

Forsgate Group

Four Tier Accounting for Charitable Remainder Trust

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Charitable Remainder Trust

- Provide an option for dealing with appreciated property to philanthropic donors
- Trust is irrevocable
- Could be established during life or at death

Charitable Remainder Trust

(continued)

- Trust promises to pay donor and/or their designated beneficiaries a stream of income

Charitable Remainder Unitrust Trust

- CRUT
- Requires trustee to pay a fixed percentage of the trust's value
- Could be done annually, quarterly, or monthly

CRUT

- Payments are made to one or more persons
- Spread over the life or lives of the non-charity beneficiaries or a fixed period no greater than 20 years
- Fixed percentage may not be less than 5% nor more than 50% of the net fair market value of the CRUT's assets

CRUT

- May not distribute assets to anyone other than the annuity beneficiary or the qualified charity beneficiary
- At least 10% of the fair market value of the contributed property to the trust must be a part of the remainder interest that will pass to the charity when the trust expires

Net Income CRUT

- Lesser of annuity percentage or CRUT trust income

Accounting for Distributions

- Calculating how much the distribution is the easy part
- Accounting for the distribution, you need to use the Four-Tier Approach

Four Tier Accounting

- Reg. 1.664-(b) establishes the rules on the CRUT distribution

Four Tier Accounting

- Tier One – Ordinary Income
- Tier Two – Capital Gains
- Tier Three – Tax Free Income
- Tier Four – Principal (corpus)

CRUT Distributions

- **W**orst
- **I**n
- **F**irst
- **O**ut
- Only when the higher category of income is exhausted does the next tier come into play

Tier One – Ordinary Income

- Interest, non-qualified dividends, rental income, etc.
 - 39.6%
- Qualified dividends
 - 15% / 20% / 23.8%

Tier Two – Capital Gains

- Short-Term Gains
 - 39.6% / 43.4%
- Gains from Collectibles
 - 28%
- Depreciation Gains (1250 Recapture)
 - 25%
- Long-Term Gains
 - 15% / 20% / 23.8%

Tiers Three & Four

- Tier Three – Tax Free
 - 0%
- Tier Four – Principal
 - 0%

Four Tier Accounting

- Within each tier category, the first deemed distribution is treated as made from that portion that would be subject to tax at the highest income tax rate.

FOUR TIER ACCOUNTING

- Follows the same sequence
- First – reduces current year ordinary income assigned to the same class
- Second – reduces prior year undistributed ordinary income assigned to the same class

FOUR TIER ACCOUNTING

ORDINARY LOSSES

- Third – reduces the cumulative ordinary income (current and undistributed income) assigned to the highest ordinary income tax rate class
- Fourth – reduces the cumulative ordinary income (current and undistributed) assigned to the next highest ordinary income class and so on
- If there still remains a loss, the loss would be carried forward to future periods retaining its original class

FOUR TIER ACCOUNTING

CAPITAL LOSSES

- Net Losses are applied to Net Gains in the following order
 - Net losses in the long-term tax rates are netted against the net gains in the long-term tax rate class
 - The highest tax rate class with a loss is first netted against each tax rate class beginning with the highest rate class

CASE STUDY

- Joe and Eileen Taxpayer contribute \$1,000,000 of cash, stock, rental property, other appreciated property and municipal bonds to a CRUT
- The annual payout is 5%

CASE STUDY – YEAR ONE

- Income in Year One

• Rental income	\$8,500
• Interest income	3,000
• Non-Qualified dividends	8,000
• Qualified dividends	20,000
• Short-term gains	12,000
• Short-term losses	(4,000)
• Long-term gains	15,000
• Long-term losses	(3,000)
• Depreciation Recapture	2,000
• Section 1231 gain	500
• Municipal bond income	<u>3,000</u>
• Total Income	<u>\$65,000</u>

YEAR ONE – Tier One

- Assume \$25,000 asset appreciation
 - $25,000 + 65,000 + 1,000,000 = \$1,090,000$ (CRUT Value)
- CRUT distribution is \$54,500 (5% of \$1,090,000)
- Reportable income in Year One:
 - Rental income: \$8,500 (OI)
 - Interest income: 3,000 (OI)
 - Non-Qualified dividends: 8,000 (OI)
 - Qualified dividends: 20,000 (15% treatment)

YEAR ONE – Tier Two

• Net Short-term capital gains	\$8,000 (OI)
• Section 1231 Gain on Collectibles	500 (28%)
• Depreciation Recapture	2,000 (25%)
• Net Long-term capital gains	<u>4,500</u> (15%)
• Total Reportable Income	<u>\$54,500</u>

• Amounts carried forward to subsequent years

• Net Long-term capital gains	7,500
• Municipal Bond interest	3,000

CASE STUDY – YEAR TWO

- The CRUT value is \$1,035,500 on 1/1/2016
- Income in Year Two
 - Rental income \$8,500
 - Interest income 1,000
 - Non-Qualified dividends 5,000
 - Qualified dividends 29,000
 - Short-term gains 12,000
 - Short-term losses (19,000)
 - Long-term gains 29,000
 - Long-term losses (28,000)
 - Section 1231 gain 3,000
 - Municipal bond income 4,200
 - Total Income \$44,700

YEAR TWO – Tier One

- Assume \$57,800 asset appreciation
 - $57,800 + 44,400 + 1,035,500 = \$1,138,000$ (CRUT Value)
- CRUT distribution is \$56,900 (5% of \$1,138,000)
- Reportable income in Year Two
 - Rental income: \$8,500 (OI)
 - Interest income: 1,000 (OI)
 - Non-Qualified dividends: 5,000 (OI)
 - Qualified dividends: 29,000 (15% treatment)

YEAR TWO – Tier Two

• Net Short-term capital gains	\$0 (0%)
• Section 1231 Gain on Collectibles	0 (28%)
• Depreciation Recapture	0 (25%)
• Net Long-term capital gains	4,500 (15%)
• Municipal bond	<u>7,200</u>
• Total Reportable Income	55,200
• Principal	<u>1,700</u>
• Total Cash Distribution	<u>\$56,900</u>

- No carryforwards to 2017
- CRUT Value is \$1,081,100 on 1/1/2017

CASE STUDY – Illustration

	2015			2016			2017		
	CLASS ADDITIONS	ALLOCATION OF LOSSES	K-1 REPORTING	CARRY-FORWARD TO 2016	CLASS ADDITIONS	ALLOCATION OF LOSSES	K-1 REPORTING	CARRY-FORWARD TO 2017	
ORDINARY INCOME TIER									
INTEREST	3,000		3,000	-	1,000		1,000	-	
NON-QUALIFIED DIVIDENDS	8,000		8,000	-	5,000		5,000	-	
NET RENTAL INCOME	8,500		8,500	-	8,500		8,500	-	
QUALIFIED DIVIDENDS	20,000		20,000	-	29,000		29,000	-	
CAPITAL GAIN TIER									
SHORT-TERM CAPITAL GAIN	12,000		8,000	-	12,000	7,000	-	-	
SHORT-TERM CAPITAL LOSS	(4,000)				(19,000)				
LONG-TERM CAPITAL GAIN	15,000		4,500	7,500	29,000	(4,000)	4,500	-	
LONG-TERM CAPITAL LOSS	(3,000)				(28,000)				
DEPRECIATION RECAPTURE	2,000		2,000	-					
GAIN ON COLLECTIBLE PROPERTY (1231)	500		500	-	3,000	(3,000)	-	-	
TAX FREE TIER									
MUNICIPAL BOND INCOME	3,000		-	3,000	4,200		7,200	-	
PRINCIPAL TIER									
	-		-	-	-		1,700	-	
	65,000	-	54,500	10,500	44,700	-	56,900	-	
TOTAL UNITRUST DISTRIBUTION				54,500			56,900		
TOTAL CRUT VALUE - YEAR ENDED									
	2015	2016							
INITIAL CONTRIBUTION/CARRY FORWARD	1,000,000	1,035,500							
INCOME	65,000	44,700							
ASSET APPRECIATION	25,000	57,800							
TOTAL CRUT VALUE	1,090,000	1,138,000							
REQUIRED DISTRIBUTION (5%)	54,500	56,900							

CASE STUDY – YEAR ONE

(With Expenses of the Trust)

- Income in Year One

• Rental income	\$8,500
• Interest income	3,000
• Non-Qualified dividends	8,000
• Qualified dividends	20,000
• Short-term gains	12,000
• Short-term losses	(4,000)
• Long-term gains	15,000
• Long-term losses	(3,000)
• Depreciation Recapture	2,000
• Section 1231 gain	500
• Municipal bond income	<u>3,000</u>
• Total Income	<u>\$65,000</u>

YEAR ONE (With Expenses of the Trust)

- Assume \$25,000 asset appreciation
 - $25,000 + 65,000 + 1,000,000 = \$1,090,000$ (CRUT Value)
- CRUT distribution is \$54,500 (5% of \$1,090,000)
- Expenses of the Trust
 - Trust Expense: \$2,300
 - Asset Management Fee: 10,900
 - Accounting Fee: 1,000
 - \$14,200
- Total CRUT Income = \$50,800 ($65,000 - 14,200$)
- Total Cash CRUT Distribution = \$54,500

TRUST EXPENSE ALLOCATION

- Expenses of the Trust are allocated pro-rata by Taxable vs. Nontaxable income
- Allocation can be based on Income or Fair Market Value
- The option to choose the method can be made each year
- If you are making monthly or quarterly payments then the method chosen in the beginning of the year is the method for the entire year
- Change of method is available in subsequent years

CASE STUDY-YEAR ONE

(With Expenses of the Trust)

	Income	%	Expenses
Rental Income	\$8,500		
Interest Income	3,000		
Non-Qualified Dividends	8,000		
Qualified Dividends	20,000		
Short-term Gains	12,000		
Short-term Losses	(4,000)		
Long-term Gains	15,000		
Long-term Losses	(3,000)		
Depreciation Recapture	2,000		
Section 1231 Gain	<u>500</u>		
Total Taxable	62,000	95.40%	13,547
Municipal Bond Income	<u>3,000</u>	<u>4.60%</u>	<u>653</u>
Total	<u>\$65,000</u>	<u>100.00%</u>	<u>\$14,200</u>

CASE STUDY-YEAR ONE

(With Expenses of the Trust)

	Income	Allocation of Expenses	K-1 Reporting
Rental Income	\$8,500	\$(8,500)	\$-----
Interest Income	3,000	(3,000)	-----
Non-Qualified Dividends	8,000	(2,047)	5,953
Qualified Dividends	20,000	-----	20,000
Short-term Gains	12,000	-----	8,000
Short-term Losses	(4,000)	-----	-----
Long-term Gains	15,000	-----	12,000
Long-term Losses	(3,000)	-----	-----
Depreciation Recapture	2,000	-----	2,000
Section 1231 Gain	500	-----	500
Municipal Bond Income	<u>3,000</u>	<u>(653)</u>	<u>2,347</u>
Total Income	<u>65,000</u>	<u>(14,200)</u>	<u>50,800</u>
Principal	-----	-----	<u>3,700</u>
Total	<u>\$65,000</u>	<u>\$(14,200)</u>	<u>\$54,500</u>