

Part III - Administrative, Procedural, and Miscellaneous

Capital Gains and Charitable Remainder Trusts

Notice 98-20

This notice provides guidance on the ordering and taxation of distributions under § 664(b)(2) of the Internal Revenue Code from a charitable remainder trust (CRT) in light of the changes made to § 1(h) by the Taxpayer Relief Act of 1997 (TRA 1997). Pub. L. 105-34, § 311, 111 Stat. 788, 831. Section § 1(h) provides that the Treasury may issue regulations to implement the provisions of § 1(h) for passthrough entities. The Treasury Department and the Internal Revenue Service plan to issue regulations incorporating the guidance contained in this notice.

BACKGROUND

Generally, a CRT is a trust that provides for a specified distribution at least annually over a specified period to one or more noncharitable recipients (a CRT distribution), with the remainder interest in the trust held irrevocably for a charitable organization.

TRA 1997 amended § 1(h) to provide for new capital gain tax rates for noncorporate taxpayers. Notice 97-59, 1997-45 I.R.B. 7, explains that a noncorporate taxpayer's long-term capital gains and losses are separated into three tax rate groups: (1)

the 28-percent group, (2) the 25-percent group, and (3) the 20-percent group. The present notice uses these terms in explaining how a CRT characterizes its capital gain distribution for taxable years beginning on or after January 1, 1998. The definitions of net capital gain, net long-term capital gain or loss, and net short-term capital gain or loss were not changed by TRA 1997. Like Notice 97-59, this notice takes into account the pending retroactive legislative corrections. H.R. 2676, 105th Cong., § 605(d) (1997).

ADDITIONAL NETTING RULES

CRTs will be expected to follow the netting rules in Notice 97-59 when determining net short-term and net long-term capital gains. The rules in § 1.664-1(d)(1)(i)(b)(2) and (3) of the Income Tax Regulations continue to apply in determining capital gains or losses carried forward to the succeeding taxable year.

GENERAL PRINCIPLES OF THE ORDERING RULE

Section 664(b) contains the ordering rule for determining the character of a CRT distribution in the hands of the recipient. The character of a CRT's income is determined at the time the income is realized by the trust. Under § 664(b), the following ordering rule applies for determining the character of a distribution in the hands of the recipient: (1) first, as ordinary income to the extent of the trust's ordinary income for the trust's taxable year and its undistributed ordinary income for prior years, (2) 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, (3) third, as other 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 (4) fourth, as a distribution of trust corpus.

The underlying policy in the ordering rule of § 664(b) and the existing regulations thereunder is that a CRT distribution is deemed to consist first of income that is subject to the highest federal income tax rate in effect at the time of the distribution and then of income that is subject to progressively lower (or no) federal income tax rates in effect at the time of distribution. The same policy applies in the regulations under § 664 when different income tax rates apply to different groups of income within a category of the items described in § 664(b), such as short-term and long-term capital gains. Therefore, income from a group that is subject to a higher federal income tax rate is deemed distributed before other income from a group, within the same category, that is subject to a lower federal income tax rate.

The following example illustrates how this principle applies to capital gain distributions after TRA 1997. Assume for the 1998 taxable year, a CRT has undistributed long-term capital gain in each of the three groups of long-term capital gain, i.e., the 28-percent group, the 25-percent group, and the 20-percent group, and also has undistributed short-term capital gain. To the

extent capital gains are deemed distributed for the 1998 taxable year, the short-term capital gain is deemed distributed prior to any long-term capital gain. The long-term capital gain is deemed distributed in the following order: (1) the gain in the 28-percent group is deemed distributed prior to any other long-term capital gain; (2) the gain in the 25-percent group is deemed distributed prior to any gain in the 20-percent group; and (3) the gain in the 20-percent group is deemed distributed last of any long-term capital gain.

A trustee of a CRT will be required to report each group of long-term capital gain separately on the Form 5227, "Split-Interest Trust Information Return." The trustee may use any reasonable method for determining the amount of each type of gain within a group that has been distributed when doing the required reporting or associated recordkeeping.

PRE-1997 LONG-TERM CAPITAL GAIN

As of January 1, 1997, many CRTs had undistributed long-term capital gains that the CRT properly took into account before January 1, 1997 (pre-1997 long-term capital gains). These pre-1997 long-term capital gains must be assigned to one of the three groups of long-term capital gains. Section 1(h) does not specifically assign pre-1997 long-term capital gains to one group of long-term capital gain. However, § 1(h) gives the Treasury broad regulatory authority to implement the provisions of § 1(h) for passthrough entities.

Pre-1997 long-term capital gains were characterized by the CRT based on the definitions of short-term and long-term capital gains applicable at the time the CRT sold a capital asset. CRTs have never been required to segregate these gains based upon the tax rate or holding period in effect at the time the gains were realized by the CRT. Thus, the undistributed pre-1997 long-term capital gains reflect gains realized when various tax rates and holding periods were in effect. Treasury will exercise its regulatory authority to treat undistributed CRT pre-1997 long-term capital gains as falling within the 20-percent group.

1997 PRE-EFFECTIVE DATE LONG-TERM CAPITAL GAINS

Long-term capital gains properly taken into account from January 1, 1997, through May 6, 1997, are covered by the rules in § 1(h) regarding pre-effective date gains. Under § 1(h), for the taxable year that includes May 7, 1997, gains and losses properly taken into account by the CRT for the portion of the taxable year before May 7, 1997, must be taken into account in determining long-term capital gain in the 28-percent group. Because the taxable year for CRTs is the calendar year, long-term capital gains properly taken into account by a CRT from January 1, 1997, through May 6, 1997, are treated as long-term capital gains in the 28-percent group.

EXAMPLE ILLUSTRATING ORDERING AND CHARACTER RULES

The following example illustrates how these rules will apply to the 1998 taxable year. At the end of the 1998 taxable year,

CRT X has no current or undistributed ordinary income and has the following net short-term and long-term capital gains:

Net short-term capital gain	\$ 5
Net long-term capital gain	\$50
By tax rate group:	
28-percent group gain - \$15	
(\$12 of gain recognized from	
1/1/97 through 5/6/97; and \$3	
of gain recognized after	
7/28/97 from an asset held for	
more than one year and less	
than 18 months)	
25-percent group gain - \$ 5	
20-percent group gain - \$30	
(\$10 of gain recognized before	
1/1/97)	

X makes a CRT distribution of \$25 for the 1998 taxable year. The CRT distribution is deemed to have the following characteristics in the recipient's hands:

Short-term capital gain	\$ 5
28-percent group gain	\$15
25-percent group gain	\$ 5
20-percent group gain	\$ 0

The undistributed 20-percent group gain of \$30 is carried forward to 1999.

EFFECTIVE DATE

The proposed regulations when published will be effective for taxable years beginning on or after January 1, 1998. CRTs and their recipients, however, may rely on the rules in this notice for the 1997 taxable year.

DRAFTING INFORMATION

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