Family Tax Planning Forum

NIMCRUTs as Retirement Savings Vehicles for Small Business Owners

By Robert S. Keebler

Small business owners often use qualified pension or profit-sharing plans created by their companies to save for retirement, but such plans may not be the best retirement savings vehicles for many of them. There are several reasons for this:

1. The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code ("the Code") impose stringent nondiscrimination requirements on qualified plans. This means that they must cover not only the owner but also the rank and file employees of the company.
2. Qualified plans may not provide as much retirement income as the business owner would like to have due to contribution limitations.
3. Qualified plans may impose burdensome reporting and recordkeeping requirements on the business.

A net income with make-up charitable remainder unitrust (NIMCRUT) can be used to provide the same tax-deferred growth as a qualified retirement plan but is not subject to the ERISA and Code coverage requirements, has no contribution limitations and has less onerous reporting requirements. Thus, charitably inclined business owners may wish to consider a NIMCRUT as an alternative retirement savings vehicle. In this column, I will explain how NIMCRUTs can be used to facilitate retirement savings and summarize their advantages and disadvantages compared with qualified plans.

How a Retirement Planning NIMCRUT Works

Recall that there are two general kinds of charitable remainder trusts—charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). A CRAT pays out a fixed percentage of the trust's initial value annually. The amount is fixed at the beginning of the trust term and stays the same each year. By contrast, a CRUT pays out a fixed percentage of the trust's value recalculated each year. Thus, the payouts change as the value of the trust assets changes.

A NIMCRUT is a special kind of CRUT that pays the settlor the lesser of a fixed percentage of the trust assets (recalculated annually) or the net trust income each year. It also includes a make-up provision stating that if trust income is less

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than the 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.

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 little or no income, like blue chip growth stocks, activating the make-up provision. 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 the value of the trust assets grows tax free.

Example 1. Beth transfers $1 million to a NIMCRUT with a six-percent payout and funds it with growth stock. During Year 1, the stock appreciates in value by 10 percent ($100,000) and pays a one-percent dividend ($10,000). The trust pays Beth the lesser of the trust income ($10,000) or six percent ($60,000). The $50,000 shortfall goes into the make-up account. In the future, Beth can receive distributions from the make-up account to the extent that the trust's income in any given year exceeds the six-percent fixed percentage.

Then when the donor retires, the NIMCRUT invests in assets that will maximize trust income, like high dividend paying stocks 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 applicable to qualified retirement plans and produces relatively high payouts after retirement. Following is a comprehensive illustration of how the NIMCRUT retirement strategy works.

Example 2. Bart is 60 years old and plans to retire at age 70. At a time when the Code Sec. 7520 rate is 2.2 percent, he transfers $1 million worth of growth stock to a life NIMCRUT paying out the lesser of five percent or net income. Bart receives a charitable deduction of $383,810 for the transfer.

The stock is expected to grow at nine percent and pay no dividends. During the 10 years before Bart retires, he receives no distributions and the full nine-percent growth goes into the makeup account. This is not a problem because Bart is still in his high earning years and does not need the income.

At the end of 10 years, the stock is worth $2,367,364 and the make-up account has grown to $765,161. Note that the stock grows in value at its pre-tax rate of return like the assets in a qualified plan, IRA or deferred annuity. This enables Bart to create a larger fund for producing income than he could have created by investing the $1 million in a taxable account. Additional annual contributions to the trust can reduce the donor's current income taxes through charitable deductions, perhaps allowing Bart to smooth income and stay out of higher tax brackets or avoid application of the net investment income tax (NIIT).

After Bart retires at the end of Year 10, the NIMCRUT sells the stock and reinvests in high yield bonds and other assets paying eight-percent annual income but producing no further appreciation. No gain is recognized on the sale because the NIMCRUT is a tax-exempt entity.

Beginning in Year 10, Bart receives his regular five-percent payout each year from the NIMCRUT. This amount is $118,368 (0.05 x $2,367,364). To the extent the annual income exceeds the five-percent fixed payout percentage, he can also receive payments from the make-up account. Given the eight-percent income produced by the trust, this amount is three percent (8% total income – 5% fixed payout). Thus, Bart can also receive $71,021 each year from the make-up account (0.03 x $2,367,364) until it is exhausted, making the total annual payout $189,389 ($118,368 + $71,021). Under the facts assumed, the make-up account is sufficient to make this $71,021 payment for 10 years after Bart retires. In Year 11, the payment would be reduced to $49,436 and in Year 12 the make-up account would be completely exhausted. Bart would continue to receive the fixed five percent payout of $118,368, however. Note that if he dies before the make-up account is used up, any further balance would simply be lost. Note also that although the chart extends only for 25 years after the NIMCRUT is created, all the columns would remain the same for as long as Bart lived.Because the annual payments come entirely from income, the principal in the trust remains constant at $2,367,364 beginning at the end of Year 10. Assuming that Bart lives at least 10 years, this is the amount the charitable remainderman will receive when Bart dies. The operation of the NIMCRUT is shown in Table 1.

TABLE 1.

Year	Beginning FMV	Growth	Fixed Payout	Make-Up Payout	Total Payout	Make-Up Account	Total Make-up Account	Ending FMV
1	1,000,000	90,000	0	0	0	50,000	50,000	1,090,000
2	1,090,000	98,100	0	0	0	54,500	104,500	1,188,100
3	1,188,100	106,929	0	0	0	59,405	163,905	1,295,029
4	1,295,029	116,553	0	0	0	64,751	228,656	1,411,582
5	1,411,582	127,042	0	0	0	70,579	299,236	1,538,624
6	1,538,624	138,476	0	0	0	76,931	376,167	1,677,100
7	1,677,100	150,939	-	-	-	83,855	460,022	1,828,039
8	1,828,039	164,524	-	-	-	91,402	551,424	1,992,563
9	1,992,563	179,331	-	-	-	99,628	651,052	2,171,893
10	2,171,893	195,470	-	-	-	108,595	759,646	2,367,364
11	2,367,364	-	118,368	71,021	189,389	-	688,625	2,367,364
12	2,367,364	-	118,368	71,021	189,389	0	617,604	2,367,364
13	2,367,364	-	118,368	71,021	189,389	0	546,583	2,367,364
14	2,367,364	-	118,368	71,021	189,389	-	475,562	2,367,364
15	2,367,364	-	118,368	71,021	189,389	-	404,541	2,367,364
16	2,367,364	-	118,368	71,021	189,389	-	333,520	2,367,364
17	2,367,364	-	118,368	71,021	189,389	-	262,499	2,367,364
18	2,367,364	-	118,368	71,021	189,389	-	191,478	2,367,364
19	2,367,364	-	118,368	71,021	189,389	-	120,457	2,367,364
20	2,367,364	-	118,368	71,021	189,389	-	49,436	2,367,364
21	2,367,364		118,368	49,436	189,389	-	0	2,367,364
22	2,367,364		118,368	-	118,368	-	2,367,364	2,367,364
23	2,367,364		118,368	-	118,368	-	2,367,364	2,367,364
24	2,367,364		118,368	-	118,368	-	2,367,364	2,367,364
25	2,367,364		118,368	-	118,368	-	2,367,364	2,367,364

NIMCRUT vs. Qualified Plan

The advantages and disadvantages of a NIMCRUT are summarized below. Note that a NIMCRUT could be used as a supplement to a qualified retirement plan as well as an alternative to a qualified plan.

Advantages

1. The coverage requirements of ERISA and the Code do not apply to charitable remainder trusts.
2. A NIMCRUT has no contribution limitation except for the adjusted gross income (AGI) limitation on charitable deductions.
3. A NIMCRUT has less stringent reporting requirements and is generally less expensive to maintain than a qualified plan.
4. The donor generally receives a substantial charitable deduction when the trust is created.
5. The donor can create additional charitable deductions by making further contributions in later years, perhaps smoothing out income.
6. A NIMCRUT can benefit charity. The value of the remainder interest passing to charity at the end of the trust term may be quite large.
7. There is no 10-percent excise tax on distributions before age 59 1/2.
8. Distributions from a NIMCRUT might be capital gains or tax free while distributions from a QRP are generally all ordinary income.
9. The remainder interest in a NIMCRUT is not taxable in the donor's gross estate.

Disadvantages

1. Contributions to a qualified plan are fully deductible (up to the applicable contribution limit). With a NIMCRUT, only the present value of the remainder interest is deductible. There is no charitable deduction for the present value of the lead unitrust interest retained by the donor.
2. A participant in a qualified plan can receive a lump sum distribution of the entire account balance after retiring. By contrast, the lead beneficiary of a NIMCRUT has only a unitrust interest and must wait for annual distributions.

3. Company employees may be left without a retirement plan. The employer might wish to offset this disadvantage to some extent by increasing pay.
4. A participant in a qualified retirement plan may be able to borrow from the plan. A loan from a NIMCRUT would be an act of self-dealing under Code Sec. 4941 and subject to severe penalties.
5. The remainder interest in a NIMCRUT must go to charity and the present value of the charity's remainder interest must be at least 10 percent of the value of the property transferred to the trust. The remainder interest in a qualified plan can go to heirs.

Conclusion

Small business owners with strong charitable intent should consider the possibility of using a NIMCRUT as an alternative to a qualified plan. This column explains the operation of a retirement NIMCRUT and highlights some of the trade-offs between using a qualified plan as a retirement vehicle and using a NIMCRUT.