

ington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-114841-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Laura Howell, (202) 622-3060; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Michael L. Slaughter, Jr., (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Prior to amendment by Section 1307 of the Taxpayer Relief Act of 1997, Public Law 105-34, August 5, 1997, (TRA 1997), section 663(c) of the Internal Revenue Code (Code) provided that, for the purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries (or classes of beneficiaries) of the trust shall be treated as separate trusts. The application of the separate share rule is mandatory where separate shares exist. Section 1.663(c)-1(d) and H.R. Conf. Rep. No. 2014, 105th Cong. 1st Sess. 712-13 and fn. 18.

Section 1307 of TRA 1997 amended section 663(c) of the Code by extending the separate share rule to estates. Prior to this amendment, a distribution to an estate beneficiary in the ordinary course of administration often resulted in the beneficiary being taxed on a disproportionate share of the estate's income. The extension of the separate share rule to estates promotes fairness by more rationally allo-

cating the income of the estate among the estate and its beneficiaries thereby reducing the distortion that may occur when a disproportionate distribution of estate assets is made to one or more estate beneficiaries in a year when an estate has distributable net income. Under the separate share rule, a beneficiary is taxed only on the amount of income that belongs to that beneficiary's separate share.

In addition, section 1305 of TRA 1997 added section 645 to the Code (originally enacted as section 646 and redesignated as section 645 by the Internal Revenue Service Restructuring and Reform Act of 1998). Under section 645, both the executor (if any) of an estate and the trustee of a qualified revocable trust may elect to treat the revocable trust as part of the decedent's probate estate for income tax purposes. The legislative history for section 1305 provides that the separate share rule applicable to estates will apply when a qualified revocable trust elects to be treated as part of the decedent's estate.

Explanation of Provisions

The proposed regulations conform the current regulations to the statutory changes. In addition, the proposed regulations address two specific matters involving separate share treatment of interests in estates: the treatment of the spousal elective share and the treatment of an electing revocable trust under section 645 of the Code.

General Separate Share Rule

If an estate has multiple beneficiaries, substantially separate and independent shares of different beneficiaries (or classes of beneficiaries) are to be treated as separate estates only for purposes of computing distributable net income. There are separate shares in an estate when the governing instrument of the estate and applicable local law create separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by the economic interests accruing to another separate beneficiary or class of beneficiaries. Thus, there are separate shares in an estate when a beneficiary or class of

Notice of Proposed Rulemaking and Notice of Public Hearing

Separate Share Rules Applicable to Estates

REG-114841-98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide that substantively separate and independent shares of different beneficiaries are to be treated as separate estates for purposes of computing the distributable net income. These proposed regulations also provide that a surviving spouse's statutory elective share of a decedent's estate is a separate share. Further, a revocable trust that elects to be treated as part of a decedent's estate is a separate share. Section 1307 of the Taxpayer Relief Act of 1997 amended section 663 of the Internal Revenue Code by extending the separate share rules to estates. These proposed regulations affect estates of decedents. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by April 6, 1999. Outlines of topics to be discussed at the public hearing scheduled for April 22, 1999, at 10 a.m. must be received by April 1, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-114841-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Wash-

beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has in the decedent's estate. The application of the separate share rule to estates is mandatory where separate shares exist. The separate share rule requires that the estate's income and deductions be allocated among the separate shares as if they were separate estates. The section 661 deduction to the estate and the section 662 inclusion in the gross income of the beneficiary are limited by the distributable net income allocable to each separate share.

These proposed regulations do not change the rules involving specific gifts and bequests described in section 663(a).

Surviving Spouse's Elective Share

Most non-community property states have some form of elective share statute which replaces common law dower and curtesy (the common law protection for surviving spouses). Generally, an elective share statute gives the surviving spouse the right to claim a share of the deceased spouse's estate if the surviving spouse is disinherited or dissatisfied with what the spouse would have received under the will or otherwise. In most states the elective share consists of a fraction, ranging from one-fourth to one-half of the decedent's estate. Elective share statutes vary as to when the share vests and whether the share includes a portion of the estate income, as well as whether the share participates in the appreciation or depreciation of the estate's assets.

Rev. Rul. 64-101 (1964-1 C.B. 77) addresses the Florida statutory dower interest which, at the time of the revenue ruling, entitled the widow to the dower interest and mesne profits thereon. The ruling holds that the value of assets transferred to the widow as dower is not a distribution to a beneficiary subject to sections 661(a) and 662(a) of the Code. Instead, the transfer of assets is governed by section 102.

Rev. Rul. 71-167 (1971-1 C.B. 163) modifies Rev. Rul. 64-101 by holding that the amount distributed to the widow representing mesne profits is subject to sections 661(a) and 662(a) of the Code. Therefore, an amount corresponding to

the allowable deduction to the estate under section 661(a) is includible in the gross income of the widow under section 662(a).

Recently, two cases, *Deutsch v. Commissione r*, TCM 1997-470, and *Brigham v. United States* 983 F. Supp. 46, (D. Mass. 1997), have addressed how to treat payments to the surviving spouse in satisfaction of the spouse's elective share amount. In *Deutsch* the surviving spouse elected to take against the decedent's will as provided by the Florida elective share statute. Under the statute, the surviving spouse was entitled to 30 percent of the net estate based upon date of death values, but was not entitled to any income of the estate, and did not participate in appreciation or depreciation of the estate assets. The Tax Court, noting Rev. Rul. 64-101, held that payments to the surviving spouse in satisfaction of her elective share amount were not subject to sections 661(a) and 662(a). Rather, the payments were governed by section 102.

In *Brigham*, the surviving spouse elected to take against the decedent's will as provided by the New Hampshire elective share statute. Under the statute, the surviving spouse was entitled to one-third of the personalty and one-third of the real estate. The court held that the payments made to the surviving spouse in satisfaction of her elective share amount were subject to sections 661(a) and 662(a). Thus, the court held that all of the estate's distributable net income was taxable to the surviving spouse because she was the only beneficiary to receive a distribution for the year in question and her distribution exceeded the amount of the estate's distributable net income.

In light of the uncertainty concerning the proper treatment of payments in satisfaction of a surviving spouse's elective share, and also given that Rev. Ruls. 64-101 and 71-167 are outdated because dower has been replaced by elective share statutes in most states, the Internal Revenue Service and Treasury have concluded that regulatory guidance is needed to provide uniform treatment.

These proposed regulations provide that the surviving spouse's elective share constitutes a separate share of the estate for the sole purpose of determining the

amount of distributable net income in application of sections 661(a) and 662(a). Therefore, only the income that is (1) allocable to the surviving spouse's separate share for a taxable year, and (2) distributed to the surviving spouse in satisfaction of the elective share will be treated as a distribution subject to sections 661(a) and 662(a). This approach results in the surviving spouse being taxed on the estate's income earned during administration only to the extent of the surviving spouse's right to share in the estate's income under state law. Comments are requested on whether there are situations in which an elective share or dower interest would not be a separate share under the separate economic interest test set forth in the proposed regulations.

Electing Revocable Trust To Be a Part Of Estate

These proposed regulations provide that a qualified revocable trust that elects to be treated as part of the decedent's estate constitutes a separate share for the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662. A separate proposed regulation project will provide further guidance concerning qualified revocable trusts that are treated as part of an estate.

Proposed Effective Date

These regulations apply to estates of decedents dying after the date that the Treasury decision adopting these rules as final regulations is published in the **Federal Register**.

Effect on Other Documents

When these regulations are finalized, Rev. Rul. 64-101 (1964-1 C.B. 77) and Rev. Rul. 71-167 (1971-1 C.B. 163) will be obsolete.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12886. 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 the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulation and how it may be made easier to understand. All comments will be available for public inspection and copying. We especially request comments concerning the treatment of pecuniary bequests (including formula pecuniary bequests) as separate shares.

A public hearing has been scheduled for April 22, 1999, beginning at 10 a.m. The hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by April 6, 1999, and submit an outline of topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 1, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of

the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Laura Howell of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.663(c)–1 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–2 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–3 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–4 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–5 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–6 also issued under 26 U.S.C. 663(c). * * *

Par. 2. Section 1.663(c)–1 is amended as follows:

1. The section heading is revised.
2. The first sentence of paragraph (a) is amended by removing the language "trust" and adding the language "trust (or estate)" in its place and removing the language "trusts" and adding the language "trusts (or estates)" in its place. The second sentence of paragraph (a) is amended by removing the language "trusts" and adding the language "trusts (or estates)" in its place.
3. Paragraph (b)(2) is removed.
4. Paragraphs (b)(3) and (b)(4) are redesignated as paragraphs (b)(2) and (b)(3).
5. Paragraph (b) introductory text, is amended by removing the language "trusts" and adding the language "trusts (or estates)" each place it appears.

6. Paragraph (c) and the last sentence of paragraph (d) are amended by removing the language "trust" and adding the language "trust (or estate)" in its place.

The revision reads as follows:

§1.663(c)–1 Separate shares treated as separate trusts or as separate estates; in general.

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Par. 3. Section 1.663(c)–2 is revised to read as follows:

§1.663(c)–2 Computation of distributable net income.

The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust or estate. Accordingly, any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate.

Par. 4. Section 1.663(c)–3 is amended by revising the section heading and removing paragraph (f) to read as follows:

§1.663(c)–3 Applicability of separate share rule to trusts.

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§1.663(c)–4 [Redesignated as §1.663(c)–5]

Par. 5. Section 1.663(c)–4 is redesignated as §1.663(c)–5 and a new §1.663(c)–4 is added to read as follows:

§1.663(c)–4 Applicability of separate share rule to estates.

(a) *General rule.* The applicability of the separate share rule to estates provided by section 663(c) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries are not affected by economic interests accruing to another beneficiary or class of beneficiaries. A separate share should be allocated only the share of the estate's income and deductions that the beneficiary (or beneficiaries) of such separate share is (or are) entitled to (if any) under the terms of the governing instrument or local law.

The separate share rule does not affect rules under section 663(a) concerning specific gifts and bequests.

(b) *Examples of separate shares* . Separate shares include—

(1) A surviving spouse's elective share;
(2) A revocable trust that elects to be part of the decedent's estate under section 645;

(3) The residuary estate, or some portion of the residuary estate, if the requirements of paragraph (a) of this section are met; and

(4) A gift or bequest of a specific sum of money or of specific property that is paid or credited in more than three installments, if the requirements of paragraph (a) of this section are met.

(c) *Shares with multiple beneficiaries and beneficiaries of multiple shares* . A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.

Par. 6. Newly designated §1.663(c)-5 is amended by:

1. Revising the section heading and introductory text.

2. Redesignating the "Example" as "Example 1" and redesignating paragraphs (a), (b), (c), (d), and (e) in newly designated Example 1 as paragraphs (i), (ii), (iii), (iv), and (v).

3. Adding Example 2, Example 3 and Example 4

The revisions and addition read as follows:

§1.663(c)-5 Examples.

Section 663(c) may be illustrated by the following examples:

Example 1 ***

Example 2 (i) *Facts* . (A) Testator died domiciled in State X on January 30, 1999, leaving an estate of \$40,000,000 after debts, expenses, and estate taxes, and survived by a spouse and three adult children from a previous marriage. Testator's will directed the executrix to pay the surviving spouse \$1,000,000 in cash and divide the residue, after payment of debts, expenses, and estate taxes, equally among Testator's three children.

(B) The surviving spouse filed an election under State X's elective share statute. The court determined that the surviving spouse's election was valid and ordered the executrix to pay the elective share. Under State X's elective share statute, a surviving spouse is entitled to one-fourth of a decedent's estate after debts, expenses, and estate taxes if the decedent had children. Further, the surviving spouse is entitled to a proportional amount of the estate net income and participates proportionally in appreciation or depreciation of the estate's assets.

(C) The executrix elected the calendar year for the estate. On June 30, 1999, the executrix distributed \$5,000,000 to the surviving spouse in partial satisfaction of the elective share. During the 1999 taxable year, the estate received dividend income of \$2,000,000 and paid expenses of \$50,000. For the 1999 taxable year, the value of the estate neither appreciated nor depreciated. The executrix made no other distributions during the 1999 taxable year.

(ii) *Holding* . Separate share treatment applies to each of the three residuary bequests, and to the surviving spouse's elective share.

(iii) *Application* . (A) After determining the income and expenses for the estate, the executrix allocated a portion of the income and expenses to each separate share based upon each share's percentage of the estate. Thus, while the surviving spouse's elective share initially constituted 25% of the estate, after the partial distribution of \$5,000,000 made on June 30, 1999, the elective share constituted a smaller percentage of the estate. Accordingly, the percentage of the estate's income and expenses allocated to the elective share after June 30, 1999, was correspondingly reduced in accordance with the executrix's determination of the proper allocation of income and expenses to the elective share.

(B) For the 1999 taxable year, the estate is treated as having distributed to the surviving spouse the distributable net income that was allocated to the elective share. In accordance with section 662, the surviving spouse must include in gross income for the 1999 taxable year an amount equal to the distributable net income allocated to the surviving spouse's separate share and distributed to the surviving spouse for the 1999 taxable year. The estate will, accordingly, be allowed a deduction under section 661 for the amount of distributable net income allocated to the elective share and distributed to the surviving spouse.

Example 3 (i) *Facts* . (A) Assume the same facts as in Example 2 except that Testator died domiciled in State Y leaving an estate of \$60,000,000 after debts, expenses, and estate taxes. Under State Y's elective share statute, the surviving spouse is entitled to the date of death value of one-third of the decedent's estate after debts, expenses, and taxes. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. Further, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the executrix to make payments.

(B) The executrix elected the calendar year for the estate. During the 1999 taxable year, the estate received dividend income of \$3,000,000, and paid administration expenses of \$60,000 and paid the sur-

ving spouse \$1,000,000 of interest payments on the elective share. Also, during the 1999 taxable year, the executrix distributed \$5,000,000 to the surviving spouse in partial satisfaction of the elective share. The executrix made no other distributions during the 1999 taxable year.

(ii) *Holding* . Separate share treatment applies to each of the three residuary bequests and to the surviving spouse's elective share.

(iii) *Application* . The distributable net income of each child's residuary bequest is \$980,000 (a 33.33% share of estate income less a 33.33% share of estate expenses). Because the surviving spouse was not entitled to any estate income under state law, no income is allocated to the spouse's separate share. The distribution in satisfaction of the spouse's elective share does not consist of any distributable net income and is not included in the spouse's gross income under section 662. The \$1,000,000 of interest payment to the surviving spouse must be included in gross income of the spouse under section 61. Therefore, the estate is treated as having distributed to the surviving spouse \$5,000,000 of amounts other than 1999 estate income. Accordingly, the estate is not allowed a deduction under section 661 for the distribution made to the surviving spouse. The taxable income of the estate for the 1999 taxable year is \$2,939,400 (\$3,000,000 (dividend income) minus \$60,000 (expenses) and \$600 (personal exemption)). The \$1,000,000 interest payment is a nondeductible personal interest expense described in section 163(h).

Example 4 (i) *Facts* . (A) Testator died domiciled in State Z on February 14, 1999, survived by a spouse and two children. Testator's will contains a nonproportional funding fractional formula marital bequest for the surviving spouse with a residuary credit shelter trust for the lifetime benefit of the surviving spouse, and remainder to the two children on the surviving spouse's death. The date of death value of the estate is \$1,650,000.

(B) The executrix elected the calendar year for the estate. Under the fractional formula, the marital bequest constitutes 60% of the estate and the credit shelter trust constitutes 40% of the estate. Accordingly, the executrix claims a marital deduction of \$990,000 on the estate tax return for the amount passing to the spouse under the fractional formula. On December 31, 1999, the executrix made a partial proportionate distribution of \$1,000,000, \$600,000 to the surviving spouse outright and \$400,000 to the credit shelter trust. As of December 31, 1999, prior to the distribution, the value of Testator's estate had appreciated to \$2,000,000.

(C) During the 1999 taxable year, the estate made no other distributions, received dividend income of \$20,000, and paid expenses of \$8,000.

(ii) *Holding* . Separate share treatment applies to the fractional formula marital bequest and the credit shelter trust.

(iii) *Application* . (A) Because Testator provided for a fractional formula marital bequest in the will, the income and any appreciation in the value of the estate assets is proportionately allocated between the marital bequest share and the credit shelter trust share. Therefore, the distributable net income must be allocated 60% for the marital separate share and 40% for the credit shelter separate share.

(B) The distributable net income allocable to the marital share is \$7,200 (60% of estate income less 60% of estate expenses). Correspondingly, the distributable net income allocable to the credit shelter share is \$4,800 (40% of estate income less 40% of estate expenses). Because the \$600,000 amount distributed in partial satisfaction of the marital bequest exceeds the distributable net income of \$7,200 allocated to the marital share, the estate is treated as having distributed to the surviving spouse \$7,200 of 1999 distributable net income and \$592,800 of other amounts. Similarly, because the \$400,000 distributed in partial satisfaction of the amount payable to the credit shelter trust exceeds the distributable net income of \$4,800 allocated to the credit shelter trust share, the estate is treated as having distributed to the credit shelter trust \$4,800 of 1999 distributable net income and \$395,200 of other amounts. Accordingly, the estate is allowed a deduction of \$12,000 under section 661 for the 1999 taxable year. The taxable income of the estate is \$0, computed as follows:

Dividends	\$20,000
Deductions:	
Distribution to surviving spouse share	\$7,200
Distribution to credit shelter trust share	4,800
Expenses	8,000
Personal exemption	600
	<u>20,600</u>
	(600)

(C) In accordance with section 662, the surviving spouse must include in gross income for the 1999 taxable year an amount equal to the distributable net income of the marital bequest share (\$7,200) that was distributed to the surviving spouse. The credit shelter trust must include in gross income for the 1999 taxable year an amount equal to the distributable net income of the credit shelter trust share (\$4,800) that was distributed to the credit shelter trust.

Par. 7. Section 1.663(c)-6 is added to read as follows:

§1.663(c)-6 Effective date.

Sections 1.663(c)-1 through 1.663(c)-5 concerning the application of the separate share rules to estates apply to estates of decedents dying after the final regulations are published in the **Federal Register**.

Robert E. Wenzel,
*Deputy Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on January 5, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1999, 64 F.R. 790)