

Charitable Remainder Trusts and the Four-Tier System of Accounting – When are Four Tiers Not Four Tiers?

Trying to explain the proposed regulations on the ordering rules of section 664(b) for characterizing distributions from charitable remainder trusts can be a little like trying to explain rocket science to a third-grader. Complicating the rules is the already convoluted treatment of dividends and capital gains under the most recent tax law revisions. Since the tax rates depend in large part on the timing of the receipt of those dividends and gains, applying the right rates to undistributed dividends and gains from a charitable remainder trust can be a daunting task. While most tax preparers use specialized software to help properly characterize the tax treatment of income and gains distributed from charitable remainder trusts, the developers of this software are questioning the fairness of proposed regulations on characterization of CRT distributions under the so-called four-tier system.

Section 664(b) of the Internal Revenue Code requires that when accounting for distributions from a CRT, it should be characterized, in order, as (1) ordinary income, (2) capital gains, (3) tax-free income, and (4) return of principal. CRT trustees must keep track of all types of interest, dividends, capital gains (long- and short-term), tax-free income, and principal value, in order to properly report on the annual distributions from a CRT. Undistributed amounts from each “pot” must be carried forward. Thus, for example, when amounts are paid in future years, undistributed interest and dividends from prior years are considered paid before newly realized capital gains or tax-exempt income can be used to make the distribution.

Changes in tax rates for dividends and capital gains have made the accounting even more complicated. Under the proposed regulations, undistributed dividends existing as of January 1, 2003, are treated as nonqualified dividends. This means that these pre-2003 dividends will not be taxed at the new 15% rate for dividends earned after January 1, 2003, even though the dividends are being distributed to taxpayers after that date.

Confused? It’s enough to drive a planned giving professional to tears. And imagine the consternation of the donors. Watch these pages for updates on the status of the proposed regulations. And take heart –a little crash course in tax law (or, better yet, purchase of the right software) should have you and your donors and clients breathing easier.