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The four tiers of income are IRS tax reporting rules that dictate the order in which a charitable remainder trust must distribute the four types of income when fulfilling payments to its income beneficiaries.

The order is as follows:

1. Ordinary income to the extent the trust has current ordinary income and past undistributed ordinary income.
2. Capital gain income to the extent the trust has current capital gain income and past undistributed capital gain income.
3. Tax-free income to the extent the trust has current tax-free income and past undistributed tax-free income.
4. Return of principal.

Note: [Final regulations](#) make clear that the IRS holds the following view: within the ordinary income and capital gain income 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.

As a result, the “four” tiers of income really look like “eight” tiers:

1. 35% ordinary income
2. 15% qualified dividends
3. 35% short term capital gain income

4. 28% capital gain income on sale of collectibles
5. 25% capital gain income on sale of real property that is attributable to depreciation recapture
6. 15% capital gain income on sale of securities
7. Tax-free income
8. Return of principal

Example

A 5% charitable remainder unitrust is funded with stock valued at \$100,000 that has a cost basis of \$20,000. The trustee sells the funding asset immediately, realizing \$80,000 in capital gain, then reinvests the proceeds in a diversified portfolio. At the end of the year, the trust has earned \$1,000 of qualified dividends and \$2,000 of interest, but must distribute \$5,000 to the income beneficiaries. The income beneficiaries will have to declare their income as follows:

\$2,000 ordinary income

\$1,000 qualified dividends

\$2,000 capital gain income

Even though the trustee had to sell \$2,000 of assets at the end of the year to have enough cash to write the \$5,000 check, none of the distribution is return of principal. The trust must distribute all \$80,000 of the capital gain realized when it sold its funding asset before it can distribute any tax-free income or return of principal.

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