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Planned Giving News—Spring 2004

Tiers and Taxes

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This past November 20, the U.S. Treasury department issued proposed regulations (REG-11089698) detailing new rules for distributions from Charitable Remainder Trusts (CRT). The new rules make ownership of equities in some CRTs even more attractive than they were before.

Up until these new proposed regulations, when trustees made distributions from CRTs, they followed what is commonly referred to as the “four-tier” system. The system required trustees to distribute (and therefore tax the beneficiary) in the following order:

- ordinary income
- capital gains
- tax-free income
- return of principal

Following the Taxpayer Relief Act of 1997 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, the new rules have expanded the four-tier system to reflect changes made to income tax rates, including the rates applicable to capital gains and dividends. The proposed regulations require that within each tier, all of the most highly taxed class of income or gain be paid out first. Once all the income or gain in the first tier has been paid out, the trustee can make distributions from the next tier (until the fourth tier is reached) starting with the highest rate in each tier:

- ordinary income:
 - ordinary income from income other than qualified dividends (35% tax rate)
 - ordinary income from qualified dividends (15% tax rate)
- capital gains:
 - short-term capital gains (35% tax rate)
 - collectibles gain (28% tax rate)
 - depreciation gain (25% tax rate)
 - all other long-term capital gain (15% tax rate)

- tax-free income (0%)
- return of principal (0%)

The new rules generally encourage investment in equities over other investments given the low dividend and long-term capital gains rates of 15% to income beneficiaries. Where applicable, trustees should take a close look at investments in their portfolios to take advantage of the new lower tax rates by adding to the equity element of their asset allocations.

“The new [distribution] rules generally encourage investment in common stocks over other investments...”

Author’s note: Here is yet another important reason to invest in individual equities instead of mutual funds or common funds. By investing in individual equities, we know *in advance* which dividends are classified as qualified dividends. As a result, we can assess tax consequences to our trust beneficiaries. Even as we go to press with this newsletter, revisions to 1099’s are still being released for mutual fund shareholders.

In approaching this review, we recommend that trustees first evaluate the individual circumstances of each trust. At Clifford Associates, we consider the following factors prior to making an asset allocation recommendation:

- Life expectancy of a trust (based on the youngest income beneficiary)
- Type of trust (CRUT, NIMCRUT, CRAT, etc.)
- Individual circumstances of donor and income beneficiary
- Individual preferences of the charitable organization, remainderman

In our fiduciary capacity, we understand the need to balance the interests of both income beneficiaries and

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remaindermen. The elements listed above may make it sensible to increase the equity allocation under some circumstances, but clearly not in others.

Example #1:

A \$500,000 CRUT with a life expectancy of 25 years and a payout rate of 5%. An income beneficiary with high income outside of this trust and in a high tax bracket.

A generous allocation to equities in this case clearly favors both income beneficiary and remainderman over the long term.

Option A:

Asset allocation: 80% equities / 20% fixed income

Total payout to beneficiary: \$25,000 (or \$500,000 times 5%)

Income rate from equities: 1-1/2%

Income rate from fixed income: 3%

Tax to beneficiary: \$4,350

(based on: \$6,000 in dividends at 15% rate
\$3,000 in interest income at 35% rate
\$16,000 in long-term capital gains at 15%)

Option B:

Asset allocation: 50% equities / 50% fixed income

Same payout

Same income rate from equities

Same income rate for fixed income

Tax to beneficiary: \$5,250 (or 20% more than option A above)

(based on: \$3,750 in dividends at 15% rate
\$7,500 in interest income at 35% rate
\$13,750 in long-term capital gains at 15%)

Option A indicates it is in the best interest of the beneficiary for the trust to have a higher equity allocation than in option B. From the standpoint of the charitable organization, it is also advantageous to have a higher equity allocation over the long term. A higher equity allocation should represent higher growth of the underlying trust assets over time. In this case, it is a win-win situation for all parties involved over the life of the trust. Distributions could vary substantially over the earlier years, however, given the inherent volatility of the equity markets.

The above Example #1 does not automatically translate to a recommendation for higher equity allocation for all CRTs. An alternative example (Example #2) could be one where all trust and beneficiary circumstances are exactly the same. Income rates from equities and fixed income are the same. New tax rates and proposed regulations are already in place.

The only difference is in the life expectancy of the trust. Instead of 25 years, it is now 3 years—a very short time frame in the equity markets, due to the inherent volatility of stocks over the short term.

During the first year, the income beneficiary would likely receive the same payout and the same lower tax rate as a result of the increased equity allocation in the portfolio. What could vary substantially is the benefit to the income beneficiary and remainderman over the short term. If the market

declines substantially during those three years (as was the case during the years 2000, 2001 and 2002), neither of the beneficiaries might obtain the benefit of the higher equity allocation.

For the income beneficiary, a distribution that was originally \$25,000 might decrease substantially in the second and third year following, given the reduced market value of the trust assets (remember the distribution is based on 5% of the value of the trust assets). In Example #1, even if the same decline occurred during the same three years, the income beneficiary should still witness the market value recovery of the trust assets and the increased cumulative distributions over time.

For the charitable organization, an aggressive investment in equities given a life as short as three years could translate to a substantially reduced remainder value in a declining equity market.

A list of examples could go on forever. The advantages of the proposed regulations are clear, but one must be careful to evaluate **all** the trust's circumstances prior to making **any** changes to the investment policy of a given charitable remainder trust. ←

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