

NIMCRUTs

Take-Away: A NIMCRUT may be a good way to spread capital gain income over an extended period of time, as opposed to paying capital gains immediately after a liquidity event. But there are some IRS created impediments that may have to be worked around.

Background: A charitable remainder trust (CRT) is often used to 'spread' capital gain income over an extended period. The CRT is taxed as a charity. If the CRT sells an appreciated asset that is transferred to it, any capital gain tax is 'spread' over an extended period, e.g., 20 years or the lifetime of the non-charitable CRT beneficiary. In addition, the individual who transfers the appreciated assets to the CRT is entitled to claim an income tax charitable deduction equal to at least 10% of the fair market value of the appreciated assets that are transferred to the CRT. This is why CRT's are often considered by some business owners who anticipate a liquidity event on the eve of their retirement, since the business interest sold by the CRT will generate an income tax charitable deduction to off-set some of the gain recognized by the business owner on the sale, and also the CRT's gain on its sale of its share of the business interest will be spread over several years and allocated to the non-charitable beneficiary and not all have to be paid in the year following the sale of the business. Thus, more assets remain in the CRT after the sale, and the income generated by those 'more' assets are available to be paid to the non-charitable trust beneficiary as part of his/her annual distribution.

NIMCRUT: A 'net income make-up charitable remainder unitrust,' or NIMCRUT, a variation on a standard charitable remainder unitrust (CRUT) is authorized under the Tax Code. [IRC 664(d)(3).] This section provides an exception to the 'general rule' that the unitrust percentage of a charitable remainder unitrust (CRUT) must be paid out annually to its non-charitable beneficiary. The trust instrument can direct that the trust may provide payments to the non-charitable beneficiary that are the *lesser* of: (i) the amount of the trust's (or fiduciary's) income, or (ii) the applicable unitrust percentage amount for the year. Consequently, if the trust income is smaller than the unitrust percentage amount for the current year, only the income must be distributed to the non-charitable beneficiary.

- **Example:** A business owner who funded his CRUT with business stock prior to the sale of the business, may also agree to work for the new business purchaser for 5 years after the sale as a business consultant, while earning a substantial salary. Delaying CRUT income for those following 5 years, using a NIMCRUT that generates negligible income, keeps the business owner from being exposed to marginally higher federal income tax brackets.

Make-up: In addition, subsection (3)(B) of IRC 664(d) provides that in years when the trust's income exceeds the applicable unitrust percentage for the current year, any prior year's under-payment

(compared to the unitrust percentage amount that otherwise would have been paid out) may be *made up* to the extent that the income was less than the applicable unitrust percentage amounts in the prior years. Accordingly, with respect to a NIMCRUT, payments are calculated based on the *lesser* of (i) the unitrust amount or (ii) the fiduciary or trust accounting income of the trust. If a payment for a year is less than the unitrust amount by reason of the trust income being insufficient, then that payment is tracked in what is commonly referred to as a *makeup account* that can be distributed in later years when the trust's income exceeds the unitrust amount.

- **Income:** The definition of *income* is found in IRC 643(b) for purposes of the NIMCRUT rules, which states that income is based upon fiduciary accounting income, which is determined under state law and to at least a limited degree, the terms of the trust instrument and it is not based upon (or taxed) income as would be measured under the Tax Code. The law of many jurisdictions, like Delaware, provides that distributions of money from an entity to its owner is generally considered to be income under the Uniform Principal and Income Act.
- **Liquidating Distributions:** Most state laws require that distributions from 'entities' that are *liquidating distributions* (which are often defined to be distributions, or a series of distributions in excess of 20% of the entities' value) must be treated for fiduciary accounting income purposes as principal distributions, rather than income distributions. But some states, like Delaware, permit more flexibility. Delaware allows a trustee to receive a large payment as *income* if there is a statement issued from the entity making the distribution that the distribution constitutes *income* even though more than 20% of the entity's value is then being distributed. Hence, an '*authorized statement*' should be issued to the trustee that the source of the distribution is state accounting income.
- **Example:** An LLC has a value of \$5.0 million. If the LLC distributed \$1.0 million or more, then that would be considered a principal distribution and cannot be allocated as an income distribution or be allowed for a *make-up* distribution. If the LLC provided to the trustee an *authorized statement* that the distribution was state accounting income, then the \$1.0 million distribution would be available for a *make-up* distribution to the trust's non-charitable beneficiary.

Regulations: Unfortunately, the IRS issued back in 1998 an interpretative regulation that limits the benefit of a NIMCRUT. The Regulation indicates that *income* from the sale or exchange of assets by a CRT cannot exceed the initial fair market value of assets as of the date of their contribution to the CRT. [Regulation 1.664-3(a)(1)(i)(b)(3).] As a result, the *make-up* payment generally must be reduced to the extent necessary to allow the NIMCRUT to have remaining assets equal in value to the original value of the CRT assets.

- **Valid Regulation?** Commentators have questioned the IRS's authority to add this limiting interpretation of *income* to IRC 664, and with the Supreme Court's ruling earlier in 2024 in *Loper Bright* that reversed the *Chevron* doctrine of required judicial deference to

administrative agency interpretative regulations, many now expect a renewed challenge to this limiting interpretation of *income* under this questionable Regulation.

- Example: A business owner transfers \$10.0 millions of investments to a NIMCRUT. The NIMCRUT is set to pay 11.48% of the value of the NIMCRUT corpus each year for 20 years. If the NIMCRUT has no *income* for the first 5 years and it maintains a \$10.0 million net worth, then the potential *make-up* account would be \$5,740,000 (11.48% times \$10.0 millions times 5 years = \$5,740,000.) Since the NIMCRUT corpus has not appreciated in value above the initial \$10.0 million contribution, the Regulation would prevent any payment from being made even though there may be sufficient fiduciary accounting income by reason of capital gains from the sale of the investments being allocated to trust *income*. If the Regulation is invalid then all or a portion of the \$5,740,000 could be distributed from the NIMCRUT as a result of the allocation of capital gains to *income* with the remaining assets in the NIMCRUT being used to fund further payments over the remaining 15-year term of the NIMCRUT, with the final payment of the remainder to charity.
- LLC Work-Around: In light of the problem posed by the Regulation that limits the definition of a NIMCRUT's *income*, one possible solution is to contribute the appreciating assets to an LLC, and later have the LLC units (ownership) transferred to the NIMCRUT, because then, there is no limit on how much can be distributed if the NIMCRUT receives other forms of fiduciary accounting income, such as certain distributions from entities. In short, the Regulation applies when the NIMCRUT sells an asset, but it does not seem to apply when the CRUT's asset, i.e., the LLC sells its own assets and makes a distribution that would be considered *income* under state law to the NIMCRUT. Restated, when the *income* of the NIMCRUT comes from a distribution from an LLC as *income* under the applicable state's Uniform Principal and Income Act and the NIMCRUT did not sell the LLC, which is the 'asset', then a valid argument can be made that the Regulation's limitation of *income* does not apply. As a result, the full distribution that the LLC makes after selling some or all of its assets can be allocated to the *income* of the NIMCRUT, and it can be paid out as a *make-up* payment to the extent that prior payments from the NIMCRUT have been less than the prior unitrust amounts, regardless of whether the value of the CRT's underlying assets have gone down in value, or even have been sold at a loss by the LLC.

Conclusion: Liquidity planning with the use of a NIMCRUT is admittedly complicated and probably not of interest to an individual whose directions are 'let's keep it simple.' Nor will a NIMCRUT be of much interest to an individual who does not embrace philanthropy. But for those few who are willing to benefit charity and who are interested in deferring large income distributions to their retirement years, a NIMCRUT has plenty to offer.

If you would like to read additional missives, [click here](#).

