FINANCIAL STRATEGIES
For estate planning and planned giving.
• Legislation
• Court decisions
• IRS developments

UNIVERSITY OF ROCHESTER

Winter 2004

PROPOSED REGULATIONS CLARIFY TAXATION OF CRT DISTRIBUTIONS

The Internal Revenue Service (IRS) has announced proposed regulations designed to bring clarity to a maze of tax-law revisions that have left the exact tax treatment of distributions from charitable remainder trusts (CRTs) somewhat in question.

Two different CRTs can make distributions of an equal dollar amount, but the income-tax ramifications of those distributions for the recipients can vary greatly based on the investment results of each trust. IRC §664(b) sets out ordering rules which clearly provide that a CRT must first distribute all current and accumulated ordinary income, followed by current and accumulated capital gain, then current and accumulated other (tax-exempt) income. If and when those sources are exhausted, the trust is deemed to distribute tax-free return of principal.

While the ordering rules of IRC §664(b) are unambiguous, not all components within each category are taxed the same way. For example, short-term capital gain is taxed at a higher rate than long-term capital gain. Existing regulations (Reg. §1.664-1[d][1][i][b][1]) require that short-term capital gain is deemed distributed before long-term capital gain–provisions consistent with the general principle of IRC §664(b), which says income taxed at a higher rate is deemed distributed before income taxed at a lower rate.

However, a number of tax-law changes in recent years have added to the uncertainty. Most recently, the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA), Public Law 108-27 (117 Stat. 752), provides that qualified dividend income as defined in IRC §1(h)(11) is taxed at rates applicable to all other long-term capital gain–essentially 5% or 15%, depending on the taxpayer's marginal tax bracket. Previously, dividends had been taxed at the marginal income-tax rate applicable to all other types of ordinary income.

Earlier, the Taxpayer Relief Act of 1997 (TRA), Public Law 105-34 (111 Stat. 788), created a system under which different types of long-term capital gain could be subject to different tax rates. The rates could be as high as 28% on gain defined in IRC §1(h)(4), and 25% on unrecaptured §1250 gain as defined in IRC §1(h)(6).

The proposed regulations will amend Reg. §1.664-1(d)(1) to revise the rules for characterizing a CRT distribution to take into account differences in the federal income-tax rates applicable to items of income that are assigned to the same category under IRC §664(b).

DRILLING DOWN–The proposed regulations provide for a system of continual "drilling down" through all items of income until they eventually are sorted into their smallest subcategories. The trust's income is assigned each year, first to ordinary income, capital gain, or other income; then, within the ordinary-income and capital-gain categories, items are assigned to different classes based on the federal income-tax rate applicable to each type of income in the category.

Distributions are made according to the ordering requirements of **IRC §664(b)**. However, within the ordinary-income and capital-gain categories, income is treated as distributed, in order, from the classes of income in that category subject to the highest tax rate to the lowest.

Example: **CRT** "A" is required to distribute $1,000 in 2004. During the year, the trust realizes the following items of income:

Interest income	$600
Qualified dividends	$500

Interest income is taxed at the recipient's regular, marginal income-tax rate on ordinary income. Qualifying dividends are taxed at either 5% or 15%, depending on the recipient's marginal bracket but, in any event, at a rate lower than the rate at which other ordinary income is taxed. ***Results:*** The trust is deemed to distribute $600 of interest and $400 of qualifying dividends. The remaining $100 of qualifying dividends is carried forward to 2005.

NETTING CAPITAL GAIN AND LOSS–The proposed regulations also provide guidance on netting of capital gain and loss. Rather than overall netting, the process starts with netting within each class of gain and loss.

Net short-term loss offsets the net gain from each class of long-term capital gain and loss, beginning with the class subject to the highest federal income-tax rate. As the gain in each class is exhausted, the process continues to the class taxed at the next lower rate until the short-term loss is exhausted.

Any net long-term loss within each class is used to offset the net gain from other classes of long-term gain and loss, again beginning with the class subject to the highest federal income-tax rate and continuing until the loss is exhausted. If there is a net loss from all the classes of long-term gain and loss, it can offset any net short-term gain.

Example: **CRT** "B" is required to distribute $1,000 in 2004. It has the following items of income and loss:

Interest income	$100
Qualifying dividends	$250
Net short-term capital gain	$250
Net long-term capital loss in 28% rate class	($300)
Net long-term capital gain in unrecaptured **§1250** gain class (25% rate)	$200
Net long-term gain in all other long-term capital-gain classes	$600

The $300 net long-term capital loss in the 28% class first offsets the $200 net long-term capital gain in the unrecaptured **§1250** class. The balance of that loss offsets $100 of the $600 net long-term capital gain in all other long-term capital-gain classes. The distribution is deemed to be comprised of the following components, in order:

Interest income	$ 100
Qualifying dividends	$ 250
Short-term capital gain	$ 250
Long-term capital gain in all other long-term capital-gain classes	$ 400
TOTAL	$1,000

The remaining $100 of other long-term capital gain carries over to 2005.

"BETTER" INCOME MAY BE DISTRIBUTED EARLIER– Because of changes in the tax treatment of qualifying dividends, adhering to the ordering rules of **IRC §664(b)** can result in certain income being distributed from a **CRT** before other income that is taxed at a higher rate. That outcome has been confirmed by the proposed regulations.

FINANCIAL

Example: George P is the income beneficiary of CRT "C" and is in the 33% marginal, federal income-tax bracket. He receives a $1,000 distribution in 2004. During the year CRT "C" realizes $500 of interest income, $300 of qualifying dividends, and $400 of net, short-term capital gain.

The trust will be deemed to distribute all of the interest and qualifying dividends because they represent ordinary income and must, under IRC §664(b), be distributed first. The interest will be taxed at 33%, but the qualifying dividends will only be taxed at 15%.

The trust will be deemed to distribute only $200 of the short-term capital gain, even though George pays tax on short-term capital gain at the 33% rate. The remaining $200 of short-term capital gain will be carried over to next year.

A public hearing on the proposed regulations is scheduled for March 9, 2004. Written or electronic comments as well as outlines of topics to be discussed at the public hearing must be received by February 17, 2004.

BRIEFLY…

No Charitable Gift-Tax Deduction for Transfers to Crummey Trust (TAM 200341002). A taxpayer created an irrevocable trust that named four charities along with several family members as beneficiaries of the trust. All of the beneficiaries were given rights to make withdrawals of each transfer to the trust proportionate to their respective interests in the trust.

Upon the death of the taxpayer, the remaining trust assets were to be distributed among the various charities. However, during the lifetime of the taxpayer, the trustee –a daughter of the taxpayer–had absolute discretion to make distributions to the beneficiaries for their education, health, maintenance, and support.

According to the IRS, the taxpayer was not entitled to a charitable gift-tax deduction for any part of transfers to the trust, despite the fact that the charities had withdrawal rights. It based its conclusion principally on the provisions of IRC §2522(c), saying:

> Under §2522(c), where a donor transfers an interest in property for a charitable purpose, and an interest in the same property is transferred for a private purpose, then in general, in the case of a remainder interest, no deduction is allowed for the charitable transfer unless the charitable interest is in the form of either a charitable remainder trust described in §664, or a pooled income fund described in §642(c). In the case of any other interest, the interest must be in the form of a guaranteed annuity or unitrust interest described in §§25.2522(c)-3(c)(2)(vi) and (vii).

Even though the IRS determined that IRC §2522(c) was dispositive of the case, it went on to state that no deduction should be allowed anyway since, in its view, the withdrawal rights were not viable and smacked of prearrangement. No withdrawals were, in fact, made, and notices were often not consistent with the requirements of the trust despite what the IRS deemed to be a fiduciary responsibility on the part of the charities' officers and directors to preserve the charities' property interests and protect them against dissipation. Because of the discretionary distribution rights of the trustee, the IRS concluded, the charities' interests could have been severely compromised by not exercising withdrawal rights.

Donor Can Contribute Stock Distributed from Profit-Sharing Plan with No Adverse Tax Consequences (Ltr. Rul. 200335017). A taxpayer received a lump-sum distribution of her employer's stock upon retirement that included net unrealized appreciation. The taxpayer wanted to use some of that stock to fund a charitable remainder unitrust that would pay her and another beneficiary income for life with the remainder passing to charity.

Since there was no indication of a pre-arranged plan involving the CRUT's disposition of the shares contributed by the taxpayer, the IRS concluded that the taxpayer would not recognize gain on the contribution of the stock.

The IRS noted that the stock constituted long-term capital-gain property to the taxpayer to the extent of the original unrealized appreciation, regardless of the time period between the date the shares were distributed and the subsequent transfer to the CRUT. The nature of any post-distribution gain would be determined by the holding period, starting with the date of distribution. To the extent there is no post-distribution gain or any such gain constitutes long-term capital gain because of the holding period, the taxpayer will not have to reduce, pursuant to IRC §170(e), any deduction to which she might otherwise be allowed. However, any deduction will be limited to 30% of the donor's contribution base (basically adjusted gross income).

IRS Extends Time to Make Election (Ltr. Rul. 200344021). The IRS has allowed a trust the opportunity to unravel a series of misunderstandings and preserve a charitable deduction following the death of the grantor. The decedent's trust made charitable provisions for a foundation but directed that distribution should not be made until the foundation received its qualification as a tax-exempt charity from the IRS.

On its first income-tax return, the trust incorrectly claimed an income-distribution deduction under IRC §661 equal to an amount set aside for the foundation pending its qualification as a tax-exempt charity. New income-tax preparers discovered the error in preparing the third-year return and filed an amended return for year two, including a timely filed election under IRC §642(c)(1), representing the deductible amounts of year two paid to charity in year three.

However, since the date for filing an effective election for year one had passed, the trust requested an extension to file under IRC §301.90100-3. That section essentially allows the IRS to grant an extension even when deadlines have passed, if evidence establishes the taxpayer has acted reasonably and in good faith and that granting the extension will not prejudice the interests of the government. The IRS concluded that those requirements were met in this case.

No Self-Dealing in Trust Reformation (Ltr. Rul. 200338006). In yet another display of grace, the IRS allowed the reformation of a trust that was drafted as a net-income charitable remainder unitrust with make-up provisions (NIMCRUT) to become a standard CRUT.

The IRS was convinced that the donor had clearly directed his advisors to prepare a standard CRUT and the drafting of the NIMCRUT constituted a scrivener's error. The trustee had followed proper procedures in seeking judicial reformation of the trust, according to the ruling.

Because no deduction was allowed for the income interest of the trust under IRC §§170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B), the self-dealing rules of IRC §4941 do not apply, even though the income beneficiaries are disqualified persons with respect to the trust. In the case of charitable remainder trusts, the deductions allowed are in respect to the remainder interests of the charities, not the income interests payable to the income beneficiaries.

Financial Strategies is distributed to a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep philanthropic planners up to date on developments in estate planning as they relate to testamentary and lifetime plans of support of qualified charities.

UNIVERSITY OF ROCHESTER
590 Mt. Hope Avenue
Rochester, New York 14620
(585) 273-5930
toll free (800) 635-4672

Edited by André R. Donikian, J.D., and Robert L. Coffman, J.D.
Pentera, Inc./Printed in U.S.A./All rights reserved