Client Alert

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Year-End Tax Saving Move for Charitable Remainder Trusts

2012 Gains Insulated from 3.8% Tax on Investment Income When Distributed

By taking quick action in the remaining weeks of 2012, a charitable remainder trust may be able to reduce its income beneficiaries' tax liability for future distributions.

Beginning in 2013, many high-bracket taxpayers will be subject to a 3.8% surtax on their net investment income, such as interest, dividends and capital gains. The tax will be levied not only on income they earn personally but also on income that a trust or other entity earns and distributes to them.

Charitable remainder unitrusts and annuity trusts themselves are exempt from income tax. Their income, however, retains its character as ordinary income, capital gain or tax-free income when distributed to individual beneficiaries. Thus a beneficiary of a charitable remainder trust could pay an extra 3.8% tax on any post-2012 distribution of trust investment income.

The Treasury Department recently issued proposed regulations interpreting the new surtax rules. The regulations declare that investment income a trust realizes in 2012, before the new tax applies, will not be subject to the extra 3.8% tax when distributed to a trust beneficiary in a later year. This allows charitable remainder trusts with significant unrealized capital gains to "harvest" gains before the end of 2012 and protect those gains from surtax liability regardless of when they are distributed to beneficiaries. Trustees also may wish to postpone recognizing investment losses until 2013 or later so that they can be used to shield additional investment income from the 3.8% surtax.

Note that this technique will produce actual tax savings only when — and to the extent that — post-2012 distributions exceed current and accumulated income, so that the trust is deemed to be distributing capital gains. Even then, the regulations will treat trust distributions as carrying out all post-2012 gains before any harvested in 2012.

Depending on the payout rate and investment mix of a particular trust, prompt action by the trustee this year could protect substantial amounts of current capital gains from surtax liability in later years. This potential tax saving, of course, is only one factor for trustees to consider in making year-end decisions about charitable remainder trust investments.

For more information about this year-end planning opportunity, please contact ….

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