

Date: 04-Mar-14

From: Steve Leimberg's Charitable Planning Newsletter

Subject: [Ted Batson: Charitable Remainder Trusts and the "Simplified Method" for Reporting the Section 1411 Net Investment Income Tax](#)

“In 2010 Congress enacted the Health Care and Education Reconciliation Act of 2010 creating new IRC § 1411, which imposes a 3.8% surtax on the net investment income of individuals, estates, and trusts. In December 2012, the IRS issued proposed regulations that included a method (the Simplified Method) for charitable remainder trust (CRT) trustees to capture and report net investment income to the trust’s non-charitable income beneficiaries. Final regulations issued in December 2013 took a different approach, but in new proposed regulations issued at the same time, the Simplified Method was retained as an alternative election.

The Simplified Method works as a complement to the pre-existing “four-tier” structure used by CRTs for income tax reporting. Under the Simplified Method, all net investment income (NII) received after December 31, 2012 is aggregated on a cumulative basis and distributed before excluded income. A trustee should consider electing the simplified method when the trust’s income beneficiaries do not meet the applicable modified adjusted gross income threshold or when the trust has realized or realizable capital losses coupled with a short expected remaining term.

Electing the Simplified Method will make sense where a CRT has a short expected remaining term and has realized or realizable capital losses that will reduce the reportable NII. Moreover, because of its reduced record-keeping requirement, the Simplified Method makes sense in any case where a CRT’s beneficiaries are unlikely to ever be subject to the NIIT because their MAGI does not exceed the applicable threshold. Alternatively, the 4-Tier Method makes sense when a CRT’s beneficiaries may be subject to the NIIT currently or in the future and there are amounts in the 4-tier classes that are excluded from NII.”

Ted Batson provides members with commentary that helps clear up some of the confusion with charitable remainder trusts and the “simplified method” for reporting the Section 1411 net investment income tax.

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Before we get to Ted's commentary, members should take note of the fact that a new 60 Second Planner by **Bob Keebler** was recently posted to the **LISI** homepage. In his commentary, Bob reports on PLR 201407001 where the IRS granted 9100 relief allowing the taxpayer additional time to opt out of an automatic allocation of GST exemption. You don't need any special equipment - [just click on this link](#).

Now, here is Ted Batson's commentary:

EXECUTIVE SUMMARY:

In 2010 Congress enacted the Health Care and Education Reconciliation Act of 2010 creating new IRC § 1411, which imposes a 3.8% surtax on the net investment income of individuals, estates, and trusts. In December 2012, the IRS issued proposed regulations that included a method (the Simplified Method) for charitable remainder trust (CRT) trustees to capture and report net investment income to the trust's non-charitable income beneficiaries. Final regulations issued in December 2013 took a different approach, but in new proposed regulations issued at the same time, the Simplified Method was retained as an alternative election.

The Simplified Method works as a complement to the pre-existing "four-tier" structure used by CRTs for income tax reporting. Under the Simplified Method, all net investment income (NII) received after December 31, 2012 is aggregated

on a cumulative basis and distributed before excluded income. A trustee should consider electing the simplified method when the trust's income beneficiaries do not meet the applicable modified adjusted gross income threshold or when the trust has realized or realizable capital losses coupled with a short expected remaining term.

COMMENT:

Introduction

In 2010 Congress enacted the Health Care and Education Reconciliation Act of 2010 creating new IRC § 1411, which imposes a 3.8% surtax on the net investment income (NIIT) of individuals, estates, and trusts.^[i] For individuals this surtax is imposed on single persons with modified adjusted gross income in excess of \$200,000 and on married couples with modified adjusted gross income (MAGI) in excess of \$250,000.^[ii] MAGI is defined as adjusted gross income plus foreign earned income less deductions and exclusions allocable to that foreign earned income.^[iii]

Net investment income (NII) includes gross income from interest, dividends, annuities, royalties, rents, and net gains from the disposition of property other than property held in a trade or business (e.g., capital gains).^[iv] Income derived in the ordinary course of a trade or business is excluded from NII unless that trade or business is (1) a passive activity (within the meaning of § 469), or (2) a trade or business of trading in financial instruments or commodities (as defined in § 475(e)(2)).^[v] Deductions allocable to the includible items of gross income and net gain are allowed in arriving at NII.^[vi]

On December 2, 2013, the Internal Revenue Service issued final regulations implementing IRC § 1411.^[vii] The method required for implementing § 1411 for charitable remainder trusts (CRTs) contained in the final regulations (the 4-Tier Method) differs from the guidance provided in the proposed regulations issued on December 5, 2012.^[viii] However, in new proposed regulations issued on December 2, 2013 in conjunction with the final § 1411 regulations, the IRS has allowed a CRT trustee to irrevocably elect to apply the method originally proposed (the "Simplified Method").^[ix] This article discusses the Simplified Method and briefly examines when a trustee should elect the Simplified Method.

Under the Simplified Method, CRT income beneficiaries are subject to the NIIT to the extent that their distributions are properly characterized as NII.^[x] But this rule is not without its own exception—only NII realized by the CRT after December 31, 2012 is includible in the CRT’s NII and consequently subject to the NIIT when distributed to the CRT income beneficiaries.^[xi] Moreover, where a CRT has more than one income beneficiary, the reportable NII is apportioned between the beneficiaries “based on their respective shares of the total annuity or unitrust amount paid by the charitable remainder trust for that taxable year.”^[xii]

Applying the Simplified Method

The Simplified Method specifies that the amount includible in an income beneficiary’s NII (i.e., the amount subject to the NIIT) is the *lesser* of (1) the amount distributed to the beneficiary for the year, *or* (2) the beneficiary’s share of the *accumulated net investment income* of the trust.^[xiii] The key to understanding this formula is the definition of “accumulated net investment income” (ANII). ANII is defined as “the total amount of net investment income received by a CRT for all taxable years that begin after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years of the trust that begin after December 31, 2012.”^[xiv] Consequently, items of gross income or net gain realized by a CRT prior to January 1, 2013 are not includible in ANII and are therefore not subject to the NIIT even if distributed many years later. Note that under the Simplified Method the amount of NII reported to the income beneficiaries is a separate and distinct computation from the determination of the tax character of CRT distributions under the four-tier system.^[xv] As illustrated below in Example 1, this can mean ANII is distributed in a different sequence than income accumulated in the four-tier system.

Electing the Simplified Method

A CRT trustee elects the Simplified Method on the Form 5227, *Split-Interest Trust Information Return*, filed for the first taxable year beginning on or after January 1, 2013.^[xvi] Once the election is made, the election is irrevocable.^[xvii]

Examples

To illustrate the application of these rules consider the following examples:

Example 1. At the start of 2013, CRT A has four-tier balances from years prior to 2013 as follows:

Interest income	\$2,500
Short-term capital gains	1,000
Other long-term capital gains	500,000

During 2013, the trustee receives NII consisting of:

Interest income	\$25,000
Long-term capital gains	<u>40,000</u>
Total	<u>\$65,000</u>

This amount represents CRT A's ANII for 2013. Also during 2013, the trustee distributes to the beneficiary a required distribution under the terms of the trust of \$60,000.

As a result of this activity, the beneficiary receives (under the 4-tier rules):

Interest income	\$27,500
Short-term capital gains	1,000
Other long-term capital gains	<u>31,500</u>
Total	<u>\$60,000</u>

Of the interest income received, \$2,500 is from prior years and \$25,000 is from 2013. The \$1,000 of short-term capital gains is all from prior years, while the \$31,500 of other long-term capital gain is all from 2013. The undistributed 2013 long-term capital gain of \$8,500 is added to the carryforward other long-term capital gain balance from 2012 of \$500,000 such that \$508,500 is carried forward into 2014.

Applying Prop. Treas. Reg. § 1.1411-3(d)(3)(i), the reportable NII is the lesser of the total amount of distributions for the year or the ANII. Therefore, the

amount the income beneficiaries of CRT A must report as subject to the NIIT is \$60,000, the lesser of the total amount of distributions for the year (i.e., \$60,000) or the ANII (i.e., \$65,000). The \$5,000 of excess 2013 NII carries forward as ANII to 2014.

This example illustrates two concepts. First, the amount of NII reportable by CRT A's income beneficiaries cannot exceed the amount they receive as distributions. Second, despite the fact that under the four-tier system \$2,500 of interest and \$1,000 of short-term capital gains distributed were accumulated during years prior to 2013, all of the amount distributed was subject to the NIIT because the 2013 ANII exceeded the amount distributed for 2013.

Example 2. The facts remain the same as Example 1 except that the 2013 realized other long term capital gains total only \$15,000. Therefore, in this Example 2, the 2013 ANII is \$40,000 comprised of:

Interest income	\$25,000
Other long-term capital gains	<u>15,000</u>
Total	<u>\$40,000</u>

Consequently, the amount of NII subject to the NIIT that the income beneficiaries must report is \$40,000, the lesser of the amount distributed, \$60,000, and the ANII, \$40,000. Note that in this example, \$20,000 of the amount distributed is from pre-2013 income excluded from NII by rule and is not subject to the NIIT.

Example 3. The facts remain the same as Example 1 except that for 2013 there is a realized other long-term capital loss of (\$12,000) and no other long-term capital gain. Therefore, in this Example 3, CRT A's 2013 ANII is \$13,000 comprised of:

Interest income	\$25,000
Other long-term capital gains	<u>(12,000)</u>
Total	<u>\$13,000</u>

Consequently, the amount of NII subject to the NIIT that the income beneficiaries must report is \$13,000, the lesser of the amount distributed,

\$60,000, and the ANII, \$13,000. Note that in this example, \$47,000 of the amount distributed is from pre-2013 income excluded from NII by rule and is not subject to the NIIT.

Example 4. The facts remain the same as Example 1 except that for 2013 there is a realized other long-term capital loss of (\$30,000) and no other long-term capital gain. Therefore, in this Example 3, CRT A's 2013 ANII is \$13,000 comprised of:

Interest income	\$25,000
Other long-term capital gains	<u>(30,000)</u>
Total	<u>(\$5,000)</u>

Consequently, the amount of NII subject to the NIIT that the income beneficiaries must report is \$0, the lesser of the amount distributed, \$60,000, and the ANII, \$0. The (\$5,000) of excess capital loss is carried forward to 2014 and used to compute ANII in 2014.

Example 5. The facts are the same as Example 1, except that now the year is 2014. The four-tier balances that carried forward to 2014 from Example 1 consisted solely of \$508,500 of other long-term capital gain. During 2014 the CRT receives the following income items:

Interest income	\$20,000
Other long-term capital gains	<u>30,000</u>
Total	<u>\$50,000</u>

Further, during 2014, per the terms of the CRT agreement the trustee distributes \$70,000 to the trust's income beneficiaries.

For 2014, CRT A has ANII of \$55,000 consisting of

Interest income	\$20,000
Other long-term capital gains	30,000

Pre-2014 NII	65,000
Pre-2014 distributed NII	<u>(60,000)</u>
Total	<u>\$55,000</u>

Therefore the amount of NII subject to the NIIT that CRT A’s income beneficiaries must report is \$55,000, which is the lesser of the amount distributed, \$70,000, and ANII, \$55,000. The \$15,000 distributed that is in excess of the current and accumulated net income is deemed distributed from years prior to January 1, 2013 and is not subject to the NIIT. Moreover, there is no ANII carryforward to 2015.

When Not to Elect the Simplified Method

The Simplified Method requires the distribution of NII even if the trust has excludable amounts received prior to January 1, 2013 or from excludable sources (e.g., an IRA or 401(k) distribution^[xviii]). The 4-Tier Method allows access to excludable amounts in the ordinary income class (including excludable qualified dividends) even if ANII is greater than the current year distribution. Accordingly, the Simplified Method generally should not be elected if the trust has excludable amounts in any tax rate class other than the other long-term capital gain tax rate class.

When to Elect the Simplified Method

The Simplified Method will produce a superior result to the 4-Tier Method when there are realized or realizable capital losses. Where a CRT has realized or realizable capital losses, those losses (when realized) will reduce the overall NII and conceivably reduce the amount of NII distributed to the CRT beneficiaries. This is because under the Simplified Method, capital losses reduce ordinary income subject to the NIIT, a result which is not permitted under the 4-Tier Method. See Example 3 above. This circumstance may exist where the trust has a diversified portfolio with latent capital losses because tax loss harvesting has not historically been a productive strategy for CRTs. However, because the election is irrevocable and the existence of capital losses in the future is uncertain, making the election based solely on the existence of 2013 actual or 2014 expected capital losses should be done in cases where the expected remaining term of the CRT is of short duration (e.g., there are only a few years remaining on a fixed term or the measuring lives of a lifetime CRT

are of advanced age).

Moreover, regardless of the availability of capital losses or excluded income, the reduced recordkeeping requirements of the Simplified Method over the 4-Tier Method should result in administrative savings. Therefore, when a CRT's beneficiaries are unlikely to exceed the applicable MAGI threshold, the Simplified Method will be preferable.

Conclusion

The proposed regulations continue to make the Simplified Method for reporting NII to CRT beneficiaries available. However, the election is irrevocable. Consequently, a CRT trustee should exercise care in choosing to make the election to use the Simplified Method.

Electing the Simplified Method will make sense where a CRT has a short expected remaining term *and* has realized or realizable capital losses that will reduce the reportable NII. Moreover, because of its reduced record-keeping requirement, the Simplified Method makes sense in any case where a CRT's beneficiaries are unlikely to ever be subject to the NIIT because their MAGI does not exceed the applicable threshold. Alternatively, the 4-Tier Method makes sense when a CRT's beneficiaries may be subject to the NIIT currently or in the future and there are amounts in the 4-tier classes that are excluded from NII.

**HOPE THIS HELPS YOU HELP OTHERS MAKE
A *POSITIVE* DIFFERENCE!**

Ted Batson

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CITES:

IRC § 1411; Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1061, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-111publ152/pdf/PLAW-111publ152.pdf>; Final Net Investment Income Tax Regulations, 78 Fed. Reg. 72394 (Dec. 2, 2013), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-12-02/pdf/2013-28410.pdf>; Proposed Net Investment Income Tax Regulations, 77 Fed. Reg. 72612, 72612 (Dec. 5, 2012), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf> (providing guidance on the implementation of the 3.8% surtax imposed by IRC § 1411); Proposed Net Investment Income Tax Regulations, REG-130843-13, 78 Fed. Reg. 72451, 72467 (Dec. 2, 2013); *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-12-02/pdf/2013-28409.pdf>.

CITATIONS:

[i] IRC § 1411(a)(1) and (2). Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1061, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-111publ152/pdf/PLAW-111publ152.pdf>.

[ii] IRC § 1411(b).

[iii] *See* IRC § 1411(d).

[iv] IRC § 1411(c)(1)(A).

[v] IRC § 1411(c)(1)(A)(i) and (2).

[vi] IRC § 1411(c)(1)(B).

[vii] Net Investment Income Tax, 78 Fed. Reg. 72394 (Dec. 2, 2013), *available*

at <http://www.gpo.gov/fdsys/pkg/FR-2013-12-02/pdf/2013-28410.pdf>.

[viii] Net Investment Income Tax, 77 Fed. Reg. 72612, 72612 (Dec. 5, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf> (providing guidance on the implementation of the 3.8% surtax imposed by IRC § 1411).

[ix] Prop. Treas. Reg. § 1.1411-3(d)(3), REG–130843–13, 78 Fed. Reg. 72451, 72467 (Dec. 2, 2013); available at <http://www.gpo.gov/fdsys/pkg/FR-2013-12-02/pdf/2013-28409.pdf>.

[x] See Prop. Treas. Reg. § 1.1411-3(d)(3)(i), REG–130843–13, 78 Fed. Reg. 72451, 72467-68 (Dec. 2, 2013).

[xi] Treas. Reg. § 1.1411-3(d)(1)(iii), 78 Fed. Reg. 72394, 72428 (Dec. 2, 2013).

[xii] Treas. Reg. § 1.1411-3(d)(1)(ii), 78 Fed. Reg. 72394, 72428 (Dec. 2, 2013).

[xiii] Prop. Treas. Reg. § 1.1411-3(d)(3)(i), REG–130843–13, 78 Fed. Reg. 72451, 72467-68 (Dec. 2, 2013).

[xiv] Treas. Reg. § 1.1411-3(d)(1)(iii), 78 Fed. Reg. 72394, 72428 (Dec. 2, 2013).

[xv] See Net Investment Income Tax, Preamble ¶ 4.B.iv., 77 Fed. Reg. 72612, 72616 (Dec. 5, 2012).

[xvi] Prop. Treas. Reg. § 1.1411-3(d)(3)(iii), REG–130843–13, 78 Fed. Reg. 72451, 72468 (Dec. 2, 2013).

[xvii] *Id.*

[xviii] See IRC § 1411(c)(5).