Section 664.—Charitable Remainder Trusts

26 CFR 1.664–1: Charitable remainder trusts.

T.D. 9190

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Charitable Remainder Trusts; Application of Ordering Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the ordering rules of section 664(b) of the Internal Revenue Code for characterizing distributions from charitable remainder trusts (CRTs). The fi-

nal 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 final regulations provide guidance needed to comply with these changes and affect CRTs and their beneficiaries.

DATES: *Effective Date*: These regulations are effective on March 16, 2005.

Applicability Dates: For dates of applicability, see §1.664–1(d)(1)(ix).

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SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 664(b) of the Internal Revenue Code. On November 20, 2003, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–110896–98, 2003–2 C.B. 1226) in the **Federal Register** (68 FR 65419). The public hearing scheduled for March 9, 2004, was cancelled because no requests to speak were received. Several written comments responding to the notice of proposed rulemaking were received. After consideration of the written comments, the proposed regulations are adopted as revised by this Treasury decision. The revisions and a summary of the comments are discussed below.

The proposed regulations reflected changes made to income tax rates, including the rates applicable to capital gains and certain dividends, by the Taxpayer Relief Act of 1997 (TRA), Public Law 105–34 (111 Stat. 788), and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108–27 (117 Stat. 752). These changes affect the ordering rules of section 664(b) for characterizing distributions from CRTs.

Prior to the TRA, long-term capital gains were generally subject to the same Federal income tax rate. The TRA provided, however, that gain from certain types of long-term capital assets would be subject to different Federal income tax rates. Accordingly, after May 6, 1997, a CRT could have at least three classes of long-term capital gains and losses: a class for 28-percent gain (gains and losses from collectibles and section 1202 gains); a class for unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and a class for all other long-term capital gain. In addition, the TRA provided that qualified 5-year gain (as defined in section 1(h)(9) prior to amendment by the JGTRRA) would be subject to reduced capital gains tax rates under certain circumstances for certain taxpayers. For taxpayers subject to a 10-percent capital gains tax rate, qualified 5-year gain would be taxed at an 8-percent capital gains tax rate effective for taxable years beginning after December 31, 2000. For taxpayers subject to a 20-percent capital gains tax rate, qualified 5-year gain would be taxed at an 18-percent capital gains tax rate provided the holding period for the property from which the gain was derived began after December 31, 2000. As a result, a CRT could also have a class for qualified 5-year gain.

Prior to the JGTRRA, a CRT's ordinary income was generally subject to the same Federal income tax rate. The JGTRRA provided, however, that qualified dividend income as defined in section 1(h)(11) would be subject to the Federal income tax rate applicable to the class for all other long-term capital gain. As a result, after December 31, 2002, a CRT could have a qualified dividend income class that would be subject to a different Federal income tax rate than that applicable to the CRT's other types of ordinary income. In addition, the JGTRRA provided that qualified 5-year gain would cease to exist after May 5, 2003, but that it would return after December 31, 2008.

In response to the changes made by the TRA and the technical corrections to the TRA made by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 685), the IRS issued guidance on the treatment of capital gains under section 664(b)(2) in Notice 98–20, 1998–1 C.B. 776, as modified by Notice 99–17, 1999–1 C.B. 871. The proposed regulations incorporated the guidance provided in Notice 98–20 and Notice 99–17. In addition, the proposed regulations provided additional guidance on the treatment of qualified dividend income under section 664(b)(1) and the treatment of a class of income that temporarily ceases to exist, like the qualified 5-year gain class.

Explanation of Provisions

The proposed regulations provided that trusts must maintain separate classes within a category of income when two classes are only temporarily subject to the same tax rate (for example, if the current tax rate applicable to one class sunsets in a future year). In the preamble to the proposed regulations, comments were requested on the degree of administrative burden and potential tax benefit or detriment of this requirement. Only one comment was received in response to this request. The commentator pointed out that maintaining a class during a temporary period of suspension could be favorable to taxpayers in one situation and unfavorable in another. For example, maintaining the qualified 5-year gain class during a temporary period of suspension would be advantageous because when the class is again in existence, gain distributed from the class probably would be taxed at a rate lower than the rates applicable to other classes of long-term capital gain. On the other hand, if the 28-percent long-term capital gain class is taxed at 15 percent during a temporary period, gain distributed from that class after the expiration of that temporary period is likely to be taxed at a rate higher than the rates applicable to other classes of long-term capital gain.

The IRS and Treasury Department continue to believe that it is appropriate for CRTs to maintain separate classes for income only temporarily taxed at the same rate, and no comment received indicated that this requirement would be unduly burdensome. Therefore, this requirement remains unchanged in the final regulations.

The proposed regulations provided that, to be eligible for inclusion in the class of qualified dividend income, dividends must meet the definition of section 1(h)(11) and must be received by the trust after December 31, 2002. Several commentators suggested that the final regulations should provide that undistributed dividends received by a CRT prior to January 1, 2003, that would otherwise meet the definition of qualified dividends under section 1(h)(11), be treated as qualified dividends.

Subsequent to the issuance of the proposed regulations, a technical correction was made to the JGTRRA by the Working Families Tax Relief Act of 2004, Public Law 108–311 (118 Stat. 1166), to provide that dividends received by a trust on or before December 31, 2002, shall not be treated as qualified dividend income as defined in section 1(h)(11). Accordingly, this suggestion has not been adopted in the final regulations.

The proposed regulations provided that, in netting capital gains and losses, a net short-term capital loss is first netted against the net long-term capital gain in each class before the long-term capital gains and losses in each class are netted against each other. One commentator suggested that this netting rule be revised to provide that the gains and losses of the long-term capital gain classes be netted prior to netting short-term capital loss against any class of long-term capital gain.

The IRS and Treasury Department believe that the netting rules for CRTs should be consistent with the netting rules applicable generally to other noncorporate taxpayers. Accordingly, the final regulations adopt this suggested change.

The proposed regulations provided that items of income within the ordinary income and capital gains categories are assigned to different classes based on the Federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the CRT. One commentator suggested that the assignment of items of income to different classes in the year the items are required to be taken into account by the CRT should be based on the Federal income tax rate that is likely to apply to that item in the hands of the recipient (for example, depending on the recipient's marginal income tax rate bracket) in the year in which the item is distributed.

The final regulations do not adopt this change. It is not feasible in many instances for trustees to determine the tax bracket of beneficiaries. The IRS and Treasury Department believe that the assignment of an item to a particular class should be based upon the tax rate applicable to each class when the item is received by the CRT, and not the various tax rates applicable to the classes at the time of a distribution to the beneficiary.

The proposed regulations provided that the determination of the tax character of amounts distributed by a CRT shall be made as of the end of the taxable year of the CRT. One commentator recommended that the language in the proposed regulations be reworded to make it clear that this rule applies to all distributions made by the CRT to recipients throughout the calendar year. In response to the comment, the second sentence in §1.664–1(d)(1)(ii)(*a*) is revised in the final regulations to read, "[t]he determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the trust shall be made as of the end of that taxable year."

The proposed regulations provided that the annuity or unitrust recipient is taxed on the distribution from the CRT based on the tax rates applicable in the year of the distribution to the classes of income that are deemed distributed from the trust. One commentator suggested that the language in the proposed regulations be reworded to make it clear that the tax rates applicable to a distribution or deemed distribution from a CRT to a recipient are the tax rates applicable to the classes of income from which the distribution is derived in the year of distribution, and not the tax rates applicable to the income in the year it is received by the CRT. This suggestion has been adopted. In the final regulations, the third sentence in §1.664–1(d)(1)(ii)(*a*) is revised to read as follows:

> The tax rate or rates to be used in computing the recipient's tax on the distribution shall be the tax rates that are applicable, in the year in which the distribution is required to be made, to the classes of income deemed to make up that distribution, and not the tax rates that are applicable to those classes of income in the year the income is received by the trust.

One commentator suggested that a cross-reference to §1.664–1(d)(4) should be made following the above sentence. This suggestion has not been adopted because the IRS and Treasury Department do not believe that a cross reference is needed. Section 1.664–1(d)(1)(ii)(*a*) confirms that a class of income will be taxed to the beneficiary at the tax rate applicable to that class in the year the distribution is made. Section 1.664–1(d)(4) identifies the year of the distribution.

One commentator proposed that the final regulations specifically address the treatment of municipal bond income and the effect of the alternative minimum tax (AMT) provisions and section 469 on CRT income. The final regulations do not address these issues, because the IRS and Treasury Department believe they are beyond the scope of these regulations. These regulations are intended to address only the income tax rates applicable to classes of income and the order in which those classes of income are to be applied to determine the character of a distribution in the hands of a recipient. The issues raised by the commentator are more appropriately addressed in separate guidance.

One commentator requested clarification of whether the ordering rules in the proposed regulations apply to a CRT that has lost its tax-exempt status under section 664(c) in the year income is distributed. Section 1.664–1(d)(1)(ii) of the proposed regulations provides that the categories and classes of income determined under §1.664–1(d)(1)(i) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient, irrespective of whether the trust is exempt from taxation under section 664(c) for the year of the distribution. The final regulations retain this provision.

One commentator recommended that the IRS provide a detailed worksheet that would include all of the possible classes of income a CRT could have so that the trustees can track a CRT's income from year to year. Because the types of income that each CRT may have can vary widely, the IRS and Treasury Department have determined that such a worksheet is not administratively feasible at this time.

One commentator recommended that a provision similar to §1.664–1(d)(4)(ii) be added to the final regulations to permit the trustee to make corrections when the trustee has made incorrect distributions as a result of mistakes in fiduciary accounting practices, suggesting that such a provision would allow the CRT to receive the benefit of any correction in the year during which the correction is made. The IRS and Treasury Department believe that the proper method to remedy such errors is the filing of amended returns, rather than a current year adjustment and, therefore, such a provision is not included in the final regulations.

One commentator requested that examples addressing the following situations be provided in the final regulations:

Situation 1. The end result of a short-term capital loss and a combination of long-term capital gains and losses that net to a long-term capital loss;

Situation 2. The end result when a class of income has a net-loss amount that is carried forward without affecting the tax character of distributions;

Situation 3. The applicability of the passive loss rules under section 469 to the ordering rules of section 664(b);

Situation 4. The applicability of the alternative minimum tax (AMT) provisions under section 55 to the ordering rules under section 664(b); and

Situation 5. The treatment of the distribution of qualified 5-year gain between January 1, 2004, and December 31, 2008.

In response to this request, Examples 4 and 5 have been added to the final regulations. Example 4 addresses situations 1 and 2. Example 5 addresses situation 5. Examples will not be added to address situations 3 and 4 because they involve issues beyond the scope of these final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Theresa M. Melchiorre, Office of Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.664–1 is amended as follows:

1. Paragraph (d)(1) is revised.

2. Paragraph (d)(2) is amended by:

a. Removing the language “or to corpus (determined under subparagraph (1)(i) of this paragraph)” in the first sentence and adding “(determined under paragraph (d)(1)(i)(*a*) of this section) or to corpus” in its place.

b. Removing the language “subparagraph (1)(i)(c) of this paragraph” from the fifth sentence and adding “paragraph (d)(1)(i)(*a*)(*3*) of this section” in its place.

c. Removing the language “or to corpus in the categories described in subparagraph (1) of this paragraph” from the last sentence and adding “described in paragraph (d)(1)(i)(*a*) of this section or to corpus” in its place.

3. Paragraph (e)(1) is amended by removing the language “paragraph (d)(1)” from the first sentence and adding “paragraph (d)(1)(i)(*a*)” in its place.

The revision reads as follows:

§1.664–1 Charitable remainder trusts.

* * * * *

(d) *Treatment of annual distributions to recipients*—(1) *Character of distributions*—(i) *Assignment of income to categories and classes at the trust level.* (*a*) A trust’s income, including income includible in gross income and other income, is assigned to one of three categories in the year in which it is required to be taken into account by the trust. These categories are—

(*1*) Gross income, other than gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the ordinary income category);

(*2*) Gains and amounts treated as gains from the sale or other disposition of capital assets (referred to as the capital gains category); and

(*3*) Other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Internal Revenue Code).

(*b*) Items within the ordinary income and capital gains categories are assigned to different classes based on the Federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the trust. For example, for a trust with a taxable year ending December 31, 2004, the ordinary income category may include a class of qualified dividend income as defined in section 1(h)(11) and a class of all other ordinary income, and the capital gains category may include separate classes for short-term and long-term capital gains and losses, such as a short-term capital gain class, a 28-percent long-term capital gain class (gains and losses from collectibles and section 1202 gains), an unrecaptured section 1250 long-term capital gain class (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation), a qualified 5-year long-term capital gain class as defined in section 1(h)(9) prior to amendment by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Public Law 108–27 (117 Stat. 752), and an all other long-term capital gain class. After items are assigned to a class, the tax rates may change so that items in two or more classes would be taxed at the same rate if distributed to the recipient during a particular year. If the changes to the tax rates are permanent, the undistributed items in those classes are combined into one class. If, however, the changes to the tax rates are only temporary (for example, the new rate for one class will sunset in a future year), the classes are kept separate.

(ii) *Order of distributions.* (*a*) The categories and classes of income (determined under paragraph (d)(1)(i) of this section) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient irrespective of whether the trust is exempt from taxation under section 664(c) for the year of the distribution. The determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the trust shall be made as of the end of that taxable year. The tax rate or rates to be used in computing the recipient's tax on the distribution shall be the tax rates that are applicable, in the year in which the distribution is required to be made, to the classes of income deemed to make up that distribution, and not the tax rates that are applicable to those classes of income in the year the income is received by the trust. The character of the distribution in the hands of the annuity or unitrust recipient is determined by treating the distribution as being made from each category in the following order:

(*1*) First, from ordinary income to the extent of the sum of the trust's ordinary income for the taxable year and its undistributed ordinary income for prior years.

(*2*) Second, from capital gain to the extent of the trust's capital gains determined under paragraph (d)(1)(iv) of this section.

(*3*) Third, from other income to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years.

(*4*) Finally, from trust corpus (with corpus defined for this purpose as the net fair market value of the trust assets less the total undistributed income (but not loss) in paragraphs (d)(1)(i)(*a*)(*1*) through (*3*) of this section).

(*b*) If the trust has different classes of income in the ordinary income category, the distribution from that category is treated as being made from each class, in turn, until exhaustion of the class, 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. If the trust has different classes of net gain in the capital gains category, the distribution from that category is treated as being made first from the short-term capital gain class and then from each class of long-term capital gain, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. If two or more classes within the same category are subject to the same current tax rate, but at least one of those classes will be subject to a different tax rate in a future year (for example, if the current rate sunsets), the order of that class in relation to other classes in the category with the same current tax rate is determined based on the future rate or rates applicable to those classes. Within each category, if there is more than one type of income in a class, amounts treated as distributed from that class are to be treated as consisting of the same proportion of each type of income as the total of the current and undistributed income of that type bears to the total of the current and undistributed income of all types of income included in that class. For example, if rental income and interest income are subject to the same current and future Federal income tax rate and, therefore, are in the same class, a distribution from that class will be treated as consisting of a proportional amount of rental income and interest income.

(iii) *Treatment of losses at the trust level*—(*a*) *Ordinary income category*. A net ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years that is assigned to the same class as the loss. Any excess loss is then used to reduce the current and undistributed ordinary income from other classes, in turn, 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. If any of the loss exists after all the current and undistributed ordinary income from all classes has been offset, the excess is carried forward indefinitely to reduce ordinary income for future years and retains its class assignment. For purposes of this section, the amount of current income and prior years' undistributed income shall be computed without regard to the deduction for net operating losses provided by section 172 or 642(d).

(*b*) *Other income category*. A net loss in the other income category for the current year is used to reduce undistributed income in this category for prior years and any excess is carried forward indefinitely to reduce other income for future years.

(iv) *Netting of capital gains and losses at the trust level*. Capital gains of the trust are determined on a cumulative net basis under the rules of this paragraph (d)(1) without regard to the provisions of section 1212. For each taxable year, current and undistributed gains and losses within each class are netted to determine the net gain or loss for that class, and the classes of capital gains and losses are then netted against each other in the following order. First, a net loss from a class of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) is used to offset net gain from each other class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Second, either —

(*a*) A net loss from all the classes of long-term capital gain and loss (beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate) is used to offset any net gain from the class of short-term capital gain and loss; or

(b) A net loss from the class of short-term capital gain and loss is used to offset any net gain from each class of long-term capital gain and loss, in turn, until exhaustion of the class, 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.

(v) *Carry forward of net capital gain or loss by the trust*. If, at the end of a taxable year, a trust has, after the application of paragraph (d)(1)(iv) of this section, any net loss or any net gain that is not treated as distributed under paragraph (d)(1)(ii)(*a*)(*2*) of this section, the net gain or loss is carried over to succeeding taxable years and retains its character in succeeding taxable years as gain or loss from its particular class.

(vi) *Special transitional rules*. To be eligible to be included in the class of qualified dividend income, dividends must meet the definition of section 1(h)(11) and must be received by the trust after December 31, 2002. Long-term capital gain or loss properly taken into account by the trust before January 1, 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss properly taken into account by the trust on or after January 1, 1997, and before May 7, 1997, if not treated as distributed in 1997, is included in the class of all other long-term capital gains and losses. Long-term capital gain or loss (other than 28-percent gain (gains and losses from collectibles and section 1202 gains), unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation), and qualified 5-year gain as defined in section 1(h)(9) prior to amendment by JGTRRA), properly taken into account by the trust before January 1, 2003, and distributed during 2003 is treated as if it were properly taken into account by the trust after May 5, 2003. Long-term capital gain or loss (other than 28-percent gain, unrecaptured section 1250 gain, and qualified 5-year gain), properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if not treated as distributed during 2003, is included in the class of all other long-term capital gain. Qualified 5-year gain properly taken into account by the trust after December 31, 2000, and before May 6, 2003, if not treated as distributed by the trust in 2003 or a prior year, must be maintained in a separate class within the capital gains category until distributed. Qualified 5-year gain properly taken into account by the trust before January 1, 2003, and deemed distributed during 2003 is subject to the same current tax rate as deemed distributions from the class of all other long-term capital gain realized by the trust after May 5, 2003. Qualified 5-year gain properly taken into account by the trust on or after January 1, 2003, and before May 6, 2003, if treated as distributed by the trust in 2003, is subject to the tax rate in effect prior to the amendment of section 1(h)(9) by JGTRRA.

(vii) *Application of section 643(a)(7)*. For application of the anti-abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see §1.643(a)–8.

(viii) *Examples*. The following examples illustrate the rules in this paragraph (d)(1):

Example 1. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2003. The annual annuity amount is $100. X's income for the 2003 tax year is as follows:

Interest income	$80
Qualified dividend income	50
Capital gains and losses	0
Tax-exempt income	0

(ii) In 2003, the year this income is received by the trust, qualified dividend income is subject to a different rate of Federal income tax than interest income and is, therefore, a separate class of income in the ordinary income category. The annuity amount is deemed to be distributed from the classes within the ordinary income category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Because during 2003 qualified dividend income is taxed at a lower rate than interest income, the interest income is deemed distributed prior to the qualified dividend income. Therefore, in the hands of the recipient, the 2003 annuity amount has the following characteristics:

Interest income	$80
Qualified dividend income	20

(iii) The remaining $30 of qualified dividend income that is not treated as distributed to the recipient in 2003 is carried forward to 2004 as undistributed qualified dividend income.

Example 2. (i) The facts are the same as in *Example 1*, and at the end of 2004, X has the following classes of income:

Interest income class	$ 5
Qualified dividend income class	40
($10 from 2004 and $30 carried forward from 2003)	
Net short-term capital gain class	15
Net long-term capital loss in 28-percent class	(325)
Net long-term capital gain in unrecaptured section 1250 gain class	175
Net long-term capital gain in all other long-term capital gain class	350

(ii) In 2004, gain in the unrecaptured section 1250 gain class is subject to a 25-percent Federal income tax rate, and gain in the all other long-term capital gain class is subject to a lower rate. The net long-term capital loss in the 28-percent gain class is used to offset the net capital gains in the other classes of long-term capital gain and loss, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The $325 net loss in the 28-percent gain class reduces the $175 net gain in the unrecaptured section 1250 gain class to $0. The remaining $150 loss from the 28-percent gain class reduces the $350 gain in the all other long-term capital gain class to $200. As in *Example 1*, qualified dividend income is taxed at a lower rate than interest income during 2004. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2004 annuity amount has the following characteristics:

Interest income	$ 5
Qualified dividend income	40
Net short-term capital gain	15
Net long-term capital gain in all other long-term capital gain class	40

(iii) The remaining $160 gain in the all other long-term capital gain class that is not treated as distributed to the recipient in 2004 is carried forward to 2005 as gain in that same class.

Example 3. (i) The facts are the same as in *Examples 1* and *2*, and at the end of 2005, X has the following classes of income:

Interest income class	$ 5
Qualified dividend income class	20
Net loss in short-term capital gain class	(50)
Net long-term capital gain in 28-percent gain class	10
Net long-term capital gain in unrecaptured section 1250 gain class	135
Net long-term capital gain in all other long-term capital gain class (carried forward from 2004)	160

(ii) There are no long-term capital losses to net against the long-term capital gains. Thus, the net short-term capital loss is used to offset the net capital gains in the classes of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The $50 net short-term loss reduces the $10 net gain in the 28-percent gain class to $0. The remaining $40 net loss reduces the $135 net gain in the unrecaptured section 1250 gain class to $95. As in *Examples 1* and *2*, during 2005, qualified dividend income is taxed at a lower rate than interest income; gain in the unrecaptured section 1250 gain class is taxed at 25 percent; and gain in the all other long-term capital gain class is taxed at a rate lower than 25 percent. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. Therefore, in the hands of the recipient, the 2005 annuity amount has the following characteristics:

Interest income	$ 5
Qualified dividend income	20
Unrecaptured section 1250 gain	75

(iii) The remaining $20 gain in the unrecaptured section 1250 gain class and the $160 gain in the all other long-term capital gain class that are not treated as distributed to the recipient in 2005 are carried forward to 2006 as gains in their respective classes.

Example 4. (i) The facts are the same as in *Examples 1*, *2* and *3*, and at the end of 2006, X has the following classes of income:

Interest income class	$ 95
Qualified dividend income class	10
Net loss in short-term capital gain class	(20)
Net long-term capital loss in 28-percent class	(350)
Net long-term capital gain in unrecaptured section 1250 gain class (carried forward from 2005)	20
Net long-term capital gain in all other long-term capital gain class (carried forward from 2005)	160

(ii) A net long-term capital loss in one class is used to offset the net capital gains in the other classes of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. The $350 net loss in the 28-percent gain class reduces the $20 net gain in the unrecaptured section 1250 gain class to $0. The remaining $330 net loss reduces the $160 net gain in the all other long-term capital gain class to $0. As in *Examples 1*, *2* and *3*, during 2006, qualified dividend income is taxed at a lower rate than interest income. The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In the hands of the recipient, the 2006 annuity amount has the following characteristics:

Interest income	$95
Qualified dividend income	5

(iii) The remaining $5 of qualified dividend income that is not treated as distributed to the recipient in 2006 is carried forward to 2007 as qualified dividend income. The $20 net loss in the short-term capital gain class and the $170 net loss in the 28-percent gain class are carried forward to 2007 as net losses in their respective classes.

Example 5. (i) X, a charitable remainder annuity trust described in section 664(d)(1), is created on January 1, 2002. The annual annuity amount is $100. Except for qualified 5-year gain of $200 realized before May 6, 2003, but not distributed, X has no other gains or losses carried over from former years. X's income for the 2007 tax year is as follows:

Interest income class	$10
Net gain in short-term capital gain class	5
Net long-term capital gain in 28-percent gain class	5
Net long-term capital gain in unrecaptured section 1250 gain class	10
Net long-term capital gain in all other long-term capital gain class	10

(ii) The annuity amount is deemed to be distributed from all the classes in the ordinary income category and then from the classes in the capital gains category, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest rate. In 2007, gains distributed to a recipient from both the qualified 5-year gain class and the all other long-term capital gains class are taxed at a 15/5 percent tax rate. Since after December 31, 2008, gains distributed from the qualified 5-year gain class will be taxed at a lower rate than gains distributed from the other classes of long-term capital gain and loss, distributions from the qualified 5-year gain class are made after distributions from the other classes of long-term capital gain and loss. In the hands of the recipient, the 2007 annuity amount has the following characteristics:

Interest income	$10
Short-term capital gain	5
28-percent gain	5
Unrecaptured section 1250 gain	10
All other long-term capital gain	10
Qualified 5-year gain (taxed as all other long-term capital gain)	60

(iii) The remaining $140 of qualified 5-year gain that is not treated as distributed to the recipient in 2007 is carried forward to 2008 as qualified 5-year gain.

(ix) *Effective dates*. The rules in this paragraph (d)(1) that require long-term capital gains to be distributed in the following order: first, 28-percent gain (gains and losses from collectibles and section 1202 gains); second, unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and then, all other long-term capital gains are applicable for taxable years ending on or after December 31, 1998. The rules in this paragraph (d)(1) that provide for the netting of capital gains and losses are applicable for taxable years ending on or after December 31, 1998. The rule in the second sentence of paragraph (d)(1)(vi) of this section is applicable for taxable years ending on or after December 31, 1998. The rule in the third sentence of paragraph (d)(1)(vi) of this section is applicable for distributions made in taxable years ending on or after December 31, 1998. All other provisions of this paragraph (d)(1) are applicable for taxable years ending after November 20, 2003.

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Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved March 10, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury.

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