

Charitable Remainder Trusts; Application of Ordering Rule

REG-110896-98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations on the ordering rules of section 664(b) of the Internal Revenue Code for characterizing distributions from charitable remainder trusts. The proposed regulations reflect changes made to income tax rates, including the rates applicable to capital gains and certain dividends, by the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. The proposed regulations affect charitable remainder trusts and their beneficiaries. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received Tuesday, February 17, 2004. Outlines of topics to be discussed at the public hearing scheduled for Tuesday, March 9, 2004, must be received by Tuesday, February 17, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-110896-98), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-110896-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at www.irs.gov/regs. The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa M. Melchiorre, (202) 622-7830; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 664 contains the rules for charitable remainder annuity trusts and charitable remainder unitrusts. In general, a charitable remainder trust provides for a specified periodic distribution (CRT distribution) to one or more beneficiaries (at least one of which is a noncharitable beneficiary) for life or for a term of years, with an irrevocable remainder interest held for the benefit of charity.

Section 664(b) provides ordering rules for determining the character of CRT distributions in the hands of the recipient of those distributions. A CRT distribution is treated: first, as ordinary income to the extent of the trust's gross income other than gains from the sale of capital assets ("ordinary income") for the trust's taxable year and its undistributed ordinary income for prior years; second, as capital gain to the extent of the trust's capital gain for the trust's taxable year and its undistributed capital gain for prior years; third, as other income (that is, tax-exempt income) to the extent of the trust's other income for the trust's taxable year and its undistributed other income for prior years; and, finally, as a distribution of trust corpus. The general principle of section 664(b) is that income subject to the highest Federal income tax rate is deemed distributed prior to income subject to a lower (or no) Federal income tax rate. The existing regulations under §1.664-1(d)(1)(i)(b)(1) follow this general principle by providing that short-term capital gain is deemed distributed prior to any long-term capital gain.

Beginning with the Taxpayer Relief Act of 1997 (TRA), Public Law 105-34 (111 Stat. 788), different types of long-term capital gains are subject to different Federal income tax rates. The different classes

of long-term capital gains and losses properly taken into account by a charitable remainder trust after May 6, 1997, may, for example, consist of 28-percent rate gain as defined in section 1(h)(4), unrecovered section 1250 gain as defined in section 1(h)(6), and all other long-term capital gains and losses. For taxable years beginning after December 31, 2002, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108-27 (117 Stat. 752), provides that qualified dividend income as defined in section 1(h)(11) is taxed at the rates applicable to all other long-term capital gains. Because dividends represent one type of ordinary income, different types of ordinary income are subject to different Federal income tax rates as a result of JGTRRA.

Notice 98-20, 1998-1 C.B. 776, as modified by Notice 99-17, 1999-1 C.B. 871, provides guidance on the treatment of capital gains under section 664(b)(2) following the changes made by the TRA and the technical corrections made by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685). The proposed regulations incorporate this guidance as well as provide additional guidance regarding the treatment of qualified dividend income under section 664(b)(1).

Explanation of Provisions

The proposed regulations will amend §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 section 664(b). The trust's income is assigned, in the year it is required to be taken into account by the trust, to one of three categories: the ordinary income category, the capital gains category, or the other income category. Further, within the ordinary income and capital gains categories, items are also assigned to different classes based on the Federal income tax rate applicable to each type of income in the category. In accordance with section 664(b), a CRT distribution is treated as being made from the categories in the following order: ordinary income, capital gain, other

income, and trust corpus. Within the ordinary income and capital gains categories, income is treated as distributed from the classes of income in that category beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. The proposed regulations also provide rules for netting different classes of capital gains and losses based on the guidance in Notice 97-59, 1997-2 C.B. 309.

Proposed Effective Date

The provisions in these regulations that were set forth in Notice 98-20, 1998-1 C.B. 776, and Notice 99-17, 1999-1 C.B. 871, are proposed to apply for taxable years ending on or after December 31, 1998, and taxpayers may rely on the provisions for taxable years beginning on or after January 1, 1998. The other provisions of these regulations are proposed to apply for taxable years ending after November 20, 2003.

Special Analyses

It has been determined that this proposed regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how

they may be made easier to understand. In addition, comments are requested on the administrative difficulty and potential tax benefit or detriment of maintaining separate classes within a category when two classes are only temporarily subject to the same rate (for example, if the current rate applicable to one class sunsets in a future year). All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, March 9, 2004, in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must use the main building entrance on Constitution Avenue. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written (signed original and eight (8) copies) or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic by Tuesday, February 17, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Theresa M. Melchiorre, Office of Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.664-1 is amended as follows:

1. Paragraph (d)(1) is revised.
2. Paragraph (d)(2) is amended by:
 - a. Removing the language "or to corpus (determined under subparagraph (1)(i) of this paragraph)" in the first sentence and adding "(determined under paragraph (d)(1)(i)(a) of this section) or to corpus" in its place.
 - b. Removing the language "subparagraph (1)(i)(c) of this paragraph" from the fifth sentence and adding "paragraph (d)(1)(i)(a)(3) of this section" in its place.
 - c. Removing the language "or corpus in the categories described in subparagraph (1) of this paragraph" from the last sentence and adding "described in paragraph (d)(1)(i)(a) of this section or to corpus" in its place.
3. Paragraph (e)(1) is amended by removing the language "paragraph (d)(1)" from the first sentence and adding "paragraph (d)(1)(i)(a)" in its place.

The revision reads as follows:

§1.664-1 Charitable remainder trusts.

* * * * *

(d) *Treatment of annual distributions to recipients*—(1) *Character of distributions*—(i) *Assignment of income to categories and classes.* (a) A trust's income, including income includible in gross income and other income, is assigned to one of three categories in the year in which it is required to be taken into account by the trust. These categories are—

(1) Gross income, other than gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the ordinary income category);

(2) Gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the capital gains category); and

(3) Other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Internal Revenue Code).

(b) Items within the ordinary income and capital gains categories are assigned to different classes based on the Federal

income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the trust. For example, the ordinary income category may include a class of qualified dividend income as defined in section 1(h)(11) and a class of all other ordinary income. In addition, the capital gains category may include separate classes for short-term capital gains and losses, for 28-percent rate gain as defined in section 1(h)(4), for unrecaptured section 1250 gain as defined in section 1(h)(6), and for all other long-term capital gains and losses. After items are assigned to a class, the tax rates may change so that items in two or more classes would be taxed at the same rate if distributed during a particular year. If the changes to the tax rates are permanent, the undistributed items in those classes are combined into one class. If, however, the changes to the tax rates are only temporary (for example, the new rate for one class will sunset in a future year), the classes are kept separate.

(ii) *Order of distributions.* (a) The categories and classes of income (determined under paragraph (d)(1)(i) of this section) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient irrespective of whether the trust is exempt from taxation under section 664(c) for the year of the distribution. The determination of the character of amounts distributed shall be made as of the end of the taxable year of the trust. The recipient is taxed on the distribution based on the tax rates applicable in the year of the distribution to the classes of income that are deemed distributed from the trust. The character of the distribution in the hands of the annuity or unitrust recipient is determined by treating the distribution as being made from each category in the following order:

(1) First, from ordinary income to the extent of the sum of the trust's ordinary income for the taxable year and its undistributed ordinary income for prior years.

(2) Second, from capital gain to the extent of the trust's capital gains determined under paragraph (d)(1)(iv) of this section.

(3) Third, from other income to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years.

(4) Finally, from trust corpus (with corpus defined for this purpose as the net fair

market value of the trust assets less the total undistributed income (but not loss) in paragraphs (d)(1)(i)(a)(1) through (3) of this section)).

(b) If the trust has different classes of income in the ordinary income category, the distribution from that category is treated as being made from each class, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. If the trust has different classes of net gain in the capital gains category, the distribution from that category is treated as being made first from the short-term capital gain class and then from each class of long-term capital gain, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. If two or more classes within the same category are subject to the same current tax rate, but at least one of those classes will be subject to a different tax rate in a future year (for example, if the current rate sunsets), the order of that class in relation to other classes in the category with the same current tax rate is determined based on the future rate or rates applicable to those classes. Within each category, if there is more than one type of income in a class, amounts treated as distributed from that class are to be treated as consisting of the same proportion of each type of income as the total of the current and undistributed income of that type bears to the total of the current and undistributed income of all types of income included in that class. For example, if rental income and interest income are subject to the same current and future Federal income tax rate and therefore are in the same class, a distribution from that class will be treated as consisting of a proportional amount of rental income and interest income.

(iii) *Treatment of losses*—(a) *Ordinary income category.* An ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years that is assigned to the same class as the loss. Any excess loss is then used to reduce the current and undistributed ordinary income from other classes, in turn, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. If any of the loss exists after all

the current and undistributed ordinary income from all classes has been offset, the excess is carried forward indefinitely to reduce ordinary income for future years. For purposes of this section, the amount of current income and prior years' undistributed income shall be computed without regard to the deduction for net operating losses provided by sections 172 or 642(d).

(b) *Other income category.* A loss in the other income category for the current year is used to reduce undistributed income in this category for prior years and any excess is carried forward indefinitely to reduce other income for future years.

(iv) *Netting of capital gains and losses.* Capital gains of the trust are determined on a cumulative net basis under the rules of this paragraph (d)(1) without regard to the provisions of section 1212. For each taxable year, current and undistributed gains and losses within each class are netted to determine the net gain or loss for that class, and the classes of capital gains and losses are then netted against each other in the following order. A net loss from the class of short-term capital gain and loss offsets the net gain from each class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. A net loss from a class of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) is used to offset net gain from each other class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. A net loss from all the classes of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) offsets any net gain from the class of short-term capital gain and loss.

(v) *Carry forward of net capital gain or loss.* If, at the end of a taxable year, a trust has, after the application of paragraph (d)(1)(iv), any net loss or any net gain that is not treated as distributed under paragraph (d)(1)(ii)(a)(2) of this section,

the net gain or loss is carried over to succeeding taxable years and retains its character in succeeding taxable years as gain or loss from its particular class.

(vi) *Special transitional rules.* To be eligible to be included in the class of qualified dividend income, dividends must meet the definition of section 1(h)(11) and must be received by the trust after December 31, 2002. Long-term capital gain or loss properly taken into account by the trust before January 1, 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss properly taken into account by the trust on or after January 1, 1997, and before May 7, 1997, if not treated as distributed in 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss (other than 28-percent rate gain as defined in section 1(h)(4), unreaptured section 1250 gain as defined in section 1(h)(6), and qualified 5-year gain as defined in section 1(h)(9) prior to its amendment by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108-27 (117 Stat. 752)), properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if not treated as distributed during 2003, is included in the class of all other long-term capital gains and losses. Qualified 5-year gain properly taken into account by the trust after December 31, 2000, and before May 6, 2003, if not treated as distributed by the trust in 2003 or a prior year, must be maintained in a separate class within the capital gains category.

(vii) *Application of section 643(a)(7).* For application of the anti-abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see §1.643(a)-8.

(viii) *Examples.* The following examples illustrate the rules in this paragraph (d)(1):

Example 1. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2003. The annual annuity amount is \$100. X's income for the 2003 tax year is as follows:

Interest income	\$80
Qualified dividend income	50
Capital gains and losses	0
Tax-exempt income	0

(ii) In 2003, the year this income is received by the trust, qualified dividend income is subject to a

different rate of Federal income tax than interest income and is, therefore, a separate class of income in the ordinary income category. The annuity amount is deemed to be distributed from the classes within the ordinary income category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Because during 2003 qualified dividend income is taxed at a lower rate than interest income, the interest income is deemed distributed prior to the qualified dividend income. Therefore, in the hands of the recipient, the 2003 annuity amount has the following characteristics:

Interest income	\$80
Qualified dividend income	20

(iii) The remaining \$30 of qualified dividend income that is not treated as distributed to the recipient in 2003 is carried forward to 2004 as undistributed qualified dividend income.

Example 2. (i) The facts are the same as in *Example 1*, and at the end of 2004, X has the following classes of income:

Interest income class	\$ 5
Qualified dividend income class	40
(\$10 from 2004 and \$30 carried forward from 2003)	
Net short-term capital gain class	15
Net long-term capital loss in 28-percent rate class	(325)
Net long-term capital gain unreaptured section 1250 gain class	175
Net long-term capital gain in all other long-term capital gain class	350

(ii) In 2004, gain in the unreaptured section 1250 gain class is subject to a 25-percent Federal income tax rate, and gain in the all other long-term capital gain class is subject to a lower rate. The net long-term capital loss in the 28-percent rate class is used to offset the net capital gains in the other classes of long-term capital gain and loss, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The \$325 net loss in the 28-percent rate class reduces the \$175 net gain in the unreaptured section 1250 gain class to \$0. The remaining \$150 loss from the 28-percent rate class reduces the \$350 gain in the all other long-term capital gain class to \$200. As in *Example 1*, qualified dividend income is taxed at a lower rate than interest income during 2004. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2004 annuity amount has the following characteristics:

Interest income	\$ 5
Qualified dividend income	40
Net short-term capital gain	15
Net long-term capital gain in all other long-term capital gain class	40

(iii) The remaining \$160 gain in the all other long-term capital gain class that is not treated as distributed

to the recipient in 2004 is carried forward to 2005 as gain in that same class.

Example 3. (i) The facts are the same as in *Examples 1 and 2*, and at the end of 2005, X has the following classes of income:

Interest income class	\$ 5
Qualified dividend income class	20
Net short-term capital loss class	(50)
Net long-term capital gain in 28-percent rate class	10
Net long-term capital gain unreaptured section 1250 gain class	135
Net long-term capital gain in all other long-term capital gain class (carried forward from 2004)	160

(ii) Net short-term capital loss is used to offset the net capital gains in the classes of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The \$50 net loss reduces the \$10 net gain in the 28-percent rate class to \$0. The remaining \$40 net loss reduces the \$135 net gain in the unreaptured section 1250 gain class to \$95. As in *Examples 1 and 2*, during 2005, qualified dividend income is taxed at a lower rate than interest income; gain in the unreaptured section 1250 gain class is taxed at 25-percent; and gain in the all other long-term capital gain class is taxed at a rate lower than 25-percent. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2005 annuity amount has the following characteristics:

Interest income	\$ 5
Qualified dividend income	20
Unreaptured section 1250 gain	75

(iii) The remaining \$20 gain in the unreaptured section 1250 gain class and the \$160 gain in the all other long-term capital gain class that are not treated as distributed to the recipient in 2005 are carried forward to 2006 as gains in their respective classes.

(ix) *Effective dates.* The rules in this paragraph (d)(1) that require long-term capital gains to be distributed in the following order: first, 28-percent rate gain as defined in section 1(h)(4); second, unreaptured section 1250 gain as described in section 1(h)(6); and then, all other long-term capital gains are applicable for taxable years ending on or after December 31, 1998. The rules in this paragraph (d)(1) that provide for the netting of capital gains and losses are applicable for taxable years ending on or after December 31, 1998. The rule in the second sentence of paragraph (d)(1)(vi) of this section is applicable for taxable years ending on or after December 31, 1998. The rule in the third sentence of paragraph (d)(1)(vi) of

this section is applicable for distributions made in taxable years ending on or after December 31, 1998. All other provisions of paragraph (d)(1) are applicable for taxable years ending after November 20, 2003.

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Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

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