

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1****[REG-110896-98]****RIN 1545-AW35****Charitable Remainder Trusts;
Application of Ordering Rule****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations on the ordering rules of section 664(b) of the Internal Revenue Code for characterizing distributions from charitable remainder trusts. The proposed regulations reflect changes made to income tax rates, including the rates applicable to capital gains and certain dividends, by the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. The proposed regulations affect charitable remainder trusts and their beneficiaries. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received Tuesday, February 17, 2004. Outlines of topics to be discussed at the public hearing scheduled for Tuesday, March 9, 2004, must be received by Tuesday, February 17, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-110896-98), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-110896-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa M. Melchiorre, (202) 622-7830; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Background**

Section 664 contains the rules for charitable remainder annuity trusts and charitable remainder unitrusts. In general, a charitable remainder trust provides for a specified periodic distribution (CRT distribution) to one or more beneficiaries (at least one of which is a noncharitable beneficiary) for life or for a term of years, with an irrevocable remainder interest held for the benefit of charity.

Section 664(b) provides ordering rules for determining the character of CRT distributions in the hands of the recipient of those distributions. A CRT distribution is treated: First, as ordinary income to the extent of the trust's gross income other than gains from the sale of capital assets ("ordinary income") for the trust's taxable year and its undistributed ordinary income for prior years; 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; third, as other income (that is, tax-exempt 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, finally, as a distribution of trust corpus. The general principle of section 664(b) is that income subject to the highest Federal income tax rate is deemed distributed prior to income subject to a lower (or no) Federal income tax rate. The existing regulations under "1.664-1(d)(1)(i)(b)(1) follow this general principle by providing that short-term capital gain is deemed distributed prior to any long-term capital gain.

Beginning with the Taxpayer Relief Act of 1997 (TRA), Public Law 105-34 (111 Stat. 788), different types of long-term capital gains are subject to different Federal income tax rates. The different classes of long-term capital gains and losses properly taken into account by a charitable remainder trust after May 6, 1997, may, for example, consist of 28-percent rate gain as defined in section 1(h)(4), unrecaptured section 1250 gain as defined in section 1(h)(6), and all other long-term capital gains and losses. For taxable years beginning after December 31, 2002, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108-27 (117 Stat. 752), provides that qualified dividend income as defined in section 1(h)(11) is taxed at the rates applicable to all other long-term capital gains. Because dividends represent one type of ordinary income, different types of ordinary income are subject to different Federal income tax rates as a result of JGTRRA.

Notice 98-20 (1998-1 C.B. 776), as modified by Notice 99-17 (1999-1 C.B. 871), provides guidance on the treatment of capital gains under section 664(b)(2) following the changes made by the TRA and the technical corrections made by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685). The proposed regulations incorporate this guidance as well as provide additional guidance regarding the treatment of qualified dividend income under section 664(b)(1).

Explanation of Provisions

The proposed regulations will amend § 1.664-1(d)(1) to revise the rules for characterizing a CRT distribution to take into account differences in the Federal income tax rates applicable to items of income that are assigned to the same category under section 664(b). The trust's income is assigned, in the year it is required to be taken into account by the trust, to one of three categories: the ordinary income category, the capital gains category, or the other income category. Further, within the ordinary income and capital gains categories, items are also assigned to different classes based on the Federal income tax rate applicable to each type of income in the category. In accordance with section 664(b), a CRT distribution is treated as being made from the categories in the following order: ordinary income, capital gain, other income, and trust corpus. Within the ordinary income and capital gains categories, income is treated as distributed from the classes of income in that category beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate. The proposed regulations also provide rules for netting different classes of capital gains and losses based on the guidance in Notice 97-59 (1997-2 C.B. 309).

Proposed Effective Date

The provisions in these regulations that were set forth in Notice 98-20 (1998-1 C.B. 776) and Notice 99-17 (1999-1 C.B. 871) are proposed to apply for taxable years ending on or after December 31, 1998, and taxpayers may rely on the provisions for taxable years beginning on or after January 1, 1998. The other provisions of these regulations are proposed to apply for taxable years ending after [DATE OF PUBLICATION OF THIS DOCUMENT IN THE Federal Register].