



CAPITAL GAINS RULES APPLIED TO
DISTRIBUTIONS FROM CHARITABLE
REMAINDER TRUSTS

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The Internal Revenue Service recently issued Notice 98-20, which explains how the recent changes in capital gains rates affect capital gains distributions from charitable remainder trusts. The IRS plans to issue regulations that incorporate the guidance in Notice 98-20, effective for taxable years beginning on or after January 1, 1998. The rules in Notice 98-20 may also be relied on, however, for the 1997 taxable year.

I. General Rule

Currently, a four-tier system determines the character of a distribution from a charitable remainder trust in the hands of the recipient. Under the four-tier system, distributions are characterized as follows:

- First, as ordinary income, to the extent ordinary income is earned by the trust from inception and not distributed by the trust in prior years;
- Second, as capital gain, to the extent that capital gain is realized by the trust from inception and is not distributed by the trust in prior years;
- Third, as tax-free income, to the extent that tax-free income is earned by the trust from inception and is not distributed by the trust in prior years; and
- Fourth, as principal of the trust.

Notice 98-20 effectively breaks down the capital gain distribution tier into additional sub-tiers as follows:

- 1) First, as **short-term capital gain**, to the extent short-term capital gain is realized by the trust from inception and is not distributed by the trust in prior years;

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- 2) Second, as **28 percent capital gain**, to the extent the trust realizes 28 percent capital gain from inception and is not distributed by the trust in prior years;
- 3) Third, as **25 percent capital gain**, to the extent 25 percent capital gain is realized by the trust from inception and is not distributed by the trust from prior years; and
- 4) Fourth, as **20 percent capital gain**, to the extent that 20 percent capital gain is earned by the trust from inception and is not distributed by the trust in prior years.

II. Pre-1997 Long-Term Capital Gains

Notice 98-20 provides that undistributed long-term capital gains realized and held by a charitable remainder trust prior to January 1, 1997 (pre-1997 long-term capital gains) will be treated as part of the 20 percent capital gain group. Accordingly, such pre-1997 long-term capital gains will be distributed pursuant to paragraph I.4 above.

III. 1997 Pre-Effective Date in Long-Term Capital Gains

Long-term capital gains taken into account from January 1, 1997 through May 6, 1997 (1997 pre-effective date long-term capital gains) are treated as long-term capital gains within the 28 percent capital gains group. Accordingly, such 1997 pre-effective date long-term capital gains shall be distributed pursuant to the terms of paragraph I.2 above.

IV. Reporting

Trustees of charitable remainder trusts will be required to report each group of long-term capital gains separately on Form 5227, "Split Interest Trust Information Return."

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