



THE
STANFORD
CHALLENGE

INCOME CATEGORIES (4 TIERS)

1 Ordinary income in this order:

Ordinary income excluding qualified dividends

Qualified dividends (15% or 0% rate*)

2 Capital gains in this order:

Short-term capital gains

28% rate long-term gains from collectibles and Sec. 1202 stock

25% rate long-term gains from unrecaptured Sec. 1250 gains

15% or 0% rate* long-term gains not included in categories listed above

3 Tax-exempt income

4 Tax-free return of principal

*Depending on beneficiary's tax bracket

Taxability of Distributions from Charitable Remainder Trusts

Q: Is the income I receive from a charitable remainder annuity trust or a charitable remainder unitrust taxable to me?

A: Yes, with few exceptions.

The Internal Revenue Code provides a clear and carefully defined set of rules to determine the taxability of distributions from charitable remainder trusts. The trustee must keep track of the following four categories (and subcategories) of income, which is deemed to be distributed to the beneficiaries in the order shown in the table at left.

The tax character of distributions to the beneficiary is determined on an annual, calendar-year basis. IRS rules treat distributions as made from Category 1 first until the full amount of Category 1 has been exhausted, and so on down through all four categories. To the extent income in any tier is not distributed, it is carried forward to subsequent years until it is finally distributed.

This system does not allow distributions to be treated as coming pro-rata from each category. The effect is to maximize the taxability and the effective tax rate on distributions. In fact, it may be virtually impossible ever to distribute the tax-exempt income or principal from Categories 3 and 4, respectively, if the trust has been funded with highly appreciated property. Upon sale of those assets, the entire capital gain falls into Category 2. The trust itself pays no tax on that gain, but so long as any of that gain remains in Category 2, it will prevent distributions from ever reaching into the tax-exempt Categories 3 and 4.

(SEE REVERSE FOR AN EXAMPLE.)

An example: David contributed \$200,000 in long-term appreciated stock with a basis of \$100,000 to a 5% standard payout unitrust on January 1. The trustee immediately sold the stock for \$200,000 (thus realizing a \$100,000 long-term gain) and reinvested the proceeds in a broadly diversified portfolio of stocks and bonds. By the end of the year, the trust had earned \$2,000 in interest, \$7,000 in qualified dividends, and \$2,000 in realized short-term capital gain. In that year, the trustee distributed the \$10,000 unitrust payment (5 percent of \$200,000) to David, and assets worth \$220,000 (representing undistributed income plus some appreciation in the value of the assets) remained in the trust.

In year 2, the trust earned \$2,000 in interest, \$5,000 in qualified dividends and recognized \$10,000 in long-term capital gain. The trustee distributed \$11,000 (5 percent of \$220,000) to David, and assets worth \$230,000 (representing undistributed income plus some appreciation in the value of the assets) remained in the trust.

Therefore, in Year 1 the beneficiary's distribution was taxable at the following rates:

- Ordinary income rate (depending on beneficiary's tax bracket): \$3,000
- 15% or 0% (depending on beneficiary's tax bracket): \$7,000

In Year 2 the beneficiary's distribution was taxable at the following rates:

- Ordinary income rate (depending on beneficiary's tax bracket): \$3,000
- 15% or 0% (depending on beneficiary's tax bracket): \$8,000



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DAVID'S INCOME BY CATEGORY AT THE END OF THE YEAR	YEAR 1	YEAR 2
Ordinary income		
Other than qualified dividends, current year	\$2,000	\$2,000
Undistributed from prior years	0	0
Qualified dividends, current year	7,000	5,000
Undistributed from prior years	0	0
Capital gain income		
Short-term gain, current year	2,000	0
Undistributed from prior years	0	1,000
Long-term gain, current year	100,000	10,000
Undistributed from prior years	0	100,000
Tax-exempt income		
Current year	0	0
Undistributed from prior years	0	0
Tax-free return of principal		
	0	0
ANNUAL UNITRUST DISTRIBUTION	10,000	11,000
CHARACTER OF DISTRIBUTION		
Ordinary income		
Other than qualified dividends (ordinary rate)	2,000	2,000
Qualified dividends (15% or 0% rate*)	7,000	5,000
Ordinary income total	9,000	7,000
Capital gain income		
Short-term gain (ordinary rate)	1,000	1,000
Long-term gain (15% or 0% rate*)	0	3,000
Capital gain total	1,000	4,000
Tax-exempt income		
	0	0
Tax-free return of principal		
	0	0
Grand total	10,000	11,000

*Depending on beneficiary's tax bracket