMD need be taken until the final year (i.e., Year 5 or Year 10 as the case may be).

70 See, e.g., Ives, "Ghost Rule," at https://www.irahelp.com/slottreport/ghost-rule

71 A NIMCRUT may also be created for the life or lives of named individuals. However, as more individuals are added, the probability of violating the 10% minimum value of the remainder increases and only individuals may be beneficiaries. If the NIMCRUT is for a fixed term, even later born persons as well as persons who are not individuals can be beneficiaries. Because the I.R.C. Section 7520 rate has almost no impact on the value of interests in a unitrust, the NIMCRUT could provide for payments of approximately 11% a year of the annual trust value for 20 years without violating the 10% minimum value of the remainder requirement, regardless of the I.R.C. Section 7520 rate.

72 For a more complete discussion on how having many beneficiaries may reduce income tax on trust income, see Blattmachr and Shenkman, "Preserving the Benefits of Trusts Despite High Income Tax," 50 ETPL 4 (Jan. 2023). And note that because additional contributions cannot be made to a charitable lead trust, a new such trust might have to be created each time the trustee wishes to make a contribution to one.

73 1997-1 IRB 85.

74 Rev. Proc. 97-23 does not prohibit having a CRT own an LLC but provides the IRS may not rule favorably on the CRT status of the trust if the grantor, trustee, or beneficiary, or anyone related or subordinate to one of them is the manager of the LLC owned 99.9% by the NIMCRUT. This is discussed in more detail in M. Blattmachr, supra.