

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Definition of Income for Trust Purposes

### REG-106513-00

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations revising the definition of income under section 643(b) of the Internal Revenue Code to take into account changes in the definition of trust accounting income under state laws. The proposed regulations also clarify the situations in which capital gains are included in distributable net income under section 643(a)(3). Conforming amendments are made to regulations affecting ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction, and trusts that are exempt from generation-skipping transfer taxes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by May 18, 2001. Outlines of topics to be discussed at the public hearing scheduled for June 8, 2001 must be received by May 18, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-106513-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-106513-00), 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/tax\\_regs/regslst.html](http://www.irs.ustreas.gov/tax_regs/regslst.html). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bradford Poston at (202) 622-3060 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, 202-622-8452 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

Section 643(b) provides a definition of the term income for purposes of subparts A through D of part I of subchapter J of the Internal Revenue Code (Code). The term *income*, when not modified by any other term, means the amount of income of the trust or estate determined under the terms of the governing instrument and applicable local law. Section 1.643(b)-1 further provides that trust provisions that depart fundamentally from the concepts of local law in determining what constitutes income will not be recognized.

These statutory and regulatory provisions date back to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiary while capital gains were allocated to the principal of the trust. Changes in the types of available investments and in investment philosophies have caused states to revise, or to consider revising, these traditional concepts of income and principal.

The prudent investor standard for managing trust assets has been enacted by many states and encourages fiduciaries to adopt an investment strategy designed to maximize the total return on trust assets. Under this investment strategy, trust assets should be invested for total positive return, that is, ordinary income plus appreciation, in order to maximize the value of the trust. Thus, under certain economic circumstances, equities, rather than bonds, would constitute a greater portion of the trust assets than they would under traditional investment standards.

One of the concerns with shifting trust investments toward equities and away from bonds is the potential adverse impact on the income beneficiary. Based on the traditional concepts of income and principal, the income beneficiary is entitled only to the dividends and interest

earned by the trust assets. The dividend return on equities as a percentage of their value traditionally has been substantially less than the interest return on bonds.

To ensure that the income beneficiary is not penalized if a trustee adopts a total return investment strategy, many states have made, or are considering making, revisions to the definitions of income and principal. Some state statutes permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiary are treated impartially, based on what is fair and reasonable to all of the beneficiaries. Thus, a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially. Conversely, a receipt of dividends or interest that previously would have been allocated to income may be allocated by the trustee to principal if necessary to treat both parties impartially.

Other states are proposing legislation that would allow the trustee to pay a unitrust amount to the income beneficiary in satisfaction of that beneficiary's right to the income from the trust. This unitrust amount will be a fixed percentage, sometimes required to be within a range set by state statute, of the fair market value of the trust assets determined annually.

Questions have arisen concerning how these state statutory changes affect the definition of income provided in section 643(b) and the other Code provisions that rely on the section 643(b) definition of income. This definition of income affects trusts including, but not limited to, ordinary trusts, charitable remainder trusts, pooled income funds, and qualified subchapter S trusts.

In addition, trusts that qualify for the gift or estate tax marital deduction must pay to the spouse all the income from the property. All the income is considered paid to the spouse if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property that the principles of trust law accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Section 25.2523(e)-1(f) of the Gift Tax Regulations and §20.2056(b)-5(f) of the Estate Tax Regulations. Questions have arisen whether the spouse is entitled

to all the income from the property in a state that permits equitable adjustments or unitrust payments.

Similarly, questions have arisen as to whether an otherwise exempt trust which uses equitable adjustments or unitrust payments will be subject to the generation-skipping transfer tax provisions of chapter 13 of the Code.

## Explanation of provisions

### *Definition of Income*

The proposed regulations will amend the definition of income under §1.643(b)-1 to take into account certain state statutory changes to the concepts of income and principal. Under the proposed regulations, trust provisions that depart fundamentally from traditional concepts of income and principal (that is, allocating ordinary income to income and capital gains to principal) will generally continue to be disregarded, as they are under the current regulations. However, amounts allocated between income and principal pursuant to applicable state law will be respected if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation. For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is a reasonable apportionment of the total return of the trust.

In addition, an allocation of capital gains to income will be respected under certain circumstances. Such an allocation will be respected if directed by the terms of the governing instrument and applicable local law. Similarly, if a trustee, pursuant to a discretionary power granted to the trustee by local law or by the governing instrument (if not inconsistent with local law), allocates capital gains to income, the allocation will be respected, provided the power is exercised in a reasonable and consistent manner.

The proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially. At the same time, the limitations imposed by the proposed regulations ensure that the Code provisions relying on the definition of income under section 643(b) are not undermined by an unlimited ability of the trustee to allocate between income and principal.

### *Pooled Income Funds*

A special rule is proposed to be added to the regulations covering pooled income funds to address the problems arising from the potential application of the new state statutes to these funds. A pooled income fund as defined in section 642(c)(5) is a split-interest trust created and maintained by certain types of charitable organizations. Noncharitable beneficiaries receive the income from the commingled fund during their lives and the charitable organization receives the remainder interests. The income that is to be paid to the noncharitable beneficiaries is income as defined in section 643(b). §1.642(c)-5(i).

A pooled income fund is a trust subject to taxation under section 641. It is entitled to a distribution deduction under section 661 for income distributed to the noncharitable beneficiaries. In addition, it receives a charitable deduction under section 642(c)(3) for any amount of net long-term capital gain which pursuant to the terms of the governing instrument is permanently set aside for charitable purposes. A pooled income fund is taxed on any net short-term capital gain that is not required to be distributed to the income beneficiaries pursuant to the terms of the governing instrument and applicable local law.

Under traditional principles of income and principal, ordinary income would be paid to the income beneficiaries. Any net long-term capital gain would be allocated to principal to be held for the ultimate benefit of the charitable remainderman and therefore would qualify for the charitable deduction under section 642(c)(3).

If a pooled income fund were to pay the income beneficiaries a unitrust amount in satisfaction of their right to income, as provided by proposed state statutes, long-term capital gains would no longer qual-

ify for the charitable deduction. Any net long-term capital gain not required to be distributed during the current year would be added to principal. However, the amount of the gain would not be permanently set aside for charitable purposes because this amount may be used in the future to make the unitrust payment to the income beneficiaries. A similar situation arises if the trustee is permitted under state law to make equitable adjustments with respect to unrealized appreciation in the value of the trust assets. A portion of any subsequently realized capital gain may already have been treated as distributed to the income beneficiaries in accordance with an equitable adjustment distribution.

The proposed regulations will amend §1.642(c)-2(c) to address these issues for pooled income funds. Thus, no net long-term capital gain qualifies for the charitable deduction if, under the terms of the governing instrument and applicable state law, income may be a unitrust amount or may include an equitable adjustment with respect to unrealized appreciation in the value of the trust assets.

### *Charitable Remainder Unitrusts*

A charitable remainder unitrust is a split-interest trust that provides for a specified distribution to one or more noncharitable beneficiaries for life or a term of years, with an irrevocable remainder interest held for the benefit of a charitable organization. Under section 664(d)(2), the amount distributed to the noncharitable beneficiaries is a fixed percentage (not less than 5% and not more than 50%) of the annual fair market value of the trust assets. Alternatively, under section 664(d)(3), the unitrust amount may be the lesser of this fixed percentage amount or trust income (with or without a make-up amount). For this purpose, trust income means income as defined under section 643(b) and the applicable regulations. §1.664-3(a)(1)(i)(b).

Under proposed state statutes, trust income could be a fixed percentage of the annual fair market value of the trust assets, and the fixed percentage may be less than 5%. A net income charitable remainder unitrust using such a state statutory definition of income would in substance be a fixed percentage unitrust with a percentage less than the 5% required by sec-

tion 664(d)(2). Therefore, the proposed regulations will amend §1.664-3(a)(1)(i)(b) to provide that income under the terms of the governing instrument and applicable local law may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If the applicable state law defines income as a unitrust amount, the governing instrument of a net income charitable remainder unitrust must provide its own definition of trust income. In addition, the proposed regulations will provide that capital gains attributable to appreciation in the value of assets after the date contributed to the trust or purchased by the trust may be allocated to income under the terms of the governing instrument and applicable local law. Such an allocation, however, may not be discretionary with the trustee. The section 664 regulations already prohibit the allocation of pre-contribution gains to income.

#### *Capital Gains and Distributable Net Income*

Section 643(a)(3) provides that gains from the sale or exchange of capital assets are excluded from distributable net income to the extent that these gains are allocated to corpus and they are not either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. The circumstances in which capital gains are considered paid or credited to a beneficiary during the year, and therefore included in distributable net income, are not entirely clear. In addition, the revisions to state law definitions of income have precipitated additional questions in this area. The question arises, for example, whether realized capital gains are included in the unitrust amount distributed to the income beneficiary under local law, if the unitrust amount exceeds the trust's ordinary income.

The proposed regulations will amend §1.643(a)-3(a) to clarify the circumstances in which capital gains are includible in distributable net income for the year. In general, capital gains are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument or local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in

accordance with a power granted to the fiduciary by the governing instrument or local law): allocated to income; allocated to corpus but treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary. As is the case under the current regulations, capital gains that are paid, permanently set aside, or to be used for the purposes specified in section 642(c) are included in the distributable net income. Capital losses are netted at the trust level against any capital gains, except for a capital gain that is utilized in determining the amount that is distributed or required to be distributed to a particular beneficiary.

Under the proposed regulations, capital gains will be included in distributable net income under certain circumstances that are directed by the terms of the governing instrument and applicable local law. Thus, any capital gain that is included in the section 643(b) definition of income is included in distributable net income. Similarly, any capital gain that is used to determine the amount or the timing of a distribution to a beneficiary is included in distributable net income.

Capital gains are also included in distributable net income if the fiduciary, pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law), treats the capital gains as distributed to a beneficiary, provided the power is exercised in a reasonable and consistent manner. Thus, if a trustee exercises a discretionary power by consistently treating any distribution in excess of ordinary income as being made from realized capital gains, any capital gain so distributed is included in distributable net income.

The provisions of sections 643(b) and 643(a)(3) are further intertwined when consideration is given to the new state statutory provisions defining income. If, under the terms of the governing instrument or applicable local law, realized capital gains are treated as income to the extent the unitrust amount or the equitable adjustment amount exceeds ordinary income, capital gains so treated are included in distributable net income. A similar result is achieved for capital gains

consistently allocated to income by the fiduciary pursuant to a discretionary power. In any other situation, capital gains will be excluded from distributable net income and will be taxed to the trust.

#### *Distributions in Kind*

The proposed regulations will clarify the consequences of certain distributions of property in kind for purposes of the distribution deductions under sections 651 and 661. Thus, if property is distributed to a beneficiary in satisfaction of the beneficiary's right to income, the trust will be treated as having sold the property for its fair market value on the date of distribution.

#### *Trusts Qualifying for Gift and Estate Tax Marital Deduction*

Certain transfers of property in trust for the benefit of the spouse qualify for the marital deduction for gift and estate tax purposes. These transfers include a life estate with a general power of appointment described in sections 2523(e) and 2056(b)(5) and qualified terminal interest property described in sections 2523(f) and 2056(b)(7). One of the requirements of these provisions is that the spouse must be entitled for life to all the income from the trust property. The rules for determining whether the spouse is entitled to all the income from either a life estate with a general power of appointment trust or a qualified terminable interest trust are set forth in §20.2056(b)-5(f) of the Estate Tax Regulations and §25.2523(e)-1(f) of the Gift Tax Regulations. These rules provide that if an interest is transferred in trust, the spouse is entitled for life to all the income from the entire interest or a specific portion of the entire interest if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property during the spouse's life which the principles of the law of trusts accord a person who is unqualifiedly designated as the life beneficiary of a trust.

The proposed regulations will provide that a spouse's interest satisfies the income standard set forth in §§20.2056(b)-5(f) and 25.2523(e)-1(f) if the spouse is entitled to income as defined under a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the

trust and that meets the requirements of §1.643(b)-1(a). As the examples under §1.643(b)-1(a) make clear, reasonable apportionment can be accomplished through a unitrust definition of income or by giving the trustee the power to make equitable adjustments between income and principal. In addition, a conforming amendment is made to §20.2056A-5(c)(2) providing rules regarding distributions of income from a qualified domestic trust.

### *Trusts Exempt From Generation-Skipping Transfer Tax*

In general, under the effective date rules accompanying the generation-skipping transfer (GST) tax statutory provisions, a trust that was irrevocable on September 25, 1985, is not subject to the GST tax provisions, unless a GST transfer is made out of corpus added to the trust after that date. Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (TRA), Public Law 99-514 (100 Stat. 2085, 2731), 1986-3 (Vol. 1) C.B. 1, 634. The regulations provide guidance on when certain changes made to the terms of an exempt trust will not be treated as causing the trust to lose its exempt or grandfathered status. One safe-harbor in §26.2601-1(b)(4)(i)(D) is for modifications that will not shift a beneficial interest in the trust to a lower generation beneficiary or increase the amount of a GST transfer.

Under the proposed regulations, the administration of a pre-September 25, 1985, trust in conformance with a state law that defines income as a unitrust amount, or permits equitable adjustments between income and principal to ensure impartiality, and that meets the requirements of §1.643(b)-1(a) will not be treated as a modification that shifts a beneficial interest to a lower generation beneficiary, or increases the amount of a generation-skipping transfer.

### **Proposed Effective Date**

The regulations are proposed to apply to trusts and estates for taxable years that begin on or after the date that final regulations are published in the **Federal Register**.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a signifi-

cant 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 a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. 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 written comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for June 8, 2001, in the IRS Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Owing to building security procedures, visitors must enter at the 10<sup>th</sup> Street entrance, located between Constitution and Pennsylvania Avenues, NW. 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 and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by May 18, 2001. A period of 10 minutes will be allotted to each person 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**

Various personnel from offices of the IRS and the Treasury Department participated in the development of these proposed regulations.

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### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1, 20, 25, and 26 are proposed to be amended as follows:

#### **PART 1—INCOME TAXES**

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

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

Par. 2. In §1.642(c)-2, paragraph (c) is amended by adding a sentence after the first sentence to read as follows:

*§1.642(c)-2 Unlimited deduction for amounts permanently set aside for a charitable purpose.*

\* \* \* \* \*

(c) \* \* \* No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if it is possible, under the terms of the fund's governing instrument or applicable local law, that the income beneficiaries' right to income may, at any time, be satisfied by the payment of either an amount equal to a fixed percentage of the annual fair market value of the trust property or any amount based on unrealized appreciation in the value of the trust property. \* \* \*

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Par. 3. Section 1.643(a)-3 is revised to read as follows:

*§1.643(a)-3 Capital gains and losses.*

(a) *In general.* Except as provided in §1.643(a)-6 and in paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in

distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law)—

(1) Allocated to income;

(2) Allocated to corpus but treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary.

(c) *Charitable contributions included in distributable net income.* If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) *Capital losses.* Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See §1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

(e) *Examples.* The following examples illustrate the rules of this section:

*Example 1.* Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has \$5,000 of dividend income and \$10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the \$10,000 capital gain to principal. During the year, Trustee distributes to A \$5,000, representing A's right to trust income. In addition, Trustee distributes to A \$12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the \$10,000 of capital gain is taxed to the trust.

*Example 2.* The facts are the same as in *Example 1*, except that Trustee intends to follow a regular

practice of treating discretionary distributions as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the \$10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

*Example 3.* The facts are the same as in *Example 1*, except that pursuant to the terms of the governing instrument (in a provision not inconsistent with applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

*Example 4.* The facts are the same as in *Example 1*, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is \$10,000, rather than \$12,000. Because Trustee will consistently use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

*Example 5.* Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

*Example 6.* Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. All capital gains realized in the year of termination are included in distributable net income. See §1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

*Example 7.* The facts are the same as *Example 6*, except Trustee is directed to distribute only one-half of the principal to A when A reaches 35. Trust assets consist entirely of stock in corporation M. If Trustee sells one-half of the stock and distributes the sales proceeds to A, all the capital gain attributable to that sale is included in distributable net income. If Trustee sells all the stock and distributes one-half of the sales proceeds to A, one-half of the capital gain attributable to that sale is included in distributable net income.

*Example 8.* The facts are the same as *Example 6*, except Trustee is directed to pay B \$10,000 before distributing the remainder of Trust assets to A. No portion of the capital gains is allocable to B because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1).

*Example 9.* State law provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that

beneficiary's right to income. State law provides that this unitrust amount shall be considered paid first from ordinary income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under State law. Trustee makes the unitrust election under State law. At the beginning of the taxable year, Trust assets are valued at \$500,000. During the year, Trust receives \$5,000 of dividend income and realizes \$80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A \$20,000 (4% of \$500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of \$15,000 is allocated to income pursuant to the State law ordering rule and is included in distributable net income for the taxable year.

*Example 10.* The facts are the same as in *Example 9*, except that neither State law nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire \$80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment with respect to all realized capital gains.

*Example 11.* The facts are the same as in *Example 9*, except that neither State law nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary income. Trustee evidences this treatment by including \$15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary income.

Par. 4. Section 1.643(b)–1 is revised to read as follows:

#### *§1.643(b)–1 Definition of income.*

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, *income*, when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal, that is, allocating ordinary income to income and capital gains to

principal, will generally not be recognized. However, amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary income, capital gains, and appreciation. For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. These adjustments are permitted when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially. In addition, an allocation of capital gains to income will be respected if the allocation is made either pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law.

Par. 5. In §1.651(a)–2, paragraph (d) is added to read as follows:

*§1.651(a)–2 Income required to be distributed currently.*

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(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in

kind was distributed as part of a distribution of all such income.

Par. 6. In §1.661(a)–2, paragraph (f) is revised to read as follows:

*§1.661(a)–2 Deduction for distributions to beneficiaries.*

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(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Par. 7. In §1.664–3, paragraph (a)(1)(i)(b)(3) is revised to read as follows:

*§1.664–3 Charitable remainder unitrust.*

- (a) \*\*\*
- (1) \*\*\*
- (i) \*\*\*
- (b) \*\*\*

(3) For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If applicable state law provides that income is a unitrust amount, the trust's governing instrument must contain its own definition of trust income. In addition, capital gain attributable to appreciation in the value of a trust asset after the date it was contributed to the trust or purchased by the trust may be allocated to income pursuant to applicable local law and the terms of the governing instrument but not pursuant to a discretionary power granted the trustee.

\*\*\*\*\*

**PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954**

Par. 8. The authority citation for part 20 continues to read in part as follows:

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

Par. 9. Section 20.2056(b)–5 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

*§20.2056(b)–5 Marital deduction; life estate with power of appointment in surviving spouse.*

\*\*\*\*\*

(f) \*\*\* (1) \*\*\* In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section, if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)–1 of the this chapter.

\*\*\*\*\*

Par. 10. Section 20.2056(b)–7 is amended by adding a new sentence to the end of paragraph (d)(1) to read as follows:

*§20.2056(b)–7 Election with respect to life estate for surviving spouse.*

\*\*\*\*\*

(d) \*\*\* (1) \*\*\* A power under applicable state law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)–1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

\*\*\*\*\*

Par. 11. Section 20.2056(b)–10 is amended by adding a new sentence at the end of the section to read as follows:

*§20.2056(b)–10 Effective dates.*

\*\*\* In addition, the rule in the last sentence of §20.2056(b)–5(f)(1) and the rule in the last sentence of §20.2056(b)–7(d)(1) regarding the spouse's right to income if the state statute provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust are applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the **Federal Register**.

Par. 12. Section 20.2056A–5 is amended by adding a new sentence in

paragraph (c)(2) after the third sentence to read as follows:

*§20.2056A-5 Imposition of section 2056A estate tax.*

\*\*\*\*\*

(c) \*\*\*

(2) \*\*\* However, distributions made to the surviving spouse as the income beneficiary in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will be considered distributions of trust income, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter. \*\*\*

\*\*\*\*\*

Par. 13. Section 20.2056A-13 is revised to read as follows:

*§20.2056A-13 Effective dates.*

Except as provided in this section, the provisions of §§20.2056A-1 through 20.2056A-12 are applicable with respect to estates of decedents dying after August 22, 1995. The rule in the fourth sentence of §20.2056A-5(c) regarding unitrusts and distributions of income to the surviving spouse in conformance with applicable state law that provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the **Federal Register**.

**PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954**

Par. 14. The authority citation for part 25 continues to read in part as follows:

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

Par. 15. Section 25.2523(e)-1 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

*§25.2523(e)-1 Marital deduction; life estate with power of appointment in donee spouse.*

\*\*\*\*\*

(f) \*\*\* (1) \*\*\* In addition, the spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section, if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)-1(a) of this chapter.

\*\*\*\*\*

Par. 16. Section 25.2523(h)-2 is amended by adding a new sentence to the end of the section to read as follows:

*§25.2523(h)-2 Effective dates.*

\*\*\* In addition, the rule in the fourth sentence of §25.2523(e)-1(f)(1) regarding the spouse's right to income if the state statute provides for reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts and estates for taxable years that begin on or after the date the final regulations are published in the **Federal Register**.

**PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986**

Par. 17. The authority citation for part 26 continues to read in part as follows:

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

Par. 18. Section 26.2601-1 is amended as follows:

1. Paragraph (b)(4)(i)(D)(2) is amended by adding a new sentence to the end of the paragraph.

2. Paragraph (b)(4)(i)(E) is amended by adding *Examples 11 and 12*.

3. Paragraph (b)(4)(ii) is revised to read as follows.

The additions and revisions read as follows:

*§26.2601-1 Effective dates.*

\*\*\*\*\*

(b) \*\*\*

(4) \*\*\*

(i) \*\*\*

(D) \*\*\*

(2) \*\*\* In addition, administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to

adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in the trust, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of §1.643(b)-1 of this chapter.

(E) \*\*\*

*Example 11. Conversion of income interest to unitrust interest under state statute.* In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define "income" as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

*Example 12. Equitable adjustments under state statute.* The facts are the same as in *Example 11*, except that in 2002, State X amends its income and principal statute to permit the trustee to make equitable adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these equitable adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

(ii) *Effective dates.* The rules in this paragraph (b)(4) are applicable on and after December 20, 2000. However, the rule in the last sentence of paragraph (b)(4)(i)(D)(2) of this section regarding the administration of a trust in confor-

mance with applicable state law providing for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts for taxable years that begin on or after the date that 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 February 14, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 15, 2001, 66 F.R. 10396)

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